

"Bankers' Banks"- The Role of Central Banks in Banking Crises

By Sam Vaknin, Ph.D.

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Central banks are relatively new inventions. An American President (Andrew Jackson) even cancelled its country's central bank in the nineteenth century because he did not think that it was very important. But things have changed since. Central banks today are the most important feature of the financial systems of most countries of the world.

Central banks are a bizarre hybrids. Some of their functions are identical to the functions of regular, commercial banks. Other functions are unique to the central bank. On certain functions it has an absolute legal monopoly.

Central banks take deposits from other banks and, in certain cases, from foreign governments which deposit their foreign exchange and gold reserves for safekeeping (for instance, with the Federal Reserve Bank of the USA). The Central Bank invests the foreign exchange reserves of the country while trying to maintain an investment portfolio similar to the trade composition of its client - the state. The Central bank also holds onto the gold reserves of the country. Most central banks have lately tried to get rid of their gold, due to its ever declining prices. Since the gold is registered in their books in historical values, central banks are showing a handsome profit on this line of activity. Central banks (especially the American one) also participate in important, international negotiations. If they do not do so directly - they exert influence behind the scenes. The German Bundesbank virtually dictated Germany's position in the negotiations leading to the Maastricht treaty. It forced the hands of its co-signatories to agree to strict terms of accession into the Euro single currency project. The Bundesbank demanded that a country's economy be totally stable (low debt ratios, low inflation) before it is accepted as part of the Euro. It is an irony of history that Germany itself is not eligible under these criteria and cannot be accepted as a member in the club whose rules it has assisted to formulate.

But all these constitute a secondary and marginal portion of a central banks activities.

The main function of a modern central bank is the monitoring and regulation of interest rates in the economy. The central bank does this by changing the interest rates that it charges on money that it lends to the banking system through its "discount windows". Interest rates is supposed to influence the level of economic activity in the economy. This supposed link has not unequivocally proven by economic research. Also, there usually is a delay between the alteration of interest rates and the foreseen impact on the economy. This makes assessment of the interest rate policy difficult. Still, central banks

use interest rates to fine tune the economy. Higher interest rates - lower economic activity and lower inflation. The reverse is also supposed to be true. Even shifts of a quarter of a percentage point are sufficient to send the stock exchanges tumbling together with the bond markets. In 1994 a long term trend of increase in interest rate commenced in the USA, doubling interest rates from 3 to 6 percent. Investors in the bond markets lost 1 trillion (=1000 billion!) USD in 1 year. Even today, currency traders all around the world dread the decisions of the Bundesbank and sit with their eyes glued to the trading screen on days in which announcements are expected.

Interest rates is only the latest fad. Prior to this - and under the influence of the Chicago school of economics - central banks used to monitor and manipulate money supply aggregates. Simply put, they would sell bonds to the public (and, thus absorb liquid means, money) - or buy from the public (and, thus, inject liquidity). Otherwise, they would restrict the amount of printed money and limit the government's ability to borrow. Even prior to that fashion there was a widespread belief in the effectiveness of manipulating exchange rates. This was especially true where exchange controls were still being implemented and the currency was not fully convertible. Britain removed its exchange controls only as late as 1979. The USD was pegged to a (gold) standard (and, thus not really freely tradable) as late as 1971. Free flows of currencies are a relatively new thing and their long absence reflects this wide held superstition of central banks. Nowadays, exchange rates are considered to be a "soft" monetary instrument and are rarely used by central banks. The latter continue, though, to intervene in the trading of currencies in the international and domestic markets usually to no avail and while losing their credibility in the process. Ever since the ignominious failure in implementing the infamous Louvre accord in 1985 currency intervention is considered to be a somewhat rusty relic of old ways of thinking.

Central banks are heavily enmeshed in the very fabric of the commercial banking system. They perform certain indispensable services for the latter. In most countries, interbank payments pass through the central bank or through a clearing organ which is somehow linked or reports to the central bank. All major foreign exchange transactions pass through - and, in many countries, still must be approved by - the central bank. Central banks regulate banks, licence their owners, supervise their operations, keenly observes their liquidity. The central bank is the lender of last resort in cases of insolvency or illiquidity.

The frequent claims of central banks all over the world that they were surprised by a banking crisis looks, therefore, dubious at best. No central bank can say that it had no early warning signs, or no access to all the data - and keep a straight face while saying so. Impending banking crises give out signs long before they erupt. These signs ought to be detected by a reasonably managed central bank. Only major neglect could explain a surprise on behalf of a central bank.

