Financial Dominance &
Central Bank Independence
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Bundesbank Conference:
Turning Points in History: How Crises have Changed the Tasks and Practice of Central Banks?
Frankfurt, July 9th, 2015
Problem: Time inconsistency

Stability

- Price stability
  - promise not to inflate in the future

- Fiscal debt sustainability
  - promise to spend in recessions (now) but consolidate (later)

- Financial stability
  - promise only to provide liquidity but not to bail-out (redistribute) insolvent institutions

Rule *(to influence expectations)*
Problem: Time inconsistency

**Stability**

- **Rule** *(to influence expectations)*
  
  - Price stability
    
    promise not to inflate in the future
    
    **Independent central bank**
  
  - Fiscal debt sustainability
    
    promise to spend in recessions (now)
    but consolidate (later)
    
    **Independent fiscal council**
  
  - Financial stability
    
    promise only to provide liquidity
    but not to bail-out (redistribute to)
    insolvent institutions
Institutional design: split authorities

Fiscal authority

split

Central Bank

independent
Institutional design: split authorities

- Monetary dominance
  - Fiscal authority is forced to adjust budget deficits

- Fiscal dominance
  - Inability or unwillingness of fiscal authorities to control long-run expenditure/GDP ratio
  - Limits monetary authority to raise interest rates
Institutional design: game of chicken

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- **0/1-Dominance vs. battle:** “dynamic game of chicken”
Institutional Design: Financial Dominance

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- **Financial dominance**
  - Inability or unwillingness of financial sector to absorb losses
    - Refusal to issue no equity – pay out dividends in early phase of crisis
Institutional Design: 2\textsuperscript{nd} Game of Chicken

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2\textsuperscript{nd} Game of Chicken

- Under Financial dominance (financial sector does not assume losses)

2\textsuperscript{nd} battle btw monetary and fiscal authority (ECB vs ESM)
  - Fiscal authorities try to push losses onto CB’s balance sheet
    - Redistributive MoPo
    - CB might be held back from raising interest rates
  - CB would like fiscal authorities to recap/stabilize banks
2\textsuperscript{nd} Game of Chicken: Weaker of two

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- Moral hazard of financial sector (after split of authorities) driven by weakest of the two
  - Bailout by fiscal authorities
  - Bailout through MoPo
Who should bear interest rate & liquidity risk?

- **Financial sector**
  - Holds long-term government bonds
  - Issues short-term deposits
  - If “well capitalized”, insures government against rollover risk
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    (financial sector focus on private credit extension)
  - Rollover risk depends on “fiscal capacity”
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    rollover risk depends on “fiscal capacity”
  - Split gov. sector into:
    - Fiscal authority
    - Independent central bank
    fiscal authority issues long-term bonds
    CB can “costly signal” future i
    backed by seignorage
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  - **Split** gov. sector into:
    - **Fiscal authority** issues long-term bonds
    - **Independent central bank**
      buys it & issue short-term money
      CB can “costly signal” future interest rates
      backed by seignorage

Large CB balance sheet
Who should bear interest rate & liquidity risk?

- **Financial sector**
  - Holds long-term government bonds (no rollover risk for gov.)
  - Issues short-term deposits
  - If “well capitalized”
    - In good times: Financial sector earns risk premium
    - In bad times: Fiscal authorities or central banks have to bail out financial sector

- Why is financial sector undercapitalized?
  - Afraid that losses will be pushed onto it (financial repression)
  - Moral hazard
Conclusion

- Problem: Time inconsistency
- Institutional design: independent institutions (e.g. CB)
- No 0/1-dominance but game of chicken
- Under financial dominance:
  - 2\textsuperscript{nd} Game of Chicken
    Who recapitalizes/stabilizes financial system
  - Weaker authority matters for MH
  - Financial sector worries about weaker authority
- Who bears interest rate and liquidity risk?
  - Fiscal vs. central bank vs. financial sector (absorption capacity)
  - If CB bears interest rate risk => QE = commitment device
  - Why should government buy liquidity risk insurance from an undercapitalized financial sector?