



UNIVERSITY OF THE PEOPLE

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1) The Importance of the Central Bank

Introduction

A central bank is vital to a country's economic stability and progress. It performs various significant functions that impact the health of a nation's financial system and economy. This essay explores the importance of central banks. “A central bank is a financial institution given privileged control over the production and distribution of money and credit for a nation or a group of nations. In modern economies, the central bank is usually responsible for the formulation of monetary policy and the regulation of member banks” (Segal, 2022).

A) Importance of Maintaining Monetary and Price Stability

A key role of central banks is to maintain monetary and price stability by controlling inflation and regulating the money supply. For example, the US Federal Reserve aims to keep inflation at an average rate of 2% per year over the medium term through monetary policy tools. Maintaining modest and steady inflation supports sustainable economic growth.

Example

In 2022, the Indian rupee was weakening sharply against the US dollar due to foreign capital outflows as investors shifted to dollar assets amidst global uncertainty. The Indian currency depreciated from 74 rupees per dollar in January 2022 to beyond 81 rupees per dollar in July 2022 - a huge drop in just 6 months. This currency devaluation posed major economic risks for India. A weak rupee would negatively impact India's large services exports industry including IT and BPOs, as their global competitiveness declined.

Additionally, a falling rupee led to more expensive imports and higher imported inflation, already problematic due to global supply chain issues. To mitigate these risks and provide some exchange rate stability, the Reserve Bank of India likely intervened heavily in the forex market, selling dollars from its ample reserves to prevent any excessive volatility. This allowed more

orderly adjustment rather than a free fall, providing some relief to Indian exporters and consumers even as macroeconomic fundamentals remained under pressure. The RBI managed to slow, though not fully prevent, the slide over the rest of 2022.

B) Managing the Exchange Rate

Central banks also influence and manage the country's exchange rate relative to foreign currencies. A stable and competitive exchange rate facilitates external trade and capital flows while preventing destabilizing volatility. For instance, central banks may adjust interest rates or intervene in the forex market to prevent or slow sharp changes in the currency value. As open economies rely heavily on international trade and investment, maintaining an appropriate exchange rate is crucial for the overall competitiveness and growth of the economy.

C) Importance for Financial Stability

Central banks monitor systemic risks and try to prevent or contain financial crises that can disrupt the economy. For instance, central banks adopt macroprudential measures such as regulating bank capital requirements to prevent reckless bank lending. They also act as a lender of last resort for banks and financial institutions facing liquidity shortfalls. Thus, they play a pivotal role in ensuring financial stability.

D) Facilitating Good Growth Prospects

By maintaining price stability and financial system stability, central banks facilitate the smooth functioning of the economy. This promotes faster and inclusive economic growth driven by private investments and innovations. The policies and actions of central banks aim to improve growth prospects.

Two of the main importance of central banks are:

- i) **Maintaining price stability:** By regulating interest rates and money supply, central banks control inflation and prevent runaway price rises. This creates a stable economic

environment conducive to growth. Uncontrolled inflation can adversely impact investments and purchasing power.

- ii) **Ensuring financial stability:** Central banks monitor systemic risks and try to prevent financial crises by regulating banks to avoid reckless lending. As the lender of last resort, they provide emergency liquidity assistance to save viable institutions facing temporary shortfalls. This contributes to the stable functioning of the financial system.

2) Central Bank Independence and Its Importance

“However, the primary goal of central banks is to provide their countries' currencies with price stability by controlling inflation. A central bank also acts as the regulatory authority of a country's monetary policy and is the sole provider and printer of notes and coins in circulation” (Heakal, 2023). A key feature that enables central banks to effectively pursue their goals is independence. Central bank independence refers to self-governance without political interference in activities like setting interest rates or printing money. An independent central bank focuses on long-term economic stability rather than short-term political pressures.

Central bank independence is vital for maintaining price stability and anchoring inflation expectations at low and steady levels. Research shows that countries where central banks enjoy high independence have lower average inflation without damaging output or employment. Independent central banks enhance policy credibility as they stick to declared inflation targets. They prevent inflationary spirals arising due to political pressures for short-term expansionary monetary policy. Overall, central bank independence fosters a stable macroeconomic environment crucial for strong and sustainable growth.

Conclusion

In summary, central banks like the Federal Reserve play indispensable roles for the health of a nation's financial systems and economy. Through independent and responsible conduct of monetary policy and oversight of the banking sector, central banks maintain price stability and financial stability essential for good growth prospects.

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