One sure sign is the number of times that a bank chooses to borrow using the discount windows. Another is if it offers interest rates which are way above the rates offered by other financing institutions. There are may more signs and central banks should be adept at reading them.

This heavy involvement is not limited to the collection and analysis of data. A central

bank - by the very definition of its functions - sets the tone to all other banks in the economy. By altering its policies (for instance: by changing its reserve requirements) it can push banks to insolvency or create bubble economies which are bound to burst. If it were not for the easy and cheap money provided by the Bank of Japan in the eighties - the stock and real estate markets would not have inflated to the extent that they have. Subsequently, it was the same bank (under a different Governor) that tightened the reins of credit - and pierced both bubble markets.

The same mistake was repeated in 1992-3 in Israel - and with the same consequences.

This precisely is why central banks, in my view, should not supervise the banking system.

When asked to supervise the banking system - central banks are really asked to draw criticism on their past performance, their policies and their vigilance in the past. Let me explain this statement:

In most countries in the world, bank supervision is a heavy-weight department within the central bank. It samples banks, on a periodic basis. Then, it analyses their books thoroughly and imposes rules of conduct and sanctions where necessary. But the role of central banks in determining the health, behaviour and operational modes of commercial banks is so paramount that it is highly undesirable for a central bank to supervise the banks. As I have said, supervision by a central bank means that it has to criticize itself, its own policies and the way that they were enforced and also the results of past supervision. Central banks are really asked to cast themselves in the unlikely role of impartial saints.

A new trend is to put the supervision of banks under a different "sponsor" and to encourage a checks and balances system, wherein the central bank, its policies and operations are indirectly criticized by the bank supervision. This is the way it is in Switzerland and - with the exception of the Jewish money which was deposited in Switzerland never to be returned to its owners - the Swiss banking system is extremely well regulated and well supervised.

We differentiate between two types of central bank: the autonomous and the semi-autonomous.

The autonomous bank is politically and financially independent. Its Governor is appointed for a period which is longer than the periods of the incumbent elected politicians, so that he will not be subject to political pressures. Its budget is not provided by the legislature or by the executive arm. It is self sustaining: it runs itself as a corporation would. Its profits are used in leaner years in which it loses money (though for a central bank to lose money is a difficult task to achieve).

In Macedonia, for instance, annual surpluses generated by the central bank are transferred to the national budget and cannot be utilized by the bank for its own operations or for the betterment of its staff through education.

Prime examples of autonomous central banks are Germany's Bundesbank and the American Federal Reserve Bank.

The second type of central bank is the semi autonomous one. This is a central bank that depends on the political echelons and, especially, on the Ministry of Finance. This dependence could be through its budget which is allocated to it by the Ministry or by a Parliament (ruled by one big party or by the coalition parties). The upper levels of the bank - the Governor and the Vice Governor - could be deposed of through a political decision (albeit by Parliament, which makes it somewhat more difficult). This is the case of the National Bank of Macedonia which has to report to Parliament. Such dependent banks fulfil the function of an economic advisor to the government. The Governor of the Bank of England advises the Minister of Finance (in their famous weekly meetings, the minutes of which are published) about the desirable level of interest rates. It cannot, however, determine these levels and, thus is devoid of arguably the most important policy tool. The situation is somewhat better with the Bank of Israel which can play around with interest rates and foreign exchange rates - but not entirely freely.

The National Bank of Macedonia (NBM) is highly autonomous under the law regulating its structure and its activities. Its Governor is selected for a period of seven years and can be removed from office only in the case that he is charged with criminal deeds. Still, it is very much subject to political pressures. High ranking political figures freely admit to exerting pressures on the central bank (at the same breath saying that it is completely independent).

The NBM is young and most of its staff - however bright - are inexperienced. With the kind of wages that it pays it cannot attract the best available talents. The budgetary surpluses that it generates could have been used for this purpose and to higher world renowned consultants (from Switzerland, for instance) to help the bank overcome the experience gap. But the money is transferred to the budget, as we said. So, the bank had to do with charity received from USAID, the KNOW-HOW FUND and so on. Some of the help thus provided was good and relevant - other advice was, in my view, wrong for the local circumstances. Take supervision: it was modelled after the Americans and British. Those are the worst supervisors in the West (if we do not consider the Japanese).

And with all this, the bank had to cope with extraordinarily difficult circumstances since its very inception. The 1993 banking crisis, the frozen currency accounts, the collapse of the Stedilnicas (crowned by the TAT affair). Older, more experienced central banks would have folded under the pressure. Taking everything under consideration, the NBM has performed remarkably well.

