Economic Policy and Global Markets

The role of central Banks – part one

The central bank in a country is a public institution that is non-market based. Do you know any examples?

It is responsible for the following:

Regulating the currency (i.e. controlling the amount of money that is in circulation in the economy)

Banker to the Government (like consumers, government deposit their money in a bank). Central bank makes payments on behalf of the government.

Lender of last resort – Central bank can grant collateral advances in times of stress

The Role of Central Banks – Part 2

Controller of credit (in other words, the central bank sets the base interest rate for all commercial banks to follow in a country)

Custodian and manager of foreign exchange reserves: To keep the exchange rate stable, the central bank buys and sells foreign currencies.

In short, the central bank is responsible for the **exchange rate** of the nation’s currency and the **monetary policy** in a local economy.

Monetary policy

Demand-side policy.

2 tools: interest rates and money supply.

Expansionary: used to encourage economic growth and to lower unemployment.

Contractionary: used to control inflation (and potentially protect the environment).

Interest rates: The cost of borrowing. Affects consumption and investment.

Money supply: quantitative easing. CB buys assets, injects money into the economy, lowers long-term interest rates. Opposite is tightening.

Exchange Rate

Like the goods and services market, there is also a foreign exchange market.

Exchange rate – the price of a currency in terms of another currency.

Exports and imports can affect the demand and supply for a currency. Causes value to depreciate or appreciate.