CENTRAL BANKS AND THE CRISIS

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"When speaking of a 'central bank', the first idea which probably comes to mind is that it is the institution that issues money. And money is the instrument we use as a unit of account, a means of payment and a store of value. Granted, the key objective of any central bank is to ensure that the value of money is preserved over time".

Jean-Claude Trichet

Abstract: *Thinking of what a global currency could be or represent – an idea on which the authors have strong public opinions – the question of the central banks' role and conduct during the last crisis has become not only complex but a changing one. As regards this latest process, we feel that we separate from something rational we have been used to, and it seems we undergo, as professionals, a hardly acceptable conversion.*

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The quick dynamic of phenomena under the central bank's control presents difficulties for us to possibly deal more directly with the generalisation of the relation or equation mentioned in the title of the chapter, which compels us to also review the present situation from which we start this chapter. From the crystallisation of the chapter to the detail filling-in we have been surprised and even overwhelmed by "precedents", considered interesting by some and

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dangerous by others, and the recent attempts to save some banking systems (in Spain, Cyprus and, according to some opinions, Malta and even Luxembourg will follow) pose almost insurmountable problems, which might also be related to a possible geopolitical change.

In March 2013 there have been several declarations concerning the need of calm. On the 12th of March, Jens Weidmann, Governor of the Central Bank of Germany, and member of the ECB Governors Council, declared – for AP and Reuters – that the crisis in the Eurozone had not ended, although the tensions in the financial market had diminished. Why? Because governments in this zone (mentioning France, Italy and Cyprus!) were far from finalizing the structural reforms for avoiding the repetition of the factors that had caused the crisis.

The priority field considered was the banking system, which required another business model so that losses should be absorbed by shareholders and creditors, thus excepting taxpayers from contributing directly to bank saving, in accordance with a reforming concept promoted by a group led by Erkki Liikanen, Governor of the Central Bank of Finland. While the Governor of the Central Bank of Finland maintained that the EU credit institutions had to separate trading/crediting from retailing (a formula supported by others as well) and to observe additional rules regarding bonuses, some banks – like BNP Paribas and Deutsche Bank – were still supporting a model of “universal bank”. We shall discuss again this aspect of principle on a broader basis, but the conflict of approaches is present.

As regards the central banks, we witness the approaches in Hungary and Japan – two countries situated far from one another but which are subject, for somewhat different reasons, to government interference, thus weakening the principle of independence of the monetary policy. We also see an alarming change in defining the mandate, which leads the monetary policy to policy-driven areas, falling into the trap of external pressures. The principle of free decision on the cost of money – “so high” that it should be reasonably used to enable return – vanishes on a horizon of ill omen.

This change, taking place in two countries – one EU member and one economic power with a reserve currency (the yen), is determined by the finding that central banks could become too strong, not for the reasons considered in Hungary or Japan, but because of the attempt to take on new obligations, such as financial stability and macroprudentiality. This was asserted by the Chief Economist of the IMF, Olivier Blanchard, in his speech delivered at he London School of Economics (on the 26th of March, according to Reuters), while finding out not the utility of this implication but the fact that illegitimate (not elected) technocrats could have discretionary power or influence.

In Hungary, the leadership change at the Central Bank looks like a political intervention linked to the mandate for reasons concerning the economic situation, taking measures for stimulating crediting, especially for SMEs. This solution poses problems since it regards the conversion of a part of the foreign currency reserve, about 3 billion euro, into a crediting fund in national currency, without knowing if an existing counterparty is affected, such as securities taken along with the liquidity injected into commercial banks exposed to the state's debt. Analysts find that the way of reducing the monetary policy debt is too small as against what economic revival requires, thus endangering even the declared conduct of the National Bank of Hungary aiming at economic growth.

Developments in Japan (deflation) reached the limit of the politicians' patience; Prime Minister Abe even set deadlines for the new governor of the Bank of Japan to overcome economic recession. It seems that the expectations determined by the first monetary policy decisions made by Haruhico Kuroda on 3^{rd}-4^{th} April were confirmed as regards "boldness", then firmly shifting to quantitative relaxation (to the needed extend), direct buying of government bonds irrespective of maturity, and extending the three-year ones to seven years, purchase of funds traded at the stock exchange and investment funds for the real estate sector, in order to reach a 2% inflation.

As regards the case of Cyprus, on the 26^{th} of March, after taking measures for bail-out without the tensions caused by the early variant, Paul Krugman said that the control on the capital movement in Cyprus symbolized the end of the era of free capital circulation in the world. Krugman's feeling, based on the belief that the capital circulation control could work for a longer time in Cyprus, exceeds by far the correct technical opinion based on the multilateral rules of Michel Barnier, EU Commissioner for the Single Market, according to which the limitation of free movement of capital should be imposed in extraordinary cases and only temporarily.

Such a measure should be approved by the IMF as a justified intention before application or reported to the IMF if urgent application is required in the case of an IMF member country. All safeguarding measures on a financial plane, for reasons concerning the balance of payments, or on a commercial plane (in relation to the WTC, former GATT 1949), for reasons concerning the protection of the national economy of a contracting party, follows this regime of exception or temporary application.

But the case of Cyprus ("little strokes fell great oaks") causes fear not through own casuistry or final solutions, but by finding first that the Eurozone seems to have overestimated the capability of controlling contagion. This time it seems we face a new reality and, maybe, a rivalry as regards the market-regulator relation. The mere confidence that market functioning ensures the return of trust is no longer enough, if the management of stabilisation measures at the EU level is incoherent, takes sides, is not uniformly applied and, the worst, is hegemonical.

