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Overstrained Saviours: Central banks, Public Finances, and the End of the Money Illusion

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Abstract

Central banks have the ability to provide commercial banks in their currency area with liquid funds at very low costs when needed. This enables them to intervene in the financial sector to stabilise it during crisis situations. However, if the liquidity shortages in the commercial banking sector are merely symptoms of a deeper, far-reaching solvency crisis in the overall economy, and if the fiscal policy capability of the public sector is already restricted due to high levels of debt, the healing powers of monetary policy reach their limits. There is evidence suggesting that many countries in the global West could soon find themselves in such a situation.

Keywords: Monetary policy, public debt, financial stability, inflation

JEL Classification: H63, E42

1. A Rescue Action with Consequences

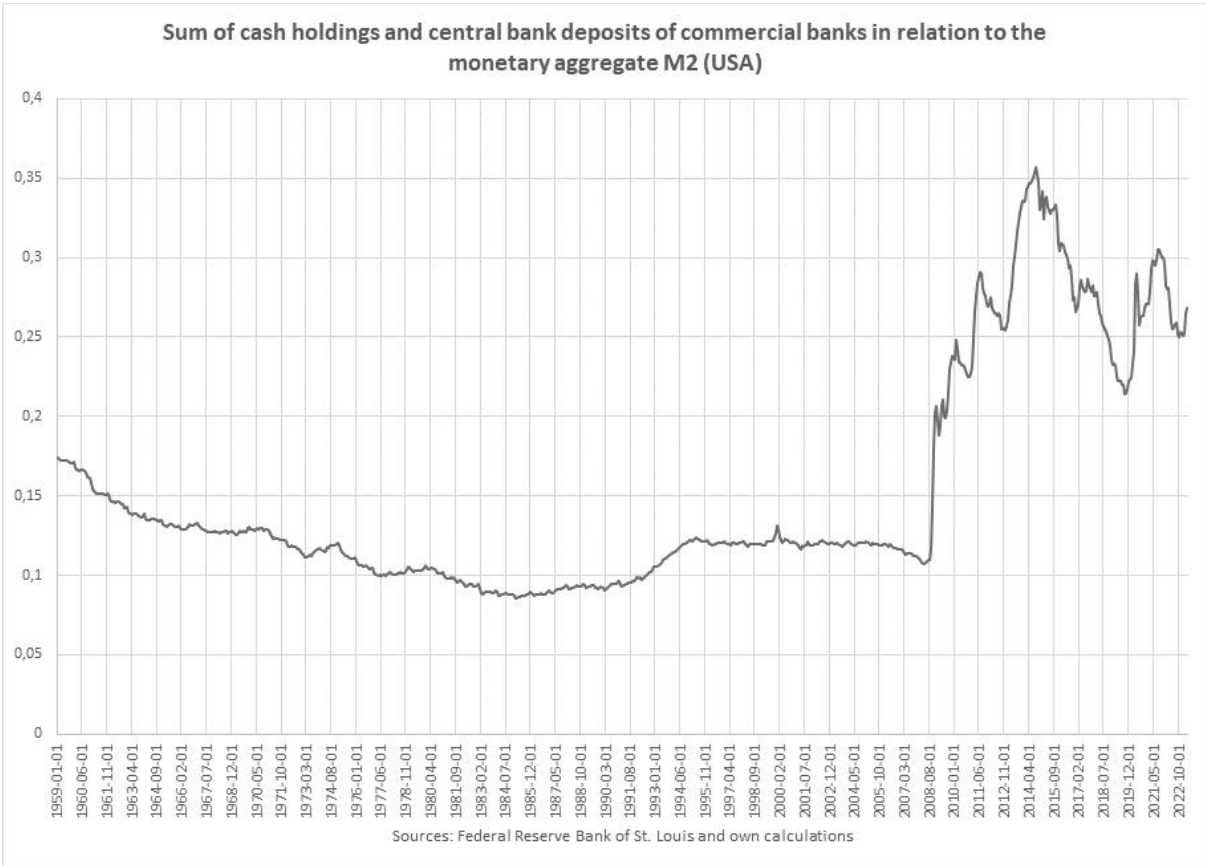
In a press release on 19 March 2023, the distressed major Swiss bank Credit Suisse (2023) announced that it would be taken over by its competitor UBS for a purchase price of around three billion Swiss francs, to be paid in its own shares. Reportedly, this decision did not come entirely voluntarily, as UBS had to be enticed into the transaction by liquidity aids and guarantees, partly decided under emergency law and mediated by the Swiss Federal Council, with a total volume of up to 100 billion Swiss francs (source: Federal Department of Finance, 2023).

