Central Banks,  
the Ultimate Safeguards against Depression

A cash crisis is the worst scenario for the banking system. Without the “last-resort lender”, without the ultimate support of a central bank that is able to guarantee savers’ deposits, this is the flight of capital from this weakened bank and from the entire system which restricts financial establishments from selling their assets to pay panicked depositors. An insidious spiral of falling asset prices occurs when banks come under pressure and attempt to recover cash to honor their commitments. This downward spiral is likely to reach the critical stage when banks need more than what is still carried as an asset on their balance sheet, and so a cash crisis turns into a solvency crisis. It is also at this point that depositors realize that their intuition and fear were after all justified… Such a rush would not, however, take place if a credible central bank guaranteed bank deposits and if these investors were confident of recovering their assets. Hence the crucial role – at least psychologically – of the central bank, guardian angel or last line of defense which assumes this vital role of purveyor of cash to the banking network. Did it not raise its interest rates in July 2008 during the subprime turmoil, i.e. a few weeks after Bear Stearns declared bankruptcy and a few weeks before Lehman’s own demise? Its mere presence in the background is to simply reassure and prevents banks from failing in a domino effect. This is a similar process that reaches the bond debt of a member country of a monetary union in case of a grave crisis. Fears about the solvency of a country (such as Greece) leads investors (markets, as they are generically referred to) to divest themselves of their Treasury bills of some other member nations of the union for fear of a cash crisis that would spread. Unless a solid central bank, worthy of this name intervenes to reassure investors who, after all, are only human beings! Without the determined presence – and determining – of a lender of the last resort, the cash crisis naturally degenerates into a solvency crisis, and the country in the spotlight then has to pay always more (interest) to persuade these investors to continue lending it. If the central bank is not on the radar, this country does not have any other cash source than that provided by the markets, which will make it pay dearly to fight without the benefit of support from a central bank. These hyperbolic financing costs contami-
nate the rest and soon enough, the other member nations of this union which assist will be powerless to withdraw cash from their Treasury bills and should in turn raise the stakes (interest rates) to continue to glean cash.

This escalade in financing costs obviously exerts perverse effects on the budget of the country and, in this regard, no country – not even Germany – is able to keep up with interest rates growing steadily on financing its public debt. Each country faces its breaking point at some stage – the one where servicing its debt leads it directly to insolvency. Except if a central bank – whose only presence has the effect of a scarecrow – lowers tension by several notches. Tension which, in reality, would not even have been raised to such extreme levels if this central bank had clearly shown its intention to support this country’s bond market. The European Central Bank would have been able to save Greece, Ireland, Spain and the European banking system from so much misery if it had only shown strong support and a willingness to provide these failing players with a cash injection. Because we must realize that this severe European crisis is only a game of cat and mouse that has turned out badly for a Europe that now threatens to sink from the mere fact of the absence of a lender of last resort. Investors seeking all naturally to preserve their assets in the bond debts of these member nations, the only vigorous affirmation on the part of the ECB showing its determination to flood these weakened countries with liquidity would have avoided such an escalation in the costs of debt financing and also banished the specter of the chain reaction bank failures. The slow pace of the ECB and the inertia of European leaders – unless it was their total ignorance of financial mechanisms? – were thus balanced by a devastating escalade in the debt charge of a number of European countries. Finally an indisputable surcharge for the ECB itself which, after much procrastination, is still committed to assisting the European banking system. “Lost battles are summed up in two words”, asserted General MacArthur, “… too late”. Indeed, the commitments of the important banks being clearly more massive than those of the states, it would have been less costly (for everyone) that the ECB support early states – crowned with popular legitimacy – than belatedly banks in private hands. Besides the symbolic, yet essential relief paid timely by the ECB to a European state. Does it not make sense that such assistance would otherwise be less onerous since the average public European debt vis-à-vis the GDP average of the Union is 80% when the debt of European banks is nearly 25% of GDP of the European Union? And the arguments according to which such bond purchases by the ECB would exacerbate inflation do not hold since, as Milton Friedman himself says however little suspected of collusion with Keynesian practices (as seen later), an argument of monetary mass does not systematically lead to inflation. On
the contrary, as Anna Schwartz and himself, in their monumental work titled “A Monetary History of the U.S.”, attribute the intensity of the Great Depression to the U.S. Federal Reserve at the time, having utterly failed to fulfill its duty as lender of last resort. Moreover, isn’t it Friedman in person to whom we owe the famous quip that encourages the monetary authorities of a country in deflation to drop bundles of banknotes, if necessary “by helicopter”? The guarantee and certainty of support by a central bank are certainly likely to encourage risk attitudes, even all kinds of abuses, among banks, financial players and even country leaders. Under its budgetary management, a government may indeed be tempted to go the route of public spending for purely demagogic reasons if it knows it is covered by cash from its central bank… However, a central bank that would not intervene on behalf of a state for fear of encouraging this “moral hazard” would be committing an unpardonable error. Moreover, why would you feel obliged to come to the assistance of private financial establishments – except to push them into the arms of risky behavior – and hesitate to support a state, and therefore populations? The obligation of a central bank is therefore to inject liquidity, whenever necessary, into both banks and countries, knowing that rules may be enacted in return for assisting states, as conditions are imposed on financial establishments drawing on public funds. Indeed, it is much healthier to make a clear separation between the intervention of a central bank (which responds to urgent needs of liquidity) and regulations for needy states and banks in peril. Thus there must be an organization designed specifically for this purpose upon which the monitoring the financial governance of European States (and their banks) should rest whereas the appeal for liquidity must be the only and singular preoccupation of their central bank, which must not in any way be incumbent upon moral considerations. Why would an approach similar to the one in effect for banks (which benefit from ECB support and which are accountable to a regulatory body) not be implemented for states? So it is the ECB which would assume its responsibilities of lender of last resort and great stabilizer of bond markets while a Pan European organization would be in charge of monitoring and regulating the issue of bonds of each member country.

