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	Rule *(to influence expectations)*
▪ 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

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  Independent central bank

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  Independent fiscal council

- Financial stability

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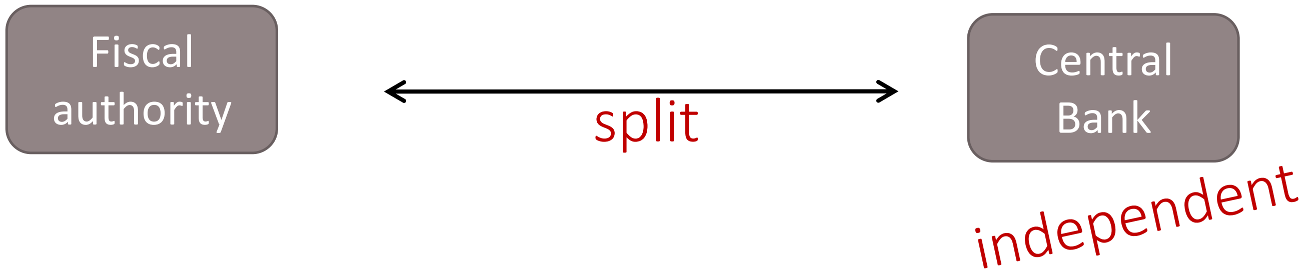
Institutional design: split authorities



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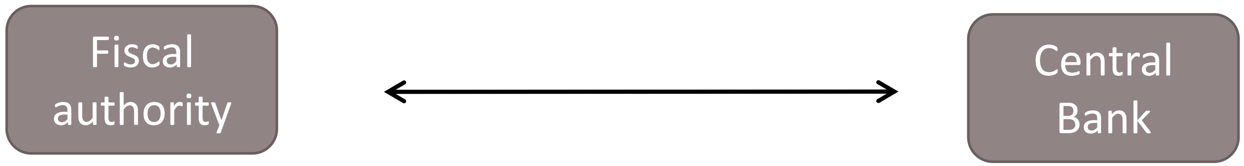

- Monetary dominance
  - Fiscal authority is forced to adjust budget deficits
- Fiscal dominance
  - Inability or unwillingness of fiscal authorities to control long-run expenditure/GDP ratio
  - Limits monetary authority to raise interest rates

Institutional design: game of chicken

Fiscal authority

Game of chicken

Central Bank

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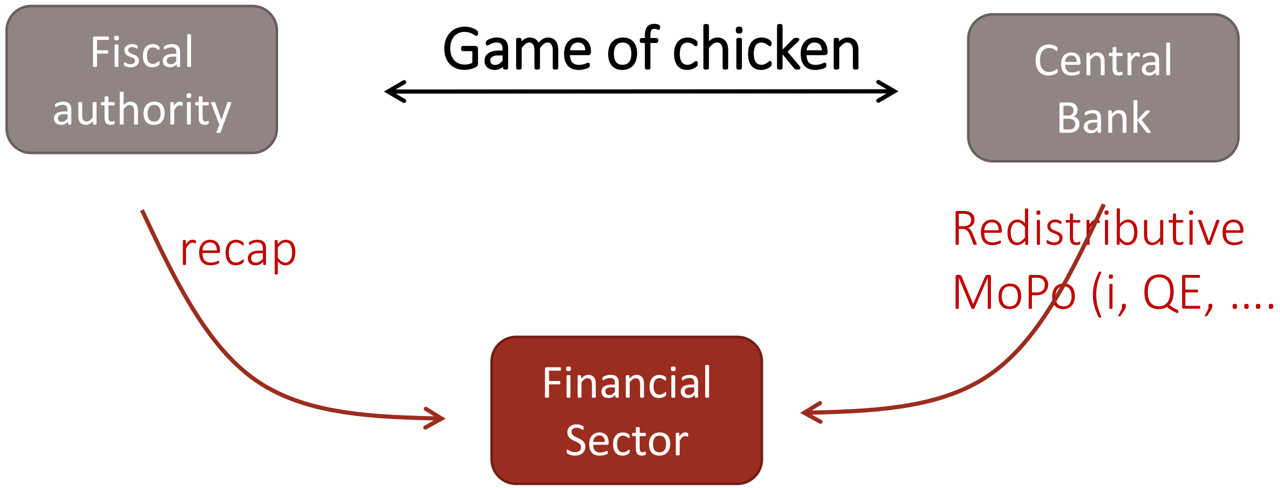
- 0/1-Dominance vs. battle: "dynamic game of chicken"

Institutional Design: Financial Dominance



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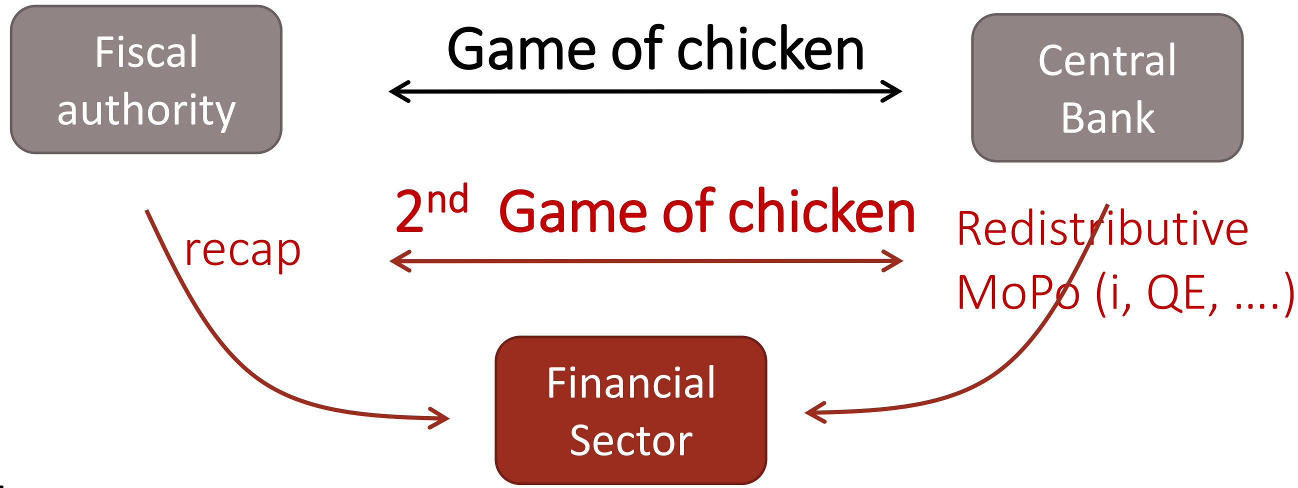
Institutional Design: 2nd Game of Chicken



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2nd Game of Chicken

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  (financial sector does not assume losses)

  2nd 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

2nd 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

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    issues long-term bonds →
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    buys it & issue short-term money
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Large CB balance sheet

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  - Issues short-term deposits
  - If "~~well capitalized~~"

In the real world

    - 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:
  - 2nd 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?