

Fifth Edition
(4/2023)
December 2023

بنك الكويت المركزي
CENTRAL BANK OF KUWAIT



Nature of Central Banks



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Preface

This fifth edition titled “Nature of Central Banks” as of December 2023 is one of the quarterly series the Central Bank of Kuwait (CBK)* has been issuing since November 2022. **The first theme** hereof titled **“The Functions of Central Banks”** includes an introduction on the emergence of Central Banks as a concept, and their functions. **The Second Theme titled “The Independence of the Central Banks and Enhancing Their Financial Resources”** briefly addresses the financial, operational and economic independence, while highlighting the experiences of the Central Banks in some selected major economies, where enhancing their financial resources have become increasingly important following the recent converged crises. Finally, **The Third Theme “Channels of Transmission of the Effects of Monetary Policy to the Economic Activity”** provides a summary of the channel of exchange rate through which the monetary policy affects various macroeconomic variables. The other channels of transmission of the effects of monetary policy to economic activity shall be the themes of future editions. This edition is the fourth and last during 2023.

* Keeping abreast with the best global trends of Central Banks in enhancing disclosure and transparency, CBK issues a series of quarterly reports that cover selected economic, monetary and banking topics and help raise awareness on the CBK’s efforts to maintain monetary and financial stability. **The First Edition (November 2022) titled “An Overview of the Key Economic, Monetary and Banking Developments”** shed the light on foremost developments in the State of Kuwait, and the key indicators in some selected countries. **The Second Edition (February 2023) titled “An Overview on Inflation, Monetary Policy and Sustainable Finance”** elaborated on the key indicators of monetary policy trends of advanced economies, the gradual tightening of CBK monetary policy, and the green finance (sustainable). **The Third Edition (May 2023) titled “CBK Efforts on AML/CFT and Customer Protection”** highlighted the CBK’s supervisory role and efforts on AML/CFT and the protection of customers’ rights. **The Fourth Edition (September 2023) “A glimpse into the Impact of Digital Transformation on Financial Stability, the Prominent International Developments, and Monetary Policy Trends”** reviews the digital transformation in the banking system at the global and local levels, sheds light on global developments and monetary policy trends in selected Central Banks, and gives a brief overview on CBK’s monetary policy trends.

First Theme:

The Functions of Central Banks

The Definition of a Central Bank

It is the public institution that manages and regulates the banking system in a country. In general, a Central Bank seeks to maintain monetary and financial stability, and help enhance economic growth, control inflation and reduce unemployment rates. The first Central Bank, even though it was not considered as a Central Bank until 1668, was established in Sweden in 1656. The Bank of England was established in 1694 to be the first bank ever having all the functions of a today's central bank. Later on, various European countries began to establish Central Banks, including Austria, the Netherlands, Finland and France.

The Functions of a Central Bank

Central Banks perform a wide range of functions, including:

I. Issue of Currency

The Central Bank is the only authority mandated for issuing the national currency, and is given the sole monopoly of this operation that distinguishes it from other banks and financial institutions that practice banking and credit functions. It must be underlined that the issue of currency should consider the general economic objectives, mainly an appropriate and acceptable level of monetary stability, financial stability and economic growth as per the monetary policy. Consequently, this may help avoid inflationary pressures on one hand, and provide an appropriate amount of economic boom on the other.

II. Bank Credit Supervision

To carry out this function, the Central Bank relies on a set of procedures and measures aimed at regulating the activity of the banking system and directing it in the appropriate and proper direction. This is achieved by supervising lending and investment banking operations, which in turn is reflected in the size or quantity of payment available in society as well as the total domestic liquidity in the country to attain monetary stability. This would ultimately be reflected in preserving the value of the national currency internally and externally, thus realizing a basic goal sought by the Central Bank or monetary authority.

A Central Bank may monitor bank credit through monetary policy tools. The purpose of using these tools is to impact the quantity and quality of bank credit, or in other words, to affect the volume and direction of credit extended to different economic sectors, as it may leave its impact on Money Supply, particularly due to the fact that commercial banks play a key role in shaping the amount of Money Supply. Eventually, effecting the components and size of the Money Supply will have its mark on the general level of prices, and ultimately on the value of the national currency that a Central Bank aspires to stabilize for the sake of economic growth.

