

Q5 Using theoretical and practical arguments assess the role of central bank as regulator of commercial banks and lender of last resort. How effective are these functions in preventing financial crisis in weak institutional settings?

Introduction

The Central bank plays a pivotal role in ensuring financial stability through regulation of commercial banks and by acting as lender of last resort. These functions are theoretically essential for preventing banking failures and financial crises; however, their effectiveness varies significantly in weak institutional settings.

• Regulation of Commercial Banks and Lender of last Resort.

1 Financial stability :-

The central bank ensures stability by regulating banks

and providing emergency liquidity during crises

2. Theoretical Basis of Regulation.
Regulation prevents moral hazard, excessive risk-taking and systematic failures in banking sector.

3. Practical Regulation:
Enforces capital adequacy, liquidity ratios, licensing, governance standards and stress testing.

4. Deposit Protection:
Regulatory oversight protects depositors' funds and maintains confidence in banks.

5. Risks in weak settings:
Misuse of LLR (Lender of last resort) for insolvent or politically connected bank increases moral hazard and fiscal burden.

Limitations :- Limited reserves, shallow markets, and weak credibility reduce the central bank's ability to act

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Conclusion:

Regulation and LLR are essential tools for financial stability, but their effectiveness depends on strong institutions, governance and central bank interdependence.