Chapter 3
Understanding the Role of Central Banks in the Financial System

ABSTRACT

The main responsibility of the central banks is to implement monetary policies. In this framework, they define interest rates and the amount of the money in the financial system. Hence, it can be said that central banks have the critical role in the development of the financial system. Because of this situation, it is obvious that central banks should satisfy some requirements, such as independence, in order to contribute to the effectiveness of the financial systems. Parallel to this aspect, this chapter aims to understand the role of the central banks in the financial system. In this context, the purpose and historical background of the central banking are explained. In addition to this situation, the subject of the central bank independence is identified as well. In the final aspect, important accounts in the analytical balance sheet of the central bank are defined.

THE NEEDS FOR CENTRAL BANK IN THE GLOBALIZED FINANCIAL SYSTEM

Especially after the globalization, economic borders between the countries are disappeared. This situation creates many different advantages for the economies. First of all, companies get an opportunity to enter new countries. In other words, they can reach new markets. This situation has an increasing
effect on the trade volume of these countries. Parallel to this aspect, it also makes contribution to the economic development of these countries (Claessens & Van Horen, 2015; Duarte et al., 2016).

In addition to this factor, new companies, which entered to the countries, increased the competition in these markets. In such a competitive environment, these companies have to take some actions in order to deal with their competitors. Otherwise, it becomes very difficult for these companies to survive in this competition. Within this framework, these companies can prefer to decrease the price of the goods. This situation brings an advantage for the consumers in this country (Nica et al., 2016; Greer and Hauptmeier, 2016).

Another important strategy, which can be implemented by the companies in such a competitive market, is to increase the quality of the goods. By developing more quality goods, these companies can be preferred more by the consumers. It can be seen that this competition provides a chance for the people to consume quality items. Moreover, innovation is an essential issue for the companies to compete with their competitors. That is to say, by creating innovative products and services, these companies can get competitive advantage. This issue also increases the quality of the products and services in this country (Kimatu, 2016).

In spite of these advantages, globalization causes many different risks for both companies and countries. Firstly, because there is an increase in international trade volume, the volatility in the currency exchange rates goes up as well (Figueiredo & Parhizgari, 2017). This situation creates a significant risk when the countries have foreign debt. Therefore, it is obvious that there is a strong need for a governmental authority which controls this situation. With the help of this institution, a destructive financial crisis can be prevented. Thus, it can be possible to take measures to prevent bankruptcy (Walter, 2017).

Another important risk caused by globalization is the volatility in interest rates. Interest rates play a very key role in the economic performance of the countries (Babajide et al., 2016; Nikolova et al., 2017). The main reason is that when interest rates are too high, the companies become very reluctant to make investments because their costs increase in an important manner. Hence, it is understood that high interest rate is not a preferred situation for the economic improvement of the countries. In this framework, it is obvious that there is a need for an authority to control interest rate volatility in the country.
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