III. Government's Bank and Financial Advisor

Central Banks have been acting as the government's bank and financial advisor by virtue of the privilege of issuing the national currency. Governments maintain their accounts with their Central Banks which regulate their payments. Central Banks also issue general government loans (bills and bonds) and undertake their services, oversee foreign exchange, manage government financial reserves, and provide advices when concluding internal and external government loans. Therefore, the Central Bank carries out the function of the government's bank, agent and financial advisor.

IV. Lender of Last Resort

The Central Bank is often described as "bank of banks". It provides loans and banking facilities to institutions of the banking system. A government and the other banks maintain cash with Central Banks that are engaged in settling interbank accounts through clearing. Central Banks operate as lenders of last resort to the banking system by extending loans and commercial banking facilities, whether by extending direct or indirect loans such as re-discounting securities submitted by these banks, or carrying out Open Market Operations (OMO), with the aim of preserving liquidity of the credit system or the banking system.

Second Theme:

Independence of the Central Banks and Enhancing Their Financial Resources

Financial Independence



Financial independence refers to the ability of Central Banks to finance its activities through its own funds, its independence in preparing a budget within international standards, providing sufficient finance to cover its business and losses - if any- as well as flexibly providing sufficient reserves to achieve its goals of monetary and financial stability in the country and providing specialized technical cadres.

Operational Independence



Operational independence is connected to the functions and objectives of the Central Bank. It is also related to the nature and strength of the powers assigned to it by law, its full ability to formulate and implement monetary policy and use its various tools, and autonomy in managing exchange rate policy in a manner that serves the local economy.

Economic Independence



Economic independence refers to the freedom to choose the targets and tools used by the Central Bank, and deny financing the government's general budget deficit through money creation in accordance with the provisions of its law, as this entails inflationary effects on the economy.

International Central Banks following Global Financial and Economic Crises and the Pandemic, and the Increasing Importance of Fortifying Financial Resources

Since 2009 until the end of last year (2022), the total net purchases of international Central Banks (the US Federal Reserve, the European Central Bank, the Bank of England, and the Bank of Japan) of assets in the form of treasury bonds and bills amounted to about USD 20 trillion (according to the London Stock Exchange Group). Following the global financial and economic crisis in 2008, Central Banks acquired bonds as part of quantitative easing programs to stimulate economies suffering from a shortage on the demand side. In 2020, the Corona Pandemic induced Central Banks to be more exorbitant by buying bonds to calm the markets. Yet, during the current year, Central Banks (except the Bank of Japan) began working to reduce their balance sheets through quantitative tightening.

In cases where Central Banks buy bonds from banks, the latter obtain credit known as Central Bank Reserves, which represent the safest and most liquid financial assets. Quantitative tightening reverses this process by reducing liquidity in the financial system. It is worth noting that maintaining very large Central Banks' budgets can cause to exacerbation of financial instability. Excess reserves distort the money market that provides liquidity, entrench dependence on the Central Bank and lead to increased operational and reputational risks. In cases where interest rates increase, Central Banks suffer losses of bond portfolios and cause further interest payment on bank reserves created by quantitative easing. **The main issue facing Central Banks in the process of reducing trillions of dollars in their balance sheets through quantitative tightening is mainly related to process of containing its impact on the economy without provoking financial and banking disturbances.**

The financial data in the annual report of **the Swedish Central Bank** (Riksbank) for the fiscal year 2022 showed losses above SEK (Swedish Krona) 80 billion (USD 7.3 billion or 1.3% of the Swedish GDP). Consequently, the value of the Riksbank's stockholders' equity reached around **SEK 18 billion (USD 1.7 billion)**. The loss is mainly due to the sharp rise in interest rates in 2022 and the engagement in quantitative easing over the past decade, whereas the Riksbank's holdings of bonds and treasury bills amounted to SEK 1,000 billion (USD 95.6 billion), in order to boost confidence in the inflation targeting policy, secure credit supply during the Corona virus pandemic and contribute to economic development. At the end of 2022, the Riksbank ceased its purchases of bonds and bills, and began selling in April 2023.

