



Linking financial soundness and independence of central banks—Central and Eastern Europe, Turkey and CIS countries

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Abstract

Two prominent cases of quasi-fiscal operations, sterilized