The parties involved thereby managed to dispel any fears that Credit Suisse's distress could escalate into a systemic financial crisis, at least for the time being. However, even for people without extensive financial knowledge, this sequence of events likely brought an important fact to mind: Contrary to appearances, bank deposits are not a near-perfect substitute for physical cash; they are liabilities of the bank where the account is held (see also Werner et al., 2012). Their value from the customers' perspective thus depends on the solvency of that institution. If the latter is no longer assured, it depends on the ability (and willingness) of private, governmental or central bank-owned security mechanisms whether depositors and other creditors of the bank will be spared from the looming potential losses.

2. Unconventional Monetary Policy: Remedy or Sedative?

As long as it is ensured that the central bank of the affected currency area will act as the "lender of last resort" in emergencies (Baring, 1797), this finding does not initially seem particularly alarming. After all, under today's conditions, a central bank is generally capable of providing commercial banks with liquid funds denominated in domestic currency in the form of cash and central bank reserves within a short period. The costs associated with this are only a fraction of the nominal value of the newly created means of payment, under the current conditions prevailing in countries in the global West. Contrary to a claim occasionally made in popular media, such actions do not necessarily lead to a potentially inflationary expansion of money circulation in the non-banking sector: if the extent of the additional liquidity created in the banking sector through such support measures is only enough to compensate for the complete or partial disappearance of other sources of liquidity, such as customer deposits and interbank loans, then these adverse effects, ceteris paribus, should not be feared.

Instead, it is another aspect of the described situation that could give cause for concern. It is evident that looming liquidity shortages in the commercial banking sector have been prevented through “unconventional” measures by central banks, such as large-scale bond purchases on the open market and extremely favourable refinancing conditions (similarly to the European Central Bank, 2017). However, the likely cause of these liquidity shortages – the limited trust of market participants in the stability of the commercial banking sector – may not have been fully addressed in many cases. This is underscored by the fact that, in most countries of the global West, the sum of cash holdings and central bank reserves, expressed as a fraction of the overall money circulation, exceeds the actually required minimum reserve ratio prescribed by the central banks by far. In the figure given below, this is shown using the example of the monetary aggregate M2 for the United States.



Such hoarding of central bank money makes sense for a commercial bank only under two (not necessarily mutually exclusive) conditions. Firstly, it appears necessary when the bank itself fears that it may not be able to cover short-term liquidity needs through borrowing from the interbank market. Secondly, it is also economically rational when the bank is concerned that by lending these reserves to partner banks or customers, it would accumulate unacceptably high additional default risks.

3. The Crisis behind the Crisis

However, the underlying liquidity crisis in the commercial banking sector, which could only be prevented from erupting through emergency monetary measures, is unlikely to have come out of the blue. In line with Andrews, Andrews, McGowan and Millot (2017), it is more likely to be considered as merely a symptom of an ongoing, latent macroeconomic solvency crisis. Until now, this crisis has been prevented from leading to a sharp increase in corporate and private insolvencies by a veritable flood of credit-financed government stabilisation measures. However, the question arises as to how long public finances will still be able to intervene to stabilise the economy while simultaneously meeting the financial challenges arising from anthropogenic global warming, demographic change, and the geopolitical "turning point" (Bender, 2023) allegedly constituted by Russia's military intervention in Ukraine.

As is known, the ability of every economic agent to cover parts of its financial needs through borrowing depends on the willingness of others to grant it credit. Important prerequisites for this willingness are the market participants' confidence in the payment capability of the (potential) borrower and the stable value of the means of payment used for interest and repayment. In Japan, several countries in the eurozone and the US, this confidence could only be sustained in the years after 2008 through central bank support purchases in the market for government bonds (as also observed by Giordano, 2020). This illustrates that the appearance of value in bank deposits and government bonds in many countries in the global West is now solely due to the ability and willingness of central banks to create new central bank money with minimal operational effort if necessary.

As long as the rates of consumer price inflation in the respective currency areas remain relatively low, this situation does not immediately pose an acute danger. However, as soon as inflationary pressures increase noticeably, for example due to the scarcity of essential production factors or the increased use of restrictive foreign trade instruments, central banks face a serious dilemma: in the interest of price level stability, they should actually be inclined to tighten their refinancing facilities for the commercial banking sector and raise policy interest rates accordingly. However, this would very likely lead to a significant tightening and increased cost of credit supply to the non-banking sector. In some cases, however, this sector may not have fully recovered from the economic upheavals brought about by past crises and current geopolitical conflicts. The background of the 2008-09 financial crisis (see, for instance, Seckelmann and Siddiqui, 2009) suggests that such a development could indeed trigger another financial crisis. However, to avoid this risk, should central banks refrain from

sufficiently restricting their liquidity offerings, there is a risk of a sustained devaluation of money. This can cause significant societal damage, even if its magnitude remains far below that of the German hyperinflation of 1923.

