

Role of Central Banks in Currency Valuation

What Are Central Banks ?

It is a national bank which provides banking and financial services for its country's government, and commercial banking systems of the country, including issuing currency and implementing the government's monetary policy.

These are the government bodies, and a main financial institute of a country or a group of countries, which manages the country's interest rate, currency value and money supply and stability.

Why does the Central Bank matter ?

They matter because it plays a major role in steering the country's economies, and their moves decide and impact on currency values. Their actions like printing more money or adjusting interest rates will affect the currency's value to rise or fall over time, this will influence your earning from the forex market without you directly doing anything.

How do central Banks influence currencies ?

These banks use key policies like including cash into the economy or raising the interest rates to maintain the strength of their country's currencies.

Setting the interest rates :

- Raising interest rates will attract foreign investors to invest money into the nation. This increases the demand for the currency and makes it stronger. Decreasing interest will lower the demand for currency.
- By lowering the interest rates, the central bank makes money cheaper for commercial banks to borrow, which makes these banks to lend more to businesses and individuals. Hence, as a result the spending and investments will accelerate and boost the economy.

Controlling money supply :

- If the central bank starts to print more money the supply rate will increase the value of each unit drop which tends to weaken the currency.

- Hence by managing the supply, central banks balance the economic growth and inflation of the country.

Central banks in foreign exchange markets

Since central banks influence the exchange rate to ensure economic stability, their role is very crucial in foreign exchange markets. Foreign exchange markets are huge and complex systems where central banks are key players in it.

Major Roles of Central Bank in Foreign Exchange Management

Every central bank follows some basic mechanics which affects foreign exchange. In India RBI is the central bank of the country and who is responsible for supervising the economic system in India.

- Maintaining economic stability
- Regulation and oversight
- Promoting international trade
- Crisis management
- Currency pegging

Impact of Central Bank on Exchange Rate Management

Managing the exchange rate is the primary role of central bank in RBI do this through various mechanisms like :

- Exchange intervention
- Maintaining forex reserves
- Monetary policy
- Open market operations
- Forward guidance

Key tools of Central Bank in Currency Valuation

Central bank plays a huge role in managing the currency values. They use various tools to manage money supply and interest rates to regulate an economy, which affects a broad range of targets, from the purchasing power of an individual to the entire national economic growth. Some of them are :

Monetary Policy

This is a technique used by central banks to affect financial conditions in an economy. This policy tries to control supplies of money, availability of credits, and interest rates, through which central banks can try to meet objectives for price stability, economic growth, and employment.

Key tools of Monetary Policy

Open market operations (OMOs) :

This is an operation where the purchase or sale of government securities or bonds takes place in the open market to adjust cash levels in the economy. When the central bank buys bonds it will add cash into the system, money supply increases and the interest rates fall in an economy, so this weakens the currency value. In the same way selling the bonds will have the opposite effect of decreasing money supply and raising the interest rate.

Hence, through OMO, Central banks affect the amount of money which is currently available in the nation's economy.

Currency intervention

Central banks often sell or buy their own currency to maintain its value. Buying their currency for example yen or euros can strengthen the value of it. Selling their currency like the dollar will weaken it.

Reserve requirements

Reserve requirements are the rules set by central banks which determines how much money the commercial banks should keep to themselves, but not to lend out. When central banks decrease the reserve requirement commercial banks can lend out more money, thus increase the money supply and boost the economy. However the changes in reserve requirements are less common, they are still a powerful tool to control the cash flow through the financial system.

Reference

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