“Objectives, Governance and Accountability of Central Banks”

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I. Five Types of Monetary Regimes

1. **The Primary State**
2. **Free Banking (competitive banking without a central bank)**
3. **Central Banking**
4. **Currency Boards (currency issuance backed by 100% forex reserves)**
5. **The Gold Standard (currency issuance with gold reserves at the gold parity)**

II. History of Monetary Regimes (1)

- **The Primary State**: In the beginning, there was neither central banking nor free banking, e.g. most of the west in the pre-19th century era and Hong Kong in the 19th century.
- In the case of 19th century Hong Kong, only a few banks could issue notes (HSBC, Chartered, Mercantile). There were some legal entry barriers to the setting up of commercial banks. No central bank existed.

II. History of Monetary Regimes (2)

- **Free Banking**: basic characteristics include
  - – 1. Competitive note issue
  - – 2. Low legal barriers to entry
  - – 3. No central control of reserves
- There were some noted cases of free banking, e.g. Scotland before 1845 and the US in the pre-Civil War era.

II. History of Monetary Regimes (3)

- Efficiency and stability of the banking system was supposedly achieved through competition.
- Clearing house(s) or banking association(s) voluntarily developed to take care of matters of common concern.

II. History of Monetary Regimes (4)

- **Central Banking**: A “central bank” as a non-government institution emerged, e.g. the Bank of England. Set up as a private bank in 1694, it later evolved into a governmental institution (through the Bank of England Act of 1844).
- In some cases, a central bank was set up by the government, e.g. the US Fed in 1913.

II. History of Monetary Regimes (5)

- Most central banks in the west were formed from late 19th century onwards.
- Under central banking:
  - Note issue is typically monopolized.
  - Legal entry barriers are imposed on commercial banking.
  - Some reserve (deposit reserve or liquidity reserve) control mechanism is put in place.

II. History of Monetary Regimes (6)

- **Currency Boards**: In the 19th century, currency boards were established mostly in British colonies (first one in Mauritius in 1849). Cash (notes and coins) issued with 100% forex reserves.
- Commercial banks obtained (returned) cash from (to) the currency board by surrendering forex reserves at the fixed exchange rate. Strict monetary discipline supposedly prevailed.

II. History of Monetary Regimes (7)

- The strict discipline, plus the “automatic” adjustment mechanisms of specie-flow and cash arbitrage, guaranteed the convertibility and stability of the ***colonial*** currency**.**
- Specie flow: the flow of funds in response to interest rate movements.
- Cash arbitrage: riskless activity taking advantage of any gap between the official and the market exchange rates by moving cash.

II. History of Monetary Regimes (8)

- **The Gold Standard**: In the late 19th century, many countries adopted the gold standard, whereby a currency was assigned a gold parity.
- Relative gold parities implied different official exchange rates. Through arbitrage which involved the shipping of gold, the market exchange rates would converge to the parities.
- The gold standard was also intended to be an ***international*** monetary regime.

III. Dominant Modes Today (1)

- Now, free banking is practically non-existent.
- The gold standard was abandoned, last time in the 1930s because of competitive devaluations. Another reason was the lack of gold supply as reserves, which resulted in a very low elasticity of money supply.

III. Dominant Modes Today (2)

- Before its demise, the gold standard co-existed with central banks in some countries, e.g. Britain and the US.
- Currency boards reached its heyday in the 1940s, but fell out of favour later as many colonies became independent.
- Nearly all countries/economies now have a central bank.

III. Dominant Modes Today (3)

- Central banks also co-exist with about a dozen currency boards, e.g. Hong Kong and the AEL (Argentina, Estonia, and Lithuania) model.

IV. Lingering Debates

- Currency board purists accuse central banks with currency boards of violating auto-pilot principles (Steve Hanke and Kurt Schuler, web site: www.erols.com/kurrency).
- Others are trying to revive the concept of free banking after Hayek’s famous 1976 and 1978 articles (George Selgin, web site: www.arches.uga.edu/~selgin).