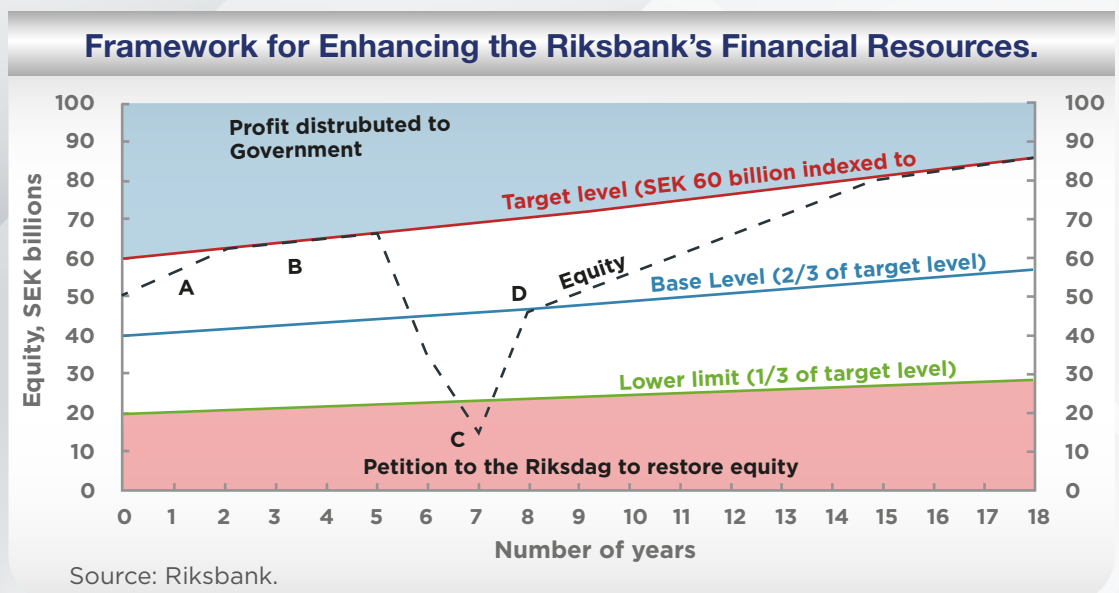


It is worth noting that bonds and fixed income instruments decline in value if interest rates rise. Accordingly, the Riksbank recorded unrealized losses from the decline in the value of its holdings of enormous bonds and treasury bills. Clearly, negative equity does not affect the Riksbank’s ability to manage monetary policy in the short term, yet maintaining the monetary policy’s autonomy in the long term requires that the Riksbank have sufficient financial resources to cover its expenses and carry out its tasks, that is, it should be financially independent.

To address the losses of the Riksbank, a new bank law (Riksbank Sveriges Act) was issued on January 1, 2023, which stipulates that “the Central Bank shall submit a request to the Swedish Parliament (Riksdag) to reinforce financial resources of the Central Bank in cases where the value of stockholders’ equity falls below a third of the target level of SEK 60 billion (USD5.5 billion), or at least a base level of SEK 40 billion (USD3.7 billion).

Within this context, the International Monetary Fund (IMF) indicated that the Riksbank Sveriges Act “places high value on ensuring the operational freedom of the Riksbank to apply the relevant tools to significantly enable it to fulfill its mandates.”

Chart:



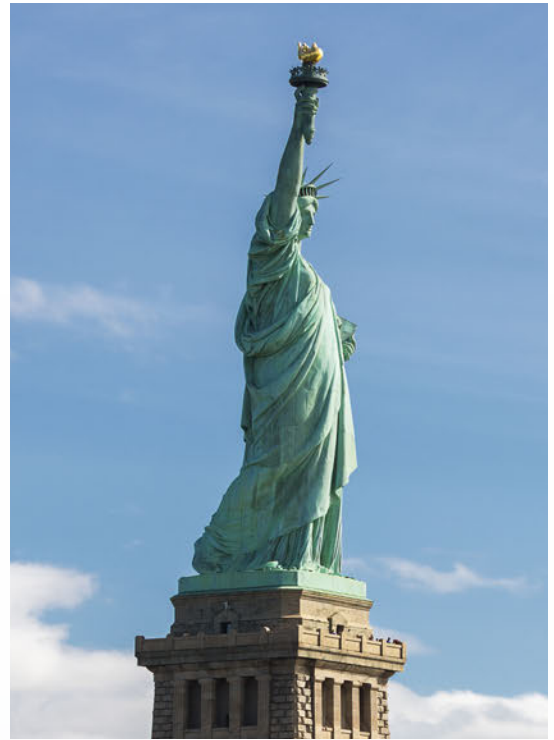
Based on the above, if the equity falls below SEK 20 billion (USD 8.1 billion), the Riksbank will have to stop distributing dividends and submit a request to the Swedish Parliament to inject funds and restore capital to the basic level. If the value of shareholders' equity exceeds the target limit of SEK 60 billion (USD 5.5 billion), the Riksbank will have to distribute profits and transfer them to the public treasury.



