What is the Banking System and How Do Central Banks Work?

Worksheet

The banking system has two tiers: commercial banks (deposits, loans, services) and the central bank (controls money supply, sets policy rates, regulates other banks). Central banks stabilize the economy by adjusting interest rates and money supply.

Questions

1. If the central bank raises rates, the bank's cost of borrowing…

A) Stays the same
B) Goes down
C) Goes up
D) Becomes zero

2. Commercial banks are required to hold reserves because…

A) They like to
B) To cover customer withdrawals and meet regulations
C) To make more profit
D) It has no reason

3. Which best describes how deposits become loans?

A) Banks keep all deposits
B) Banks lend most deposits, keep a small reserve
C) Deposits never become loans
D) Only the government can lend

4. A central bank's main tool to fight inflation is…

A) Lower interest rates
B) Raise interest rates to reduce spending
C) Increase government spending
D) Freeze all accounts

5. You deposit $1,000 in a bank. The bank lends it to a business. What role does the central bank play?

6. If the central bank raises interest rates, what happens to your savings account and a mortgage?

7. A bank takes in 10 million in deposits and lends out9 million. What is its reserve?

8. Define: What do commercial banks do?

9. Define: What does a central bank do?

10. Define: What is a bank reserve?

Answer Key

1. C) Goes up — Central banks lend to commercial banks. Higher policy rate = higher cost for banks.
2. B) To cover customer withdrawals and meet regulations — Reserves ensure banks can handle withdrawals and comply with safety rules.
3. B) Banks lend most deposits, keep a small reserve — Banks lend out most deposits (minus reserves), earning profit from the interest spread.
4. B) Raise interest rates to reduce spending — Higher rates discourage borrowing/spending, cool inflation, stabilize prices.
5. Central bank sets policy rate → bank's borrowing cost determined Central bank regulates the bank to ensure safety Bank earns profit from interest margin (deposit rate vs loan rate)
6. Central bank raises policy rate → commercial banks raise all rates Your savings earn more (higher savings rate) Mortgage becomes more expensive (higher loan rate)
7. Reserve requirement = deposits not lent out Reserve = 10M − 9M = 1M Reserve ratio = 1M / 10M = 10%
8. Accept deposits, make loans, provide banking services (checking, savings, payment processing).
9. Sets policy interest rates, controls money supply, regulates commercial banks, manages inflation.
10. Cash held by a bank (not lent out) to meet withdrawal demands and comply with regulations.