Moreover, a number of orthodox experts assert that, if a state is forced to seek assistance when it is faced with a liquidity crisis, the central bank must abstain when the crisis becomes a solvency problem. The reasoning is the same for banks. However, how do you make a clear and unequivocal distinction between a liquidity crisis and that of solvency? If today – and rare are those who question it – Greece is de facto insolvent, are Spain and Ireland also insolvent or can their woes be simply attributed to liquidity problems? How would markets (basic, primitive, impulsive, short-term) be able to assess the financial situation
of a state – and therefore to lend at a more or less high rate – when our best economists are incapable of clearly diagnosing the creditworthiness of an European state against undeniable transparency yet replete with abundant economic statistics? In reality, a sovereign debt crisis affecting one or several member states of a monetary union is characterized by an inextricable mix of problems implying both their solvency and their immense difficulties in sourcing cash. While the cash crisis is translated into escalating financing costs for a State to conclude logically that a crisis is affecting its solvency, this State exacerbates its liquidity worries with a key intensification of threats on its insolvency. In practice, it is extremely complicated to distinguish whether a nation’s problems are linked to its solvency or its liquidity. A central bank must therefore be generous and not skimp on infusing cash with a view to restoring its liquidity to quash any inclination to see it as insolvent.

A central bank cannot thus afford to indulge in its cozy isolation, since it must constantly “do its job”, i.e. confront the ever changing or steadily deteriorating realities on the ground. And contrary to what Friedman claimed (which will be analyzed later), a central bank’s monetary policy should not be disconnected from the budgetary and fiscal realities of the countries or regions which are its responsibility. Although decisive, the definition of interest rates must not be the only reason why central banks exist, which, despite wanting to pass for elders and characters beyond the reach of political power, end up performing their measurement work of the business cycle mechanically. This shock, brutal but predictable, is forced to question the supposed independence or neutrality of central banks which is perceived – and rightly so – as goodwill vis-à-vis the financial markets. If at least one piece of evidence is revealed in favor of this crisis, it is that the central banker can no longer adorn itself with its well accommodating garb of independence vis-à-vis political power, since its acts are fundamentally and intrinsically clad with political connotations, and even its refusal to take action! That it prevents a financial institution going bankrupt or that, on the other hand, it does not lift its little finger to prevent another from collapsing. That it issues its caution in favor of commitments undertaken by such a sector of economic activity. That it fights hard against any inflationary pressure or, on the contrary, tolerates a certain degree of it, favoring or penalizing either the holders of Treasury bills or the debtors. A central banker, whose every decision is highly political – who is up to his neck in the ring –, cannot continue to pride himself on this independence which is only a myth. Moreover, as it is no longer plausible to leave such power in the hands of individuals not elected by the people, one of the major battles which to be delivered out of this crisis will lie in redefining the job of the central banker, his powers his duty of accountability and the possibility of removing him, if and when applicable. The
framework in effect since the 1990s until 2007 of low inflation and almost uninterrupted growth should not actually be misleading. If central bankers ascribe merit to it, they must in turn be responsible for the creation of multiple speculative bubbles, who poorly understood the risks of a sprawling financial sector and who completely missed out on monitoring and regulating gargantuan inequalities in cross-border and continental capital flows.