In the same context, the **Swiss National Bank (SNB)** recorded, on January 2023, a large Gross Loss of CHF 132 billion (USD 5.149 billion) in 2022. The loss came from the net losses of foreign positions by CHF 5.131 billion, losses from Swiss Franc positions by CHF 0.1 billion, and profits from the revaluation of gold by CHF 41.0 billion. On the other hand, the gross losses mentioned were covered by retained profits from previous years by CHF 5.102 billion. Accordingly, SNB's net loss amounted to CHF 5.39 billion (USD 7.44 billion) during the year 2022.

It is worth noting that the assets of the **Swiss National Bank** increased due to the purchase of large quantities of foreign currencies to protect the exchange rate of the Swiss Franc, and the positions of those currencies were subjected to a significant decline in their value. In addition, the value of treasury bonds and bills at the Swiss Central Bank declined due to monetary tightening and raising interest rates. **In accordance with the provisions of the Swiss National Bank Law and the dividend distribution agreement between the Federal Department of Finance (FDF) and the Swiss National Bank, this net loss prevents distribution for the fiscal year 2022,** while the Swiss National Bank transferred about CHF 6 billion (USD 8.6 billion) to FDF last year.

In this context, the **US Federal Reserve** announced in a report issued on September 14, 2023, a loss of about USD 134 billion at the end of 2022, since the beginning of raising interest rates in March 2022. This means that the losses will include the entire US Federal Reserve capital of USD 43 billion (i.e. 3 times its capital), as well as a loss of another USD 91 billion. This loss is likely to increase before it stops raising interest rates, and the US Federal Reserve continues to pay interest costs greater than what it receives from the interest it earns on the bonds it owns and from the services it provides to the financial sector. The US Federal Reserve covers its losses by creating deferred assets, which is “an accounting measure for calculating what needs to be covered in the future before the US Federal Reserve can return to its usual practice of returning its profits to the US Department of the Treasury”.



The loss accumulated as a result of the US Federal Reserve’s strict decisions to raise interest rates significantly to control rising inflation, as it continued to tighten its monetary policy and raise the interest rate 11 times by 550 basis points to reach the level of (5.25%-5.50%) since March 2022, and with the recession of inflationary pressures, it is expected that the monetary tightening cycle has ended or is close to an end. But this does not mean that losses will stop mounting, as the current level of short-term interest rates would cause the negative net income to increase for some time. The losses will eventually stop due to the ongoing process by the US Federal Reserve to **shrink its balance sheet**, as the Federal Reserve aggressively bought bonds during the Corona pandemic and its immediate aftermath. **The total holdings of assets (Treasury and backed-mortgage securities - MBSs) at the Federal Reserve reached 30% of the US GDP, which is slightly less than USD 8 trillion.**



During 2022, the **Bank of England** (BoE) reported losses of GBP 29 billion (USD 36.6 billion), due to the continuous increases in interest rates, decline in bond prices, and the government transferring the amount to the Central Bank. BoE’s losses are expected to rise to GBP 170 billion (USD 4.214 billion) due to the bond purchasing program over the next decade as it ends quantitative easing, “which is largely supported by the Treasury”. This is a radical shift from the large profits BoE achieved from purchasing bond in the years immediately following the global financial and economic crisis in 2008. When the interest rates fell to their lowest levels, BoE has made cumulative gains from quantitative easing of GBP 124 billion (USD 4.156 billion) in which it transferred the amount to the HM Treasury.



The importance of strengthening the financial resources of Central Banks:

- Financial resources' availability helps alleviate the losses on Central Banks that have accumulated over the past years as a result of quantitative easing and the significant expansion of Central Bank budgets in the past decade.
- Exchange rates protection and market intervention.
- The availability of sufficient financial resources at Central Banks significantly enhances risks management associated with the banking sector by providing sufficient flexibility to take proactive measures and remedial steps in order to prevent the occurrence of banking crises and address their repercussions.
- Increasing financial resources enhances the Central Banks' flexibility to achieve their goals and objectives and reach monetary and financial stability through the use of appropriate monetary policy tools and their associated costs.
- Strengthening Central Banks' financial resources enhances governance standards as well as the financial and operational independence of Central Banks.