V. The Rationale of Central Bank (1)

- **Informational deficiencies** for bank customers under free banking:
  - – 1. On banks’ financial viability
  - – 2. On types of risk (specific versus general)
  - – 3. Concerning moral hazard
- **“Voluntary” centralized bank(s)/clearing house(s)** might solve these problems, e.g. Hong Kong before the HKMA.

V. The Rationale of Central Bank (2)

- But **serious problems** exist in “voluntary” centralized banks/clearing house(s)
  - 1. Conflict of interest among competitive banks
  - 2. Conflict between profit maximization and the need to maintain sufficient reserves necessary for the monetary regime
  - 3. Non-independence to act as an arbiter for the “club” of banks
  - 4. The free rider problem

V. The Rationale of Central Bank (3)

- Problems with **private insurance** to protect depositors: the avoidance of moral hazard requires regulation and intervention.
- The **support given by a central bank** to commercial banks is far greater than that available from “club” manager(s) to the “club” members.

V. The Rationale of Central Bank (4)

- A central bank needs to be a **non-profit making**, **non-competitive** institution with sufficient credibility and resource to perform its **two core functions**:
  - – 1. Preventing bank failures at the micro level;
  - – 2. Maintaining monetary stability at the macro level.

VI. Objectives and Functions of Central Bank (1)

- Objectives and functions of central banks are constantly evolving, in the light of changing circumstances.
- **Micro level**
  - **Banking supervision**: “mechanical” (ratio) approach versus “engaging” or “situationist” (Bank of England) approach that is based on understanding individual banking operation.

VI. Objectives and Functions of Central Bank (2)

- **Micro level**:
  - **Market infrastructure development**: in a world of rapid financial innovation, a balance has to be struck between facilitation and regulation, efficiency and stability.

VI. Objectives and Functions of Central Bank (3)

- **Macro level**:
  - **Monetary Management**: depends heavily on the the type of financial regime prevailing:
    - What are the objectives: inflation control? growth?
    - Floating exchange rate: monetary targeting
    - Fixed exchange rate:
      - Currency board arrangement
      - Gold standard
      - Forex control

VI. Objectives and Functions of Central Bank (4)

- **Macro level**:
  - **Reserves management**:
    - Managing forex reserves for the government
    - Hong Kong's peculiar situation: fiscal reserves transferred to the Exchange Fund and managed by the HKMA
  - **Banker to the Government**
    - Normal transactions
    - Covering deficits: out of the fashion (even in the Mainland)

VI. Objectives and Functions of Central Bank (5)

- **A case study**: ***deposit reserve requirement***. Two opposing views.
  - 1. Should be abolished: banks can take care of themselves, and at most a liquidity requirement will do. Example: Hong Kong.
  - 2. Should be raised to 100% (Milton Friedman): the money supply will be equal to the monetary base and under the perfect control of the central bank. No examples.

VI. Objectives and Functions of Central Bank (6)

- The first option (abolishing deposit reserve requirment) has been viewed more favourably in recent years. But for a currency board system like Hong Kong operating a fixed exchange rate regime, the lack of a sufficiently large reserve pool (in the RTGS) has been having serious liquidity and interest rate implications.

VI. Objectives and Functions of Central Bank (7)

- The second option is based on a mistrust of fractional-reserve banking: i.e., commercial banks' ability to create money through the multiplier effect. A 100% reserve requirement means that the multiplier is just one ("one in, one out"). In reality, such an option would only push money creation to the "unofficial" circuit, where control is more difficult.

VII. The Role (s) of Central Bank (1)

- Two dominant views on the role of the central bank: (1) Keynesianism; and (2) Monetarism.
- **Keynesianism**: the market economy shows some inherent instability, so the central bank needs to take care of multiple objectives: inflation, growth, cyclical fluctuations.

VII. The Role(s) of Central Bank (2)

- **Monetarism**: the market economy is inherently stable, hence the central bank should just concentrate on controlling the money supply (preferably following a constant supply rule) and thereby inflation.
- Both views have varying implications for the independence of the central bank.