They seem as paralyzed by ideological prejudices according to which financial markets always end up regaining their stability and according to which international movements of capital generate an optimal distribution of wealth. Indeed, the overwhelming majority of our central bankers belong to the generation of economists blinded by the teachings of Milton Friedman, who espoused that the Great Depression and the speculative boom of the 1920s which preceded it had no correlation. Our monetary managers have indeed only contempt for economic unorthodox economic theories as difficult to equate. In this troubled and constant imbalanced world, the job of the central banker requires, however, continuous finesse and anticipation. That’s why; the lack of a true central bank worthy of this name, the actual European architecture irrevocably transforms solvent countries into insolvent countries. It is important to realize that its absolutist quest for a hardline orthodoxy led the ECB – and, as such, European economies – straight into the wall. Did it not raise its interest rates in July 2008 during the subprime turmoil, i.e. a few weeks after Bear Stearns declared bankruptcy and a few weeks before Lehman’s own demise? Did it not raise its rates twice – so unlikely – during the European tempest, in 2011? That is also why – to borrow from Martin Wolf – the ECB will be remembered as the “magnificently orthodox central bank of a failed currency union”.

When will we finally understand that the current European woes are in no way due to public debts? Why do orthodoxy, mainstream thinking, the overwhelming majority of economists and political leaders (who do not understand much), persist in considering this crisis as that of European “sovereign debts”? A little history is illuminating in this regard. And that it is regrettable for all of us that they do not look back to 1931 – tragic for all – from which to draw parallels and precious information for today… From the bankruptcy of the very large Austrian bank, Österiechishe Kredit Anstalt, over-exposed in East and Central Europe. On the History of France in this case because it is a French law in the early 1970s that would focus this financial orthodoxy – and write in stone the sacrosanct independence of the central bank – responsible for the current devastation of European Union! To the general financial instability of Europe under threat from currency implosion due to unpaid German reparations. On January 3, 1973 the new status of the
Banque de France were indeed adopted that would revolutionize the job of a central banker, turning it into a sort of “teflon” character – totally non-stick – not having to be accountable to the executive of the country or its citizens. To the U.S. intervention in the sense of debt restructuring for a Germany that was tied to a gold standard, yet one of the main reasons for the Great Depression. It’s actually to 1973 and to French law that we can trace the beginning of the irresponsibility of the central banks, particularly in its Article 25 which states that “the Treasury cannot be the nominator of its own effects at the discount of the Bank of France”. Only countries which abandon the first gold standards (Great Britain followed by the Scandinavian countries) are the first to pull themselves out of this terrible crisis without incurring too much damage. Therefore turning crucial in the management of public finances of Western nations which followed in the footsteps of France. The unexpected rise in U.S. interest rates in 1928 was certainly the first sign of this crisis. States being henceforth – and de facto – permanently at the mercy of the banking system, since their Treasury no longer had the right to borrow from its central bank. As well, the deflationary global calamity, linked to a global economic contraction, is rooted in the gold standard, particularly due to the attitude… of France, presented by a number of experts as mainly responsible for the intensification of the Great Depression! Historic step on the path to international financial liberalization, crossed and initiated by France, which now prohibited recourse to the printing of money of its central bank if needed. It is actually the substantial increase in France’s gold reserves (from 7 to 27% between 1927 and 1932!), which, in creating scarcity for this metal, would undoubtedly contribute to an enormous deflationary spiral for all developed nations at that time. A burning topical issue in the European context today! With deflation as the distinctive sign of the Great Depression, it could have been avoided if the central banks at that time (and the French one in the first place) had maintained their 1928 gold bearing ratios… Indeed, it is this frenetic accumulation of the yellow metal by eminent central banks which fueled global deflationary pressure. Moreover, the adoption of this law left nothing to chance at a time when France was headed by a former banker, namely Georges Pompidou. However, maintaining gold reserves at their levels prior to the Great Depression would not have altered the historical correlation between consumer and production pricing and the quantities of gold held by central banks. The dollar was no longer convertible into gold which was part of the decision of U.S. President Nixon in 1971 to suspend all purchases and sales of gold. It was Léon Blum, Prime Minister, who finally took France out of the gold standard in 1936, but the damage was done. And in an atmosphere of international financial stress where the U.S. hoped to prosper, illustrated by the famous repar-