4. Debt relief as an emergency solution?

In principle, this state of collective delay in bankruptcy, supported by monetary policy means, can theoretically continue indefinitely – because central banks are protected from the risk of being unable to fulfil payment obligations in domestic currency due to their monopoly on the issuance of central bank money. This raises the question of whether the top currency authorities should promote the financial recovery of public finances by unilaterally (completely or partially) waiving the repayment of those debt securities they have accumulated as a result of their "unconventional" monetary measures.

From an accounting perspective, this would entail the need to write down the book values of these bonds, which have so far been oriented either at current market rates or at the continued acquisition costs, to an amount that corresponds to the now reduced, expected future repayment amounts. The corresponding offsetting entry for this transaction would have to be made in the profit and loss statement under write-downs of financial assets, which would likely result in the affected central banks having to report losses that would partially or completely deplete their equity capital. Bell et al. (2023) point out, with reference to a series of historical precedents (including cases in Mexico, Chile, the Czech Republic and Israel), that central banks can indeed continue their operations with temporarily negative equity capital. Among other things, the authors attribute this to the fact that, despite the negative book value of their net assets during this phase, the affected central banks were able to maintain public confidence in the stability of their currencies, the foreign payment capability of the state, and the stability of the financial sector.

However, it is questionable whether this finding would provide an argumentative justification for a voluntary but factually forced waiver of claims by central banks, which is the result of latent over-indebtedness of public finances as well as many private actors. The monetary base in the affected currency areas would not change as a result of such an action, which, from a purely quantity-theoretic point of view, does not suggest that it would result in a direct inflationary impulse. However, the omission of the repayments that have now been waived would eliminate the dampening effect they would otherwise have had on the growth of

aggregate demand in the future. Consequently, the risk of inflationary "overshooting" of aggregate demand beyond the growth path of production potential cannot be prevented in the long run through this method (as also argued by Schulz, 2012). Thus it is increasingly evident, not only among parts of the economic expert community, that real economic scarcity problems, such as those related to land, drinking water, raw materials, energy or qualified labour, cannot be sustainably solved through financial instruments but rather can only be temporarily hidden.

Moreover, a unilateral waiver of claims by central banks vis-à-vis their public debtors would be tantamount to admitting that the bonds of the affected debtors appeared valuable mainly because the central banks were ready to step in as the ultimate bond buyers in times of need. Conversely, such a step would suddenly make it clear to the public that the cash holdings and bank deposits listed on the liability side of central bank balance sheets is not nearly backed by intrinsically valuable assets of sufficient magnitude. This also creates the risk of an initially creeping erosion of trust in the stability of the value of money, which can accelerate over time and take on the character of a self-fulfilling prophecy.

5. Growing distrust intensifies conflict potential

Under these conditions, actors who do not have to spend all of their income on basic needs have a strong incentive to invest significant portions of their savings in assets whose stability is not affected by bank insolvency or a possible loss of purchasing power of money. Examples of such capital goods include agricultural land, commodities, and shares in companies whose products are indispensable for human survival even under crisis conditions, such as food, drinking water, energy and medical supplies. It is well known that not all wealthy and famous individuals have a particular inclination to disclose details of their financial circumstances to a wider public; however, articles by Fox (2018), Estes (2021) and Shephard and Jason (2023) give the impression that the flight into crisis-resistant tangible assets described above is already in full swing there. Whether this trend will contribute to mitigating the perceived conflict-prone inequality in income and wealth in countries in the global West (and worldwide) remains doubtful.

Likewise, many actors outside these countries likely now have considerable doubts about the stability of the US dollar, euro and yen. A strong indication supporting this is the significant increase in cumulative gold reserves of central banks worldwide in 2022 (source: Verma,

2022). In addition, the partly successful efforts of the BRICS countries, as documented in the work of Liu and Papa (2022), to establish alternatives to the internationally established trading and investment currencies, strongly support this assumption.

All of this gives rise to concern that the economic basis of the societal orders existing in many countries in the global West could undergo an accelerating process of erosion in the coming years. It is far from clear at present whether and how political leaders in these countries will succeed in conveying to their populations the necessity of the renunciation of claims (Schröter, 2015) that are likely unavoidable to halt this process. In any case, the silence shrouding significant parts of the public opinion and political class regarding this issue is unlikely to calm anxious minds.

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