



Financial Dominance & Central Bank Independence

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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

- Fiscal debt sustainability

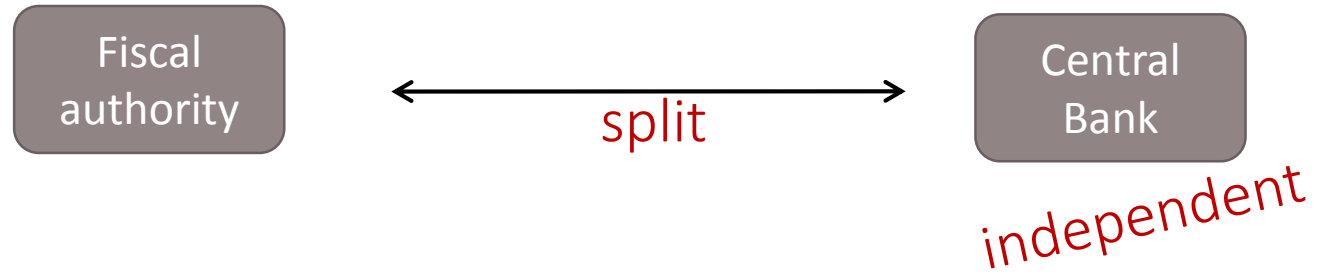
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Independent fiscal council

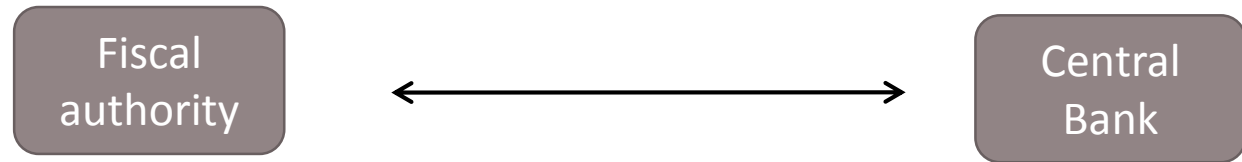
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|| Institutional design: split authorities

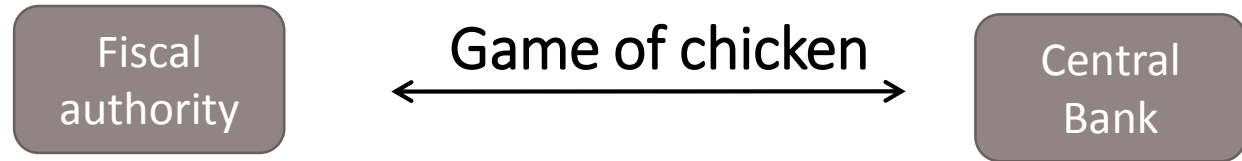


III Institutional design: split authorities



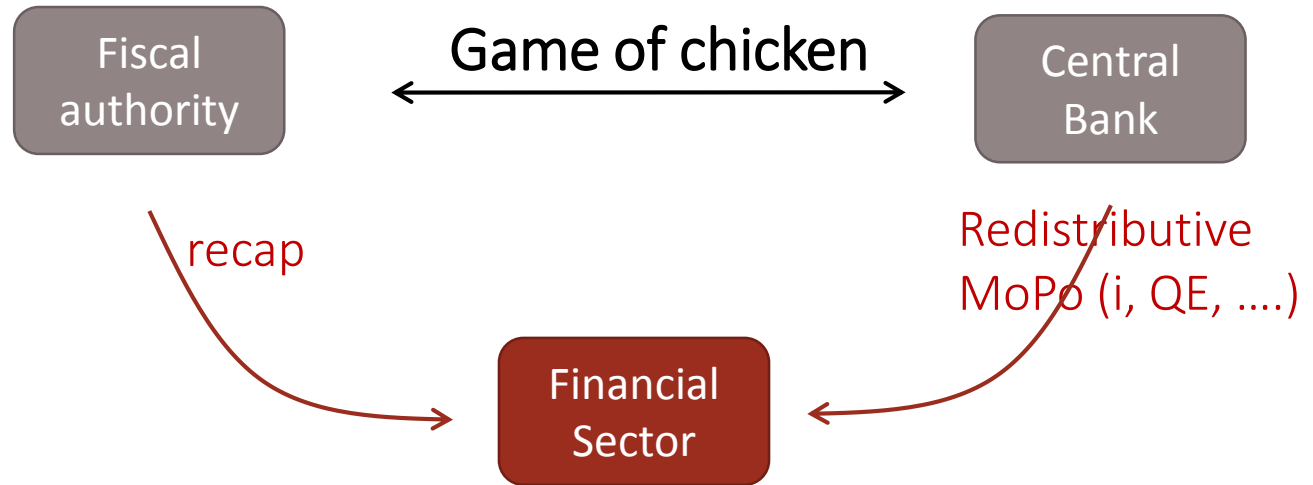
- Monetary dominance
 - Fiscal authority is forced to adjust budget deficits
- Fiscal dominance
 - Inability or unwillingness of fiscal authorities to control long-run expenditure/GDP ratio
 - Limits monetary authority to raise interest rates

III Institutional design: game of chicken



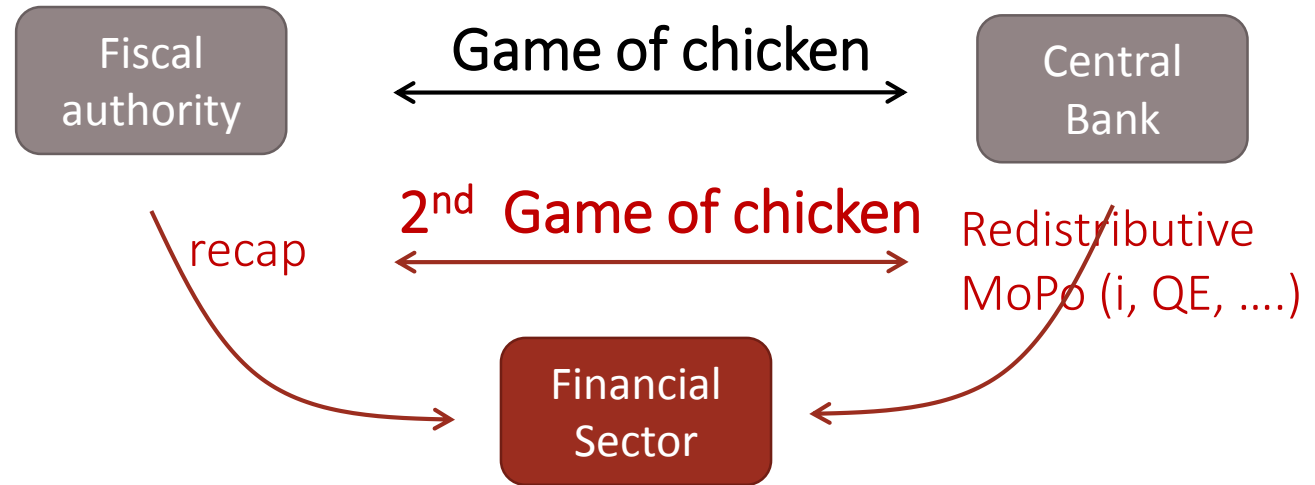
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- 0/1-Dominance vs. battle: “dynamic game of chicken”

III 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

III Institutional Design: 2nd Game of Chicken



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2nd Game of Chicken

- Under Financial dominance
(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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■ Financial sector

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- Issues short-term deposits
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(financial sector focus on private credit extension)
rollover risk depends on “fiscal capacity”

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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 i
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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?