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Fundamentals of Central Banking

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II Fundamentals of Central Banking

A Central Bank is that agency whose liability is the money that commer cial banks use in making thier settlements and which can vary the quantity of such reserve money by banking operations, i.e. by acquiring or selling assets in exchange for its own monetary liability. The Central Bank, by these banking operations in which its own liabilities are used in making the payments, affects in a systematic way the actual or potential quantity of the money used by the public. There is no need for a Central bank to have many ofthe attributes that Central banks usually have: it need not

1. have a monopoly of note issue
2. be the holder and manager of the international monetary or financial reserves of an economy.
3. be the fiscal agent for the government.

Today in almost all countries the Central Bank is either a specially chartered agency or a branch of the administrative with well defined responsibilities and powers, although Central Banks have existed and functioned without any special legal authority. Whether a Central Bank is a government agency or privately owned, whether its position isthe result of an evolutionary process or of legislation, its actions have to be consistent with the actions and objectives ofthe government insofar as they relate to economic policy.

A slogan whcih often has been put forward to describe the desired relation between the political government and the Central Bank is "an independent Central Bank". This slogan if interpreted literally means that the Central Bank could pursue an economic policy without considering the objectives of the national administration: the Central Bank could actively oppose and, if its tools are in fact powerful enough, it could veto government policy. As no government can long tolerate the existence of such a private or bureaucratic veto, the independence of the Central Bank is of necessity greatly limited. As acts by both the Central Bank and the fiscal authorities affect the overall behavior of the economy as a minimum cooperation between these two is necessary. As fiscal ~~deesseena~~ decisions in a country sech as the United States are the result of a political decision making process--Congress and the President determine tax schedules and expenditure programs--the freedom of action of the Central Bank is greatly limited once the political administration sets the National Policy objectives. The Central Bank's independence becomes an independence within government, that is the Central Bank's executive can present and advocate particular objectives for economic policy and can argue for a program to achieve these

objectives, but, once the political administration decisions are made, the Central Bank must support these decisions. An independent Central Bank therefore is an independent administrative and analytical agency within the government apparatus which will carry out specialized operations in order to advance politically determined economic objectives and which has a limited right to publically advocate alternative policies to those which have been adopted.

Money is that asset which is generally accepted for payments within a class of economic units. Various types of money can exist, both for payments within a class of economic units or between classes. The terms upon which one type of money is exchanged for another is called the exchange rate. Exchange rates between the monies of different countries is a familiar concept, but the same phenomena exists within a national economy whenever various types of money exists.

For our purposes these different types of money can be distinguished: the publics money, bankers money and international money. The public consists of households, non-financial business firms, state and municipal governments and non-commercial bank financial intermediaries.

For almost payments these units use demand deposits at commercial banks and currency. Commercial banks use demand deposits at the Central Bank in making payments to each other and to the national government. International payments are made in specie or in international currencies. In addition there are various kinds of near money in existence: liquid assets which cannot be used in their present form for payments but which on the basis of past behavior of the economy the owner has a right to expect to be able to transform into money quickly and without any significant costs whenever the need or desire arises. The exchange rate among the forms of money state the terms under which one form of money can be transformed into another.

If the amount of the three classes of money is existemce and their command over resources were independently determined then the exchange rates between the various forms of money would vary, just as exchange rates among national currencies. However usually the amounts of the three types of money in existence are not independently determined for the various money issuing units are committed to exchanging one type of money for another at par: the historic limitation upon free commercial banking is the requirement that the bank will trade reserve money for

its own liabilities ap par upon demand, hence the amount of reserves it owns determines a banks willingness to emit deposits. In the United States currency is a liability of the Treasurey and the Federal Resefve Banks while demand deposits are liabilities of commercial banks. Commercial banks are committed to exchanging currency for demand deposits at the will ofthe owners of demand depoaits. As much more demand deposits exist than currency, a change in tastes in favor of holding currency rather than demand deposits could result in currency rising to a premium over demand deposits.

Bankers are committed to exchanging currency for demand deposits. If the volume of currency is fixed and the demand for currency increases, bankers have to go into the financial markets and buy currency(or, what amounts to the same thing, buy up claims to currency outstanding in the form of demand deposits). This is done by exchanging the banks earning assets for currency or demand deposits which will cause the market price of abnak bank earning assets to fall. As a result of the pressure upon them, bankers will not readily be extending new credit. The terms upon which banks will be willing to finance new activities and purchases of assets will become unfavorable to the borrower. A downward pressure

on the market price of real as well as financial assets will result and this will be accompanied by a decreased rate of income flows. As banks and financial institutions in general are thin equity organizations, a small decrease in the market price of their earning assets can result in insolvency. Any threat of insolvency will increase the pressure to substitute senior fixed value assets for bank liabilities.

Given that the price level relevant to current output is stated in terms of currency and demand deposits, it is best to describe what happens when banks exchange earning assets for currency and demand deposits under such pressures as earning and real assets going to a discount. The market price of earning and real durable assets can fall much more rapidly than the costs which determine the supply price of current output: the supply price of current output falls as a result of a time consuming process which involves declining real income and unemployment. The fall in the market price of financial and existing real assets will result in second hand assets being favorably priced so that new investment and hence income falls rapidly. Because of these relations between financial and real variables, the Federal Reserve System was created to bring about a flexible currency supply, so that the substitution of currency for demand deposits

would not cause any serious repercussion. Whenever pressure on Commercial Banks to substitute currency for demand deposits arises, the Central Bank can create currency acquiring in the process the earning assets which had been owned by the Commercail Bank s. This results in an infinitely elastic supply of currency in exchange for demand deposits and a floor under the price of the earning assets woned by the Commercial Banks. In a private economy, when no floors exist under the price of earning asset, it is difficult to develop institutional arrangements which result in substantial positions being taken in a falling market. Once a Central Bank exists sets such floors to the price of assets, private position taken will arise who in fact make the exercise of the Central Banks residual powers unncessary in almost all cases.

An interesting aspect of the above interpretation of what Central Banking does isthat the Central Bank becomes a Commodity Credit Corporation which maintains minimum prices in specified financial markets by standing ready and being able to buy without limit. As financial markets and institutions evolve, the question arises whether the specified financial markets in which the Central Bank will intervene need also evolve.