THE POLITICAL ECONOMY OF CENTRAL BANKING IN THE DIGITAL AGE

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A CONCEPTION OF CENTRAL BANKING TODAY

- *Nature:* Pivot of the monetary-cum-credit system
- *Purpose*: Monetary system stability
- *Activities*: Twofold:
  - Changing state's consolidated b/sheet
  - Constraining private banking system's b/sheets
- *Problem*: Excessive power?

PIVOT OF MONEY-CREDIT SYSTEM

- Two types of central bank money:
  - Physical notes
  - Reserve accounts
  - Hence, a tiered monetary/payments system
- Three things taken for granted:
  - Private banking inevitably exists
  - The money and credit systems are inter-twined
  - The central bank is called into existence as liquidity reinsurer
- To ban central banking, or fractional-reserve banking?

PURPOSE OF THE MONETARY AUTHORITY

- Paul Volcker in 1990:
    - *“I insist that neither monetary policy nor the financial system will be well served if a central bank loses interest in, or influence over, the financial system”*
- Monetary-system stability:
    - Stability of central bank money in terms of goods and services
    - Stability of deposit money in terms of central bank money

MONEY-CREDIT CONSTITUTION

1) A target for inflation (or some other nominal varable)
2) Requirement for banking institutions to hold reserves (or assets exchangeable into reserves) that increases with riskiness and social significance
3) Liquidity-reinsurance facilities
4) Resolution regime
5) Constraints on central bank balance sheets

- (4) and (5) new relative to 19th century *MCC*

SCHEMATIC BANKING SYSTEM CONSTRAINTS

- X% of short-term liabilities (S) to be ‘covered’ by liquid assets, discounted to the value attributed to them by the central bank (d.LA)
- Where x =100%, there is full liquid assets cover for short-term liabilities.
- Residual assets ((1-d).LA plus assets ineligible at the central bank) to be funded in prescribed minimum proportions by common equity (K) and debt that can be converted into equity without disruption (B), plus any ‘uncovered’ short-term liabilities ((1-x).S).
- K and B higher, the riskier or lumpier the asset portfolio.

THE CHALLENGES FROM FINTECH

- Will CB Money remain final settlement asset?
- Will (and should) fractional-reserve banking continue?
- Might everyone bank with the central bank?
    - If not everyone, more intermediaries?
- Will the scope of prudential reg/sup widen?
    - Will its focus shift to cyber integrity?

A NEW PIVOT: THE CLEARING HOUSE

- Settlement in bundles of designated financial assets (*eligible instruments*)
- PvP and DvP succeeded by DvD
- Clearing house as:
  - Guarantor of deferred transactions
  - Gate-keeper to being a market maker
  - Minimum haircut and margin requirements, including macro-pru
  - Perhaps Market Maker of Last Resort
  - The new Pivot

STICKINESS OF FIAT MONEY

- Miles away from settlement in bundles of real assets
- Government underpins money via legal tender laws
- Government unlikely to give up seigniorage easily
- We (citizens) are unlikely to be comfortable with a private body issuing fiat money and so controlling the inflation tax

CENTRAL BANKING FINTECH

1) Central bank money stored in cards, i-phones etc
   - The new bank notes: big deal operationally, but not profound
2) E-central bank money
   - Debate has tended to be about negative rates etc, but
   - If means holding an account at central bank, very big deal because entails a banking relationship with the state

- Cannot see households being able to borrow directly from CB
- If so, a tiered payments/credit system continues

BEYOND BANKS AS WE KNOW THEM

- Charles Hawtrey a century ago:
  - *"Anyone who can borrow from the central bank can thereby procure legal tender money"*
- Corollaries:
  - Anyone who can procure legal tender can offer private monetary liabilities,
  - Anyone who can offer monetary liabilities should be regulated as a monetary institution.
- Applies to shadow banking: ie a normative truth already, affected by fintech only in potential breadth of application

BEYOND PRU-SUP: BACK TO PLUMBING

- Easy to take the deep infrastructure for granted. Eg:
  - Transferability of negotiable instruments
  - Dematerialisation of money-market instruments and securities
  - Finality of book-entry transfer

- Today:
  - Cyber laws and norms: eg ownership of money necessary for adjudication of property-right disputes
  - Proof against cyber wars: closing down payments and settlement systems

- *Central banks not as fiscal or regulatory operators, but as plumbers*

CONCLUSIONS-I

- Central bank money will survive as the final settlement asset
- As such central banks will remain the pivot
- But a role they could eventually share with central-counterparty clearing houses

CONCLUSIONS-II

- Fractional-reserve banking will continue, so the money and credit systems will remain inter-twined
  - But many more types of intermediary involved in payments services, clearing or liquidity-insurance might gain access to the central bank
  - If so, that should be recognised formally rather than stumbled into in the midst of crisis
  - Thus, regulation and oversight of private monetary institutions is likely to become broader

CONCLUSIONS-III

- Will continue to conduct financial operations that reshape the state's consolidated balance sheet
  - But more likely to find themselves acting as Market Makers of Last Resort
- Central banker as plumber is likely to be resurrected.
- Challenge is to minimise the scope and depth of their role, and to ensure that it enjoys wide public and political support.
  - Might be a bigger deal than technological change itself.