The proof is in the stability of the local currency, the Denar. This is the main function of a central bank. After the TAT affair, there was a moment or two of panic - and then the street voted confidence in the management of the central bank, the Denar-DM rate went down to where it was prior to the crisis.

Now, the central bank is facing its most daunting task: facing the truth without fear and without prejudice. Bank supervision needs to be overhauled and lessons need to be learnt. The political independence of the bank needs to be increased greatly. The bank

must decide what to do with TAT and with the other failing Stedilnicas?

They could be sold to the banks as portfolios of assets and liabilities. The Bank of England sold Barings Bank in 1995 to the ING Dutch Bank.

The central bank could - and has to - force the owners of the failing Stedilnicas to increase their equity capital (by using their personal property, where necessary). This was successfully done (again, by the Bank of England) in the 1991 case of the BCCI scandal.

The State of Macedonia could decide to take over the obligations of the failed system and somehow pay back the depositors. Israel (1983), the USA (1985/7) and a dozen other countries have done so recently.

The central bank could increase the reserve requirements and the deposit insurance premiums.

But these are all artificial, ad hoc, solutions. Something more radical needs to be done:

A total restructuring of the banking system. The Stedilnicas have to be abolished. The capital required to open a bank or a branch of a bank has to be lowered to 4 million DM (to conform with world standards and with the size of the economy of Macedonia). Banks should be allowed to diversify their activities (as long as they are of a financial nature), to form joint venture with other providers of financial services (such as insurance companies) and to open a thick network of branches.

And bank supervision must be separated from the central bank and set to criticize the central bank and its policies, decisions and operations on a regular basis.

There are no reasons why Macedonia should not become a financial centre of the Balkans - and there are many reasons why it should. But, ultimately, it all depends on the Macedonians themselves.

Sam Vaknin is the author of "Malignant Self Love - Narcissism Revisited" and "After the Rain - How the West Lost the East". He is a columnist in "Central Europe Review", United Press International (UPI) and ebookweb.org and the editor of mental health and Central East Europe categories in The Open Directory, Suite101 and searcheurope.com. Until recently, he served as the Economic Advisor to the Government of Macedonia.

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Global Banking Forced to Favour the Customer

by: David Liennac

Banks worldwide are offering more and more new services that help the customer understand and plan for their future. The bank or financial institution is nothing without the customer and finally the customer is reaping some of the rewards. Visitors to <http://www.choosingabank.com> can find out about the best financial institutions, choices, options and the best competitive rates – interest both on loans and term deposits.

With healthy scepticism ... surely this is not for the benefit of the customer but really illustrates the need for banks to get competitive. The 10 most successful (profitable) banks in the world listed below show their clear profits for 2003: Citigroup 20 billion Bank of America 15 billion HSBC 10 billion RBS 8 billion Wells Fargo 7 billion JP Morgan Chase 7 billion United Bank of Switzerland (UBS) 6 billion Wachovia Bank 5 billion Morgan Stanley 5 billion Merrill Lynch 4 billion

So with money and big business like this Banks are becoming more and more competitive and more and more client focused.

New Services include:

Flexible and Adaptable Home Loans offer competitive interest rates and more options for first time buyers. Banks rely heavily on the interest that is made on loans as well as investing our 'banked' money. So it's great to see that the customer is being treated with the financial respect that they deserve.

Another great service that banks are offering is low credit card rates and the opportunity to consolidate your other credit card debts. Some rates are as low as .99% for the first few months.

The new customer service policies that the Banks are introducing are also much more user friendly, with all information and terms and conditions in multiple languages and also in basic English. Banking customers are finally having a say and a greater understanding as to what happens to their well earned money.

There are several different types of banks – not just your local one at the end of the high street. Central banks usually control monetary policy and may be the lender of last resort in the event of a crisis Investment banks underwrite stock and bond issues and advise on mergers Merchant banks engage in trade financing Private banks manage the assets of "high net worth" (rich) individuals Savings banks write mortgages exclusively Offshore banks are banks located in jurisdictions with low taxation and regulation Commercial banks are otherwise undistinguished

Banks are now merging and offering a greater service to the small customer. There are

huge advantages to banking now ... but keep abreast with what's going on – what's on offer and you could save literally thousands of dollars!

David Llennac works in the field of Education in Sydney Australia and is the owner of a number of websites including <http://www.choosingabank.com>.

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