MPI Collective Goods

Martin Hellwig

Central Banking and Financial Stability

A Critical Overview

Some History: The „Great Banks“ in Germany and the Reichsbank

Tilly 1990:

- German banks could engage in financing long-term industrial investment because they knew that the Reichsbank would solve any liquidity problems by through the discount facility
- UK banks did not do so because the Banking Act of 1843 did not allow the Bank of England to do the same.

Moral Hazard and the 1931 Crisis

- Schnabel 2004, 2009
  - The Reichsbank had a record of giving the „Great Banks“ with branch networks privileged access to the discount window
  - In 1930/31, the „Great Banks“ with branch networks had lower liquidity ratios and then lower-quality liquid assets, namely discountable commercial paper
  - In contrast Berliner Handelsgesellschaft had better liquidity

The 1931 Crisis

- The 1931 crisis was a twin crisis:
  - First, there were significant withdrawals at Danat and Dresdner because of suspected insolvency: BHG unaffected
  - Then after Brünings call for a moratorium on reparations, there was a run on the currency
  - When this ebbed off, the Danat crisis erupted and the run renewed
  - The Reichsbank provided liquidity by discounting (even bad paper) until it hit the 40 % coverage ratio for the currency
  - At that point all banks had to close their doors

The 1931 Crisis

- „Great Banks“ were nationalized and partly merged
- BHG was not – despite greater dependence on foreign funding, their liquidity management had helped them through on their own

And today?

- 2004 Warning by the German Monopolies Commission: A policy of creating national champions gives rise to too-big-to-fail problems and to moral hazard – see 1931
- Government response: Any comparison with 1931 is ludicrous. Today we have banking regulation and supervision preventing such events!
- 2008: Merger Commerzbank – Dresdner Bank encouraged by the Government, financed by debt, required a 18 bn. EUR bailout.

The Theory – pre 2007

- Banking supervision is micro, a matter for supervisors under the direction of the finance minister
- Solvency problems must be addressed by the finance minister: They require taxpayer money
- Central banks can provide liquidity assistance
  - Institution wise by national central banks
  - Market interventions by ECB
- Relation to monetary policy unclear

The Practice: Government Policy

- Pre 2007: Supervision lax – finance ministers more concerned with champions and with government funding than with financial stability
- Zero risk weights for government funding not mandated by Basel, but result from political choice (EU CRD III)
- 2008 interventions: intransparent, without any attempt to take control, impose adjustments in market structure, reduce vulnerability

The Practice: Central Banks

- The only institutions able to act quickly
- 2007: Effective liquidity provision to substitute for interbank markets
- 2008: Expansion of the set of assets taken as collateral raises questions about the boundaries between liquidity provision and bailouts
- 2010: ECB Securities market programme raises questions about the boundaries between liquidity provision and (indirect) government finance

Analytical Issues

- What is the role of interbank markets?
- Economizing on liquidity – why?
- If central bank money paid a proper rate of return, would we have interbank markets?
- The optimum quantity of money argument
- Providing incentives to hold large deposits with the central bank reduces frictions
- Counter-argument: Selling or pledging assets to the central bank creates moral hazard problems

Analytical Issues 2

- If the central bank makes losses on acquired assets, these are real losses of seigniorage – even if the expansion of the money supply has no inflationary effects
- If there is inflation, the inflation tax comes on top of the seigniorage loss

Analytical Issues 3

- Given that we are in this mess, monetization – in spite of the costs it involves – may be the least costly way to handle it.
- … but the moral hazard it creates may make it the mostly way.
- Politicians are discovering that, if they cannot get direct control over the printing press, they still can get it indirectly by having banks fund government-preferred activities and having the central bank bail out the banks.

Policy conclusions

- We need stricter banking regulation, in particular for capital, risk weights for sov. debt
- Regulation and supervision must also be made more effective, e.g., by eliminating the fragmentation that prevails in the US and is a major source of regulatory arbitrage and intransparency
- Supervision should be independent – even though taxpayer money is at stake (Embedding supervision in a European network may be a step in this direction.)

Policy Conclusions 2

- We need an effective system for providing information flows from supervisors to central banks – this requires proper organization and processing of data.
- Institutional relations between supervisors and central banks?
- Central banks need to develop a conceptual framework for assessing the relation between monetary policy and financial stability.
  - Example: Switzerland 1988, 1990 ff.

A skeptical note

- The problem of fiscal discipline is fundamental
- As the experience of the seventies and eighties is receding from memory, politicians are thinking again that central bank independence is an anomaly and that a printing press is a convenient source of funds.
- In the Eurozone, as in Argentina in the nineties, market discipline from investors is reduced...
- Proposals to impose discipline by a European finance minister presume a European polity.