

CAN YOU STOP THE FIRE BEFORE IT BURNS DOWN THE BLOCK?

CENTRAL BANKS AND THE FISCAL COSTS OF FINAN- CIAL CRISES

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Updated: 2016/11/15
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WHAT WE THOUGHT ABOUT EMERGENCY LIQUIDITY ASSISTANCE

What is Emergency Liquidity Assistance?

Emergency Liquidity Assistance (ELA):

- discretionary provision of funds to financial institutions,
- (typically) against collateral,
- in response to acute need from distressed financial institutions.

What is the conventional economic wisdom on ELA?



Conventional wisdom provided by Thornton via Walter Bagehot. . .

What is the conventional economic wisdom on ELA?

*“to avert panic, central banks should **lend** early and freely (i.e. without limit), to **solvent** firms, against **good collateral**, and at **high rates**”*

(quote from Tucker 2009, emphasis added)

Consequences

The consequences of the Bagehot model are that:

- solvent banks survive, insolvent banks fail,
- the central bank is paid back, *no collateral is seized*.

In reality during a moment of acute stress:

- hard to know if a bank is fundamentally solvent,
- hard to know what is good collateral,
- strong political incentives to help banks regardless of solvency.

In reality, what comes after?

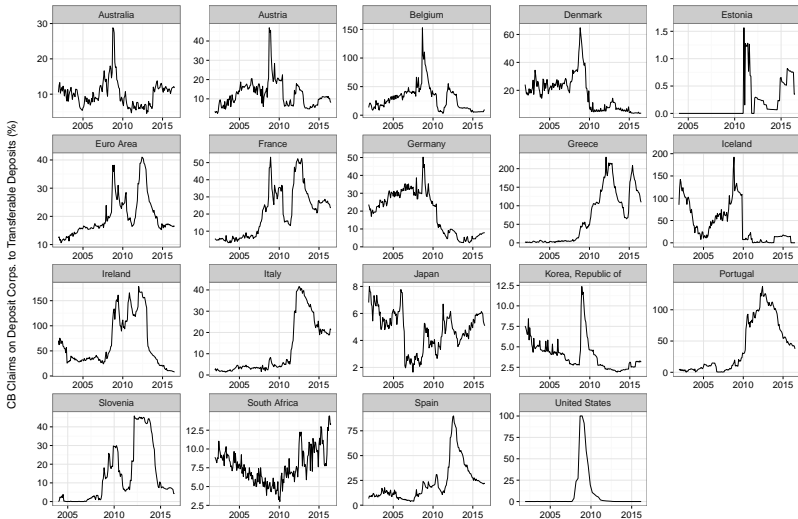
What are the likely **consequences of our ELA choices** given **political** realities?

Political realities?

The policy choice has largely been **ignored** by the political economy literature.

Some work has been done (Rosas, 2006; Gavin 2016), mostly focused on democracies vs. non-democracies

But...



OUR ARGUMENT: A POLITICAL ECONOMY MODEL OF ELA

Counter to Bagehot, we argue that :

Hypothesis:

- conditional on collateral requirements and the accounting regime,
- failed banks provided with ELA are resolved faster and so
- are less likely to become “zombie banks”.

What is a government finance accounting regime?

Government finance accounting regime:

The **rules** for determining and reporting the value/cost of public activities.

+

The **institutions** that make and implement these rules.

THE MODEL

The problem

A liquidity crisis—banks are unable to meet their liabilities and are about to fail.

Players/choices at time t_1

Players:

- central bank
- elected politician

Initial choices:

- emergency liquidity assistance,
- bank liability guarantee,
- some combination.

Policymakers want stability

The Central Bank and Elected Politician most prefer a banking system able to meet its liabilities—**not failing**.

Policymakers also want...

They *also* want (to varying degrees):

- To minimise the effect of their choices on *their respective balance sheets*.
- **Price stability**, which can be hurt by a weaker central bank balance sheet.

Key distinction for restructuring

Guarantees are unsecured.

ELA is secured by collateral.

Strategic use of collateral by banks

Even if public authority demands 'high quality' collateral, the banks often have **more information** → **disproportionately include non-performing loans** in the collateral pool.

Implication

If collateral is called, secured assistance (e.g. ELA) leads the government to **automatically** begin bank balance sheet **restructuring**.

What structures choices for secured vs. unsecured assistance?