VIII. The Independence and Accountability of Central Bank (1)

- Besides Keynesianism versus Monetarism, which concentrates on economic arguments, there is the a third political-economy dimension: **freedom from political pressure versus democracy**.
- **Keynesianism**: No firm judgment on the independence of the central bank. It depends on how well the central bank can perform its multiple tasks.

VIII. The Independence and Accountability of Central Bank (2)

- In reality, the co-ordination between monetary policy and other (e.g. fiscal or even income) policies implies a limit on central bank autonomy.
- **Monetarism**: in favour of central bank independence as interference by the treasury may undermine its effort to control the money supply: e.g. the lack of fiscal discipline on the part of the government.

VIII. The Independence and Accountability of Central Bank (3)

- However, the independence is matched by a very limited role for the central bank.
- **Freedom versus democracy**: Independence would give the central bank freedom from governmental/sectoral influence to increase the money supply (resulting in inflationary bias). Critics say that it is undemocratic to have monetary policy controlled by an elite responsible to no one.

VIII. The Independence and Accountability of Central Bank (4)

- The meaning of independence:
  - 1. The central bank can put into practice a monetary policy not approved by nor to the liking of the government or **other political force and interest groups**.
  - 2. The central bank can achieve its objectives without the help of action by other policy makers.
- The second meaning is more practical.

VIII. The Independence and Accountability of Central Bank (5)

- Independence is a complicated operational matter.
- For example, **the US Fed**: a system of checks and balances to maintain its "independence" from (a) the government and (b) vested interests in the banking sector. Both bottom-up and top-down appointment/election.

VIII. The Independence and Accountability of Central Bank (6)

- The Board of Governors (14 yr term) and the Chairman (4 yr term) appointed by the President with Senate's consent.
- Once appointed, the Governors and the Chairman can ignore the President's or the Congress's wishes because the latter have no legal rights to interfere.

VIII. The Independence and Accountability of Central Bank (7)

- The Federal Open Market Committee (FOMC) is the most powerful decision-making body in the Fed: 7 Governors from the Board and 5 representatives from the 12 Federal Reserve Banks.
- The Fed has huge resources: earning US$15 billion a year! It is also not subjected to the normal budgetting and auditing procedure.

VIII. The Independence and Accountability of Central Bank (8)

- There have been some congressional pressures to make the Fed more accountable: e.g. the House Concurrent Resolution 133 in 1975, requiring the Fed to announce targets for monetary growth; and the Balanced Growth Act of 1978 (the Humphrey-Hawkins Bill), requiring the Fed to explain how the targets are consistent with the President's economic plans.

VIII. The Independence and Accountability of Central Bank (9)

- **The Bank of England**: from private (1694) to public institution (1844). In the process, it was given monopoly powers (e.g... notes issue from 1844 onwards).
- Such a monopoly-conferring process undermined the “independence” of the Bank of England (BoE). It was “nationalized” in 1946 (Bank of England Act).

VIII. The Independence and Accountability of Central Bank (10)

- The Prime Minister “after consultation with the Chancellor of the Exchequer” appoints the Court of Directors including the Governor and Deputy Governor of the BoE.
- There have been efforts to enhance the “autonomy” and credibility of the BoE, especially under the Labour Government of Tony Blair, e.g. the establishment of the Monetary Policy Committee.

IX. The Future of Central Banks (1)

- The rationale for a central bank is so pervasive that central banking will be the norm for monetary control in many decades to come. Free banking is just a wild idea in a world of rapid financial innovation and huge and unpredictable capital flows.

IX. The Future of Central Banks (2)

- There is however strong pressure to render the operation of a central bank more transparent and accountable, with its role(s) clearly defined.
- There is also a case for better and more effective international monetary coordination: a World Central Bank?

X. The HKMA as a Central Bank

The HKMA as a central bank:

(1) No formal central banking legislation.

(2) Currency board system constraints.

(3) Small open economy constraints.

(4) Huge reserves.

(5) Political considerations.

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