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te of the Treasury Secretary John Connally at the time: “The dollar is our currency but your problem”! Isn’t the parallel obvious in today’s Europe where austerity is the new gold standard? In short, the collapse of the Bretton Woods system established in 1944 (under the influence of Keynes) ushered in a new era where the risks were expected to be borne by investors, now facing the vagaries of currency fluctuations. What a pity that policies are not a little like historians since the conjuncture of the 1930s strangely resemble our situation today, except that at that time it was only Germany which was in the same situation as peripheral Europe finds itself today. The abandonment of this convertibility also had a fundamental impact on the financial actors who obviously did not fail to seize the opportunities offered by speculation on the volatility of emerging market currencies. Entirely dependent on foreign capital, it had been steam rolled by unrealistic reparations stipulated in the Treaty of Versailles within a general framework of grossly under-capitalized national banks. Deregulation and liberalization of the financial sector was therefore the essential prerequisite that would allow its players to take advantage of these new market fluctuations. Indeed, this is the whole problem relative to the reparations imposed on Germany, and their disastrous consequences, which have today been removed from the debate to make room for deficit obsession. It is in this environment from which emerged the concept of central banks independence whose objective was to sterilize monetary policy. The ardent defenders of austerity actually impose an absolute diktat on the media, opinions, public policy and academia by imbuing a climate of disaster where only hyperinflationary trauma seems worthy of interest. And to avoid any interference from politicians too often inclined to use it for economic recovery, at the risk of fueling inflation. It is as if the disaster from the reparations imposed on Germany had been waned before the imaginary disease of deficits. Is it because Germans are perfectly aware of the multiple Treaties of Versailles that they dictate today to Greece, Spain, Portugal and other nations forced to pay much more than their abilities and means allow? It turned into a sort of cardinal – or gray eminence – immured in a permanent conclave and quick to distil the black smoke to prevent any attempt to monetize its debt by the executive of its country. Indeed, this is violent and unprecedented austerity that Germany had to implement at the beginning of the 1930s in favor of the drying up its international funding, which resulted in an unemployment rate that at one time was higher than 35% France – which at that time was the Germany of today – was doing well. Here is the central banker – reporting to no one – who therefore had the power to sanction vis-à-vis the elected. It was one of the most prosperous and solid economies in the world at that time. As a result, monetary policy – i.e., the crucial definition of interest rates – was becoming passive. It was content to pass on
and echo the wishes and dictates of high finance. In a position to transform itself into a financial engine for the rest of Europe from the end of the 1920s and beginning of the 1930s, instead, France preferred to withdraw behind a wall of selfishness by refusing to adopt a conciliatory and expansionist monetary and economic policy, opting instead to ignore the plight of its neighbors. This French law of 1973 was subsequently repealed... only to be replaced in 1992 by the Treaty of Maastricht and in 2009 by that of Lisbon jealously defending the same orthodoxy. The financial collapse of Europe owes a lot to this navel gazing by France at that time. Namely to prevent any overdraft facility or credit granted by the European Central Bank to governments, regions or local communities members of the Union. Just as the peripheral European nations can today, with reason, blame German intransigence for their intolerable end that they reached. As our states could no longer call on their central bank to finance their accounts and public spending should they needed to, therefore we have all become dependent on the commercial banking system which, itself, was indeed able to create liquidity privately from nothing to lend to our states through interests. From what remains, France could not escape this crisis which had rudely contaminated it since 1932. Practice initiated in 1973 by France but almost everywhere since an IMF study actually reveals that two-thirds of the 152 central banks around the globe restrict considerably – when they do not prevent a short – all ready or make central banks available to their government. How is it that we fail to recognize that the France of so many years ago is today’s Germany, mired in missteps and which revels in mistakes that it will end up by paying – it also – a heavy price? On behalf of the venerable and untouchable “price stability”. Since if there is one country which, amongst all, is worried about retaining the teachings of the past, that country is Germany. So, in defiance of macroeconomic stability. why do we accord so much importance to the 1923 hyperinflation when we should instead be deeply concerned about avoiding 1933, the year which saw the extinction of democracy? And too bad if the cost of financing their debt by our states attain untenable sums, and for public finances, growth and the purchasing power of the citizen... This essential German shift will, however only see the light when this country recognizes its financial debt toward the European Union that it will clearly never leave. In an environment of absolute European depression weathered with the collapse in tax revenues, shrinking welfare and soaring unemployment. Since such a possibility would immediately translate into a strengthening of the rediscovered national currency – the Deutsche Mark – and an inevitable deterioration of the standard of living of its citizens in favor of a dramatic decrease in its exports. With states to finance their lifestyle – so we did! Indeed it is the advent of the single currency which allowed Germany to more than
double its exports from 469 billion Euros in 1999 to more than one trillion Euros in 2010, during which its economy grew twice faster than the European average during the same period. This impressive rise in German exports is undoubtedly inseparable from the quality of its manufactured products. Simply because it is impossible for us to be financed by our central bankers who wrap themselves in their robes of independence. There remains no doubt that its competitiveness was undeniably favored by a relatively weak currency. Independence which in reality is only a smoke screen intended to mask their allegiance to the banking system. So this country benefits on several levels from the woes of hyper weak nations of the EU.