

Abstract

The discussion on central bank financial strength has been disregarded for a long period as it has been considered that central banks do not require financial strength. However, theoretical and empirical literature argues that even central banks require sufficient level of financial strength in order to perform their functions effectively and hence, achieve stipulated objectives. This study examines the relationship between central bank financial strength and key economic outcomes. While providing evidence for a group of advanced and emerging countries, this study further focuses on the South Asian perspective, particularly on two countries: India and Sri Lanka. Key measures of economic outcomes namely price stability, output growth, real interest rate variability and nominal exchange rate variability are modeled with measures of central bank financial strength. Although results are not consistent across sub samples of countries and for proxies of economic outcomes, it is observed that price stability is broadly related to central bank financial strength. It is also observed that, real interest rate variability in emerging countries can be explained using the changes in central bank finances. At the same time, it is noted that capital based measures remain the appropriate measures for central bank financial strength rather than profitability based measures. These results and observations have important implications for policy makers, particularly for central bankers.

JEL Classification: E42, E52, E58, E63

Key Words: Central Bank Capital, Net Worth, Financial Strength, Economic Outcomes, South Asia