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!
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.
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.
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.