Secondly, the way of negotiating the bail-out for Cyprus cause a crises of mistrust not only in the European banking system, but also in the very European construction – the EU. The latter reflects the same perception – increasing at the European citizen level – of the illegitimacy of the European Commission, which is not elected on a democratic basis, by only several bureaucrats or representatives of some member states discuss and decide on the fate of the states. The message sent by the crisis in Cyprus – especially by affecting the population's bank deposits – is that the Union does not protect the interests of its own citizens.

Thirdly, it is possible that the case of Cyprus raises Euroscepticism to a higher level, as it is combined with a resentment caused by the generalized effects of the austerity programmes, without decisively overcoming the crisis, the severe unemployment (12% in March 2013) and the diminution in wage earnings.

Fourthly, we should note a political aspect – very important in our opinion – that confirms the increasing gap between strong states and weak states.

Diminishing the population's bank deposits below the guaranteed level – even as intention, while in other EU countries such a measure is not considered – means to many European citizens that politically and economically stronger states are more important to the European Commission or the European Council that others are. Slovenia, which already faces banking problems, may show strong fear.

Moreover, the crisis in Cyprus, a member state of the Eurozone, might reveal something important and actual for the EU, that the steps taken for the functioning of the banking union have been too slow. The Cyprus crisis shows, even by its questionable economic and financial size, that the fiscal and political union cannot be postponed too long without risking collapse. Larry Elliott, editor economist of *The Guardian Economics Blog* (2nd April, 2013), suggests that the diminution and return cycle of the crisis risk in the Eurozone – with apparently diminishing influence on the Wall Street quotations at the expense of the large corporations' profit – leads to fears that another country follows (in this case, after Cyprus). Could we complete his conclusion implied in the title of his article – *Crisis in the Eurozone require one banking policy, one fiscal policy and one voice* - with the intuition that the EU's attention might vanish?

On the opposite side of the critics of the German hegemony, Daniel Ronald, from AFP, raised the question of the challenges to Germany in a wakening Eurozone, the most important one being the test regarding the restoration of relationships with France.

The reference to hegemonical governance is also related to the crisis in Cyprus, and this time the blame came from Jean Asselborne, Foreign Minister of Luxembourg, because of the same oversized sector. He said for Reuters that Germany had no right to decide on any business model for other EU member states… It cannot be Germany, France or the United Kingdom that should tell us that we needed financial centres only in those countries and not in others … that fighting for hegemony was wrong and non-European, against a single internal market and solidarity in Europe. No comments are needed, but the danger of hindering political consensus in the EU in difficult moments to come, when cooperation is required is obvious.

Therefore, we are not surprised by the response of Joachim Poss, deputy leader of the opposition in the German Parliament, to Asselborne's declarations, mentioning that the first beneficiary of the euro crisis was Germany, at least as regards a significant diminution in the cost of loans, and that investors preferred safe havens. Poss insisted on reforming the financial centres responsible for the dumping by the low taxes in the Eurozone, and cited countries like Luxembourg, Malta and Ireland. He said that on long term we could not accept a business model that circumvented fair competition, and Luxembourg pertained to the group of countries facing this problem, even if his attack was part of the campaign for the 2013 federal elections.

Another clearly pro-growth orientation came from Mario Draghi, ECB chief, who – after the latest decision taken in March 2013 to keep the interest at 0.75% – declared that he was ready to lower this interest if the Eurozone economies would show signs of weakness against the forecasted better performance in the second semester of 2013, while the crisis of debts entered the fourth year. He also said that the European policy remained accommodative as long as necessary… pursuing to monitor all information on economic and monetary development and to assess the impact on price stability.

Moreover, as there are doubts on the economic prospects of the EU in the second part of 2013, some officials said that during the last monetary political meeting the ECB considered "a variety of actions", including the stimulation of SME's crediting. Draghi, in his opening speech concerning the ECB's decisions - but actually aiming at the near future - said that a variety of instruments was analysed, which obviously concerned the economic recovery of the Eurozone.

From another perspective, the deviation from the orthodox line of the central banks aroused the fear of their increasing power, not through the "value added" of the public pressure or interference, but by expanding some competences in the field. Olivier Blanchard says that if we think that now central banks have more responsibilities and broader instruments, then the question of their independence becomes even more difficult. This is another opinion that follows the same somewhat formalized direction, i.e. another way of living with the political aspect – supporting macrostability.

John Gieve, a former Vice-governor of the Bank of England, pleaded for a dual mandate of the central bank – economic growth and inflation target – similar to the FED. This argument was a consequence (astonishing, in our opinion) of the fact that the Bank of England and the Treasury concluded "an explicit partnership agreement" aiming at counteracting a contractionist fiscal policy by an expansionist monetary policy. Gieve says that such partnership cannot produce the expected results on only one side – the Treasury – if the central bank retains only the mandate regarding the inflation target.

Other observers say that the explicit partnership between the Bank of England and the Treasury is "purely cosmetic" (Gabriel Stein, director at Stein Brothers, UK), as it validates what has already happened in the UK, but the question to be answered has two parts: Isn't option for the nominal GDP target not conflicting with the role of the central bank as regards price stability?, and: Isn't a dual mandate, in Europe, giving to markets a signal on conflicting policies?

What one may feel is the fact that the new rules to be formalized, after decades of multilateral negotiations (i.e. capital account liberalisation, strict utilisation of the central bank's instruments, express mandate, etc.) might become obsolete very easily, which means losing trust in any agreement. The same might happen to the independence of banks or the prohibition of monetary financing of budget deficits.

But any world order is based on the confidence inspired by the observance of agreements, *pacta sunt servanda.* The beginning of their non-observance is frequently considered as a dangerous precedent, and from this to chaos there is only one step. That is why we must not ignore the real fact – especially in a globalized world – that a decision on monetary policy has never been confined exclusively to the national space of competence of a central bank important to the world economy, but on medium and long terms it has even produced geostrategic effects.

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