Accounting regimes

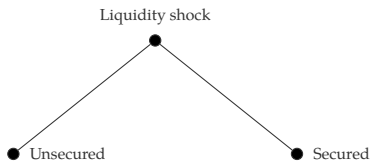
Accounting regimes structure **how attractive** unsecured assistance is relative to secured assistance.

Extremes:

- Unsecured guarantees may be treated as entirely off of the public balance sheet. **Or** they may be fully disclosed.
- Secured ELA may be treated as a 'financial transaction' and so have no net effect. **Or** it may be treated as an expense.

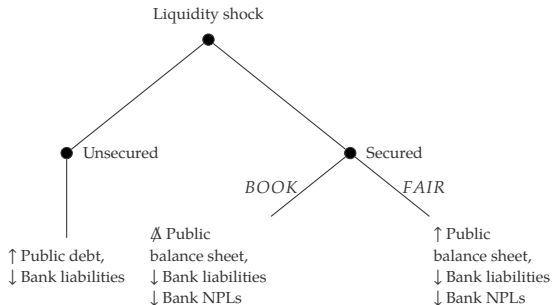
Policymakers choose the policy mix that **minimises their balance sheet impact**, while **maximising** their preferences for **financial and monetary policy stability**.

Simplified consolidated public choices t_1



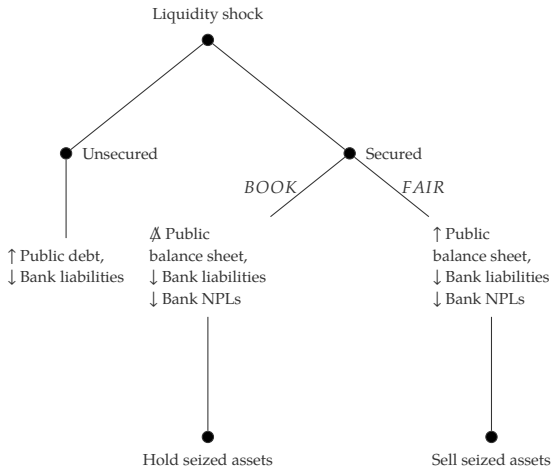
Choice influenced by what policy mix allows for the least public balance sheet impact.

Simplified consolidated consequences at t_2



Accounting rules specify whether seized assets are held at *BOOK* or *FAIR* value.

Simplified consolidated public choices t_3



CASE STUDY: AFRICAN BANK

Decision to assist the bank

African Bank's main creditors were systemically and politically important.

So, SARB and the National Treasury decided to assist/restructure African Bank.

Central Bank's balance sheet objective:

- Volatile EM currency + private shareholders → very concerned with limiting bank restructuring costs on its balance sheet.

National Treasury's balance sheet objective:

- Very concerned with avoiding policies that increased the deficit/debt–EM with ~ 35% foreign sovereign financing.

South African accounting regime

- SARB '**sterilizes**' assistance with debt issues to maintain monetary policy stability.
- SARB legally prohibited from providing ELA without high quality collateral. Needs National Treasury **guarantee** otherwise.
- **Subsidiaries** of SARB count against its balance sheet.
- **Cash accounting** → any cash assistance hits deficit/debt at full value, not allowed to treat as investment.
- Strong foreign investor pressure (and National Treasury pressure on SOE) to fully **declare guarantees** → fully reported annually.

South African **accounting rules strongly discouraged** both large guarantees to African Bank and emergency liquidity assistance.

A good/bad bank split minimised upfront need for public assistance.

SARB provided ELA to the bad bank (backed by a small National Treasury guarantee).

- Bad bank provided a guarantee to the good bank, not on SARB or National Treasury balance sheet.

SARB provided a 50% equity stake in the good bank. Does not appoint any board members → not on public balance sheet.

As of October 2016, the only public body to lose money was the Public Investment Corporation (manages government employees' pensions).

While fully owned and partially guaranteed by the Ministry of Finance, it **does not show up on the public budget**.

CONCLUSIONS

Since 2008/09 financial crisis, considerable academic and policy efforts have been made to create legal structures for effective bank assistance and resolution (e.g. EU's BRRD). Often built on Bagehot.

But almost no attention has been given to creating conditions where politicians have incentives to choose policies that:

- Limits public assumption of private risks
- Encourages rapid restructuring/avoiding “zombie banks”

Our work shows that the **government finance accounting regime** can be important for **creating these incentives**.