Third Theme:

Channels of Transmission of the Effects of Monetary Policy to the Economic Activity

A light will be shed on the channels of transmission of the effects of monetary policy to the economic activity and the mechanisms of its impact in a series of quarterly reports, as the success of Central Banks in achieving their goals can be attributed to many different factors, most importantly the Central Bank's awareness of the channels of transmission of the effects of monetary policy to the economic activity. Through such channels the monetary policy is able to influence various macroeconomic variables. The channels of transmission of the effects of monetary policy can be limited to five main channels:



In this edition, we will provide an overview of the **exchange rate channel**, which is one of the most important channels through which the impact of monetary policy is transmitted, especially in light of economies that are characterized by a high degree of integration into the global economy. This makes them susceptible to international economic fluctuations, and more vulnerable to external crises and problems. Therefore, a large number of Central Banks pay special attention to the exchange rate when designing and managing monetary policy, and prioritize the stability of their currency exchange rates to avoid the sharp fluctuations that currency markets experience from one period to another. This stability is a fundamental pillar in international commercial transactions and supports the provision of an appropriate climate to attract investments, savings and maintain price stability. **The exchange rate channel of monetary policy transmission mechanism can be explained as follows:**

The exchange rate affects **aggregate supply and demand**, by affecting the relative prices of domestic and foreign goods. On the **aggregate demand side**, a depreciation of the exchange rate of a currency leads to a decrease in export prices and an increase in import prices. This results in a competitive advantage for the local product, which increases the country's ability to export. On the aggregate supply side, the depreciation in the exchange rate leads to an increase in the prices of imported inputs, which prompts projects to increase the prices of locally produced goods, leading to inflationary burdens on the national economy, aka imported inflation. Therefore, this channel is particularly important for countries that rely heavily on imported inputs from abroad, or countries that are trying to increase their exports.

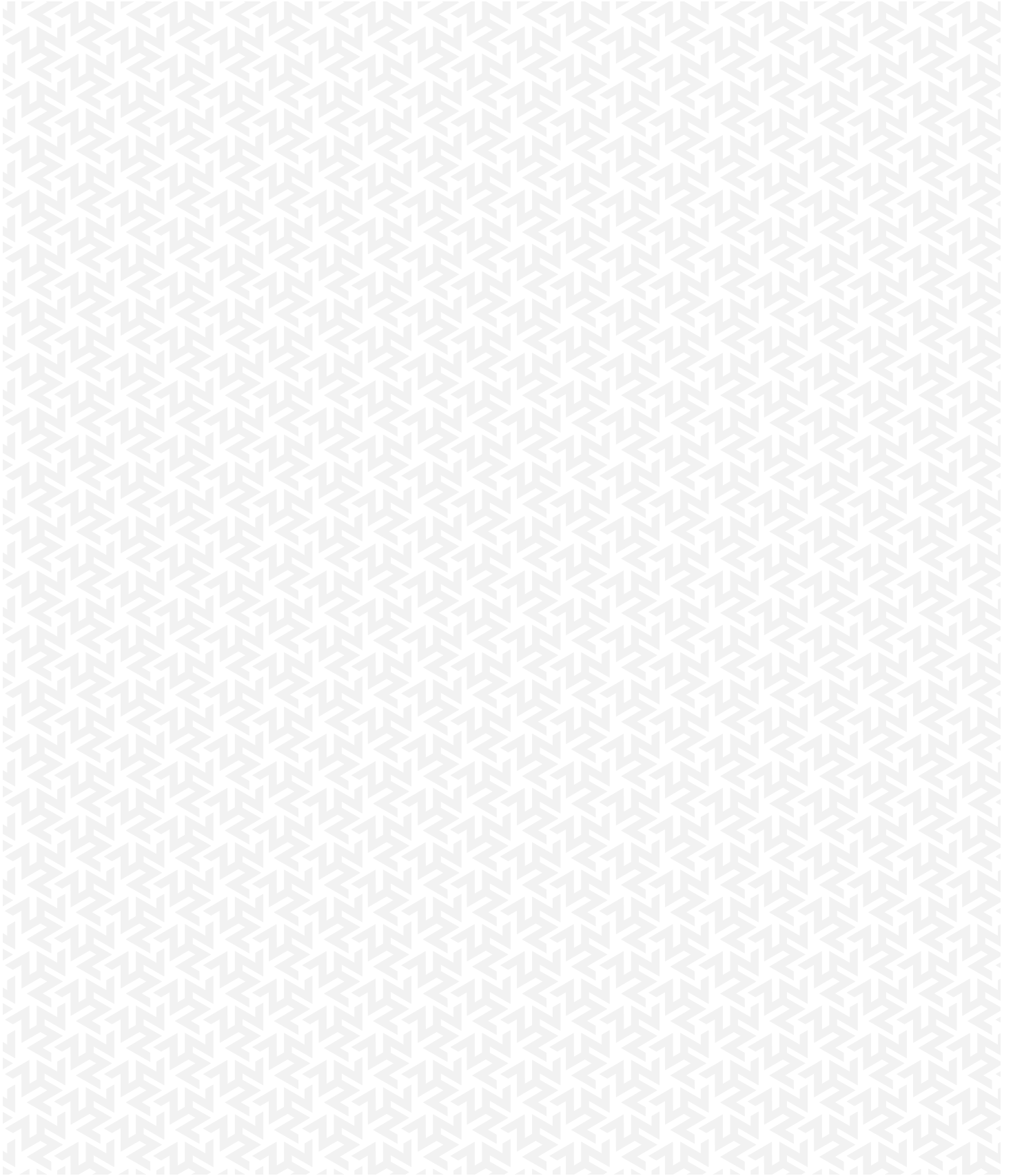
The exchange rate channel is linked to the interest rate in the local economy, as the rise in the real interest rate in the local economy relative to its counterpart abroad leads to attracting foreign capital, which increases the demand for the local currency, causing appreciation in the exchange rate of national currency, and this might be negatively affects exports. On the other hand, the ability to purchase more imports from abroad increases as a result of the rise in the purchasing power of the local currency, thus negatively affects the country's current account. Also, a decrease in import prices will lead to a decrease in the prices of imported production inputs, thus reducing the costs of locally produced goods and services, which later decrease the selling prices to consumers without encouraging more investments. In the long term, and as a result of tightening monetary policies that preserve the value of the exchange rate because of its wide-ranging real and financial impact on the economy, the rise in the value of the national currency increases the volume of consumer spending due to the positive influences on income. As a result of the higher value of the national currency, the demand for imported goods increases due to their prices compared to the prices of local goods, then the demand for local goods decreases, which worsens of the competitive position of local products and companies.

The exchange rate channel also affects the financial positions of economic units, as the financial portfolios of individuals and companies include liabilities in foreign currencies, and if these debts do not have corresponding assets in foreign currencies, exchange rate changes affect net wealth and debt-to-assets ratios, which may lead to the instability of the financial positions of these units, consequently affecting the size of the total demand.

The time period required for the exchange rate channel to transmit the effects of monetary policy and the size of the impact on macroeconomic variables varies from one country to another depending on the degree of openness to the outside world and liberalization of its financial sector. Also, the degree of its effectiveness depends on the exchange rate system followed by the country.

Evidences indicates the success of the exchange rate channel (along with other channels) in conveying the impact of monetary policy to the real economy in the State of Kuwait, which follows a fixed exchange rate a system of pegging KWD to a special, weighted and undisclosed basket of currencies of countries that have significant trade and financial relations with the State of Kuwait, in accordance with the Amiri Decree No. 147/2007 issued on 20 May 2007, with high consideration of the nature of the Kuwaiti open economy, as the volume of foreign trade as a percentage of the GDP reached 77.7% in 2022. In addition, Kuwait economy heavily relies on the other countries to meet most of the local market needs (the ratio of imports to GDP reached 20.5% in 2022), and the free movement of capital.

Although the Kuwaiti economy depends on oil exports as a primary source of income, the success of the exchange rate channel and fixed exchange rate system pegged to a weighted basket of currencies (the decline of the Kuwaiti Dinar against other currencies is offset by an increase against other currencies according to the movements of the exchange rates of these currencies and their weighted basket) is evident, by maintaining the stability of the general level of prices in the local economy, and reducing imported inflationary pressures, especially in the rise of inflation rates to unprecedented levels, as well as maintaining the financial positions of individuals and economic units with a positive impact on aggregate demand in the local economy, which is a determining factor in economic growth.



بنك الكويت المركزي

CENTRAL BANK OF KUWAIT



T: +(965) 1814444 | P.O. Box: 526, Safat 13006, Kuwait
cbk@cbk.gov.kw | www.cbk.gov.kw

 @centralbank_kw |  Central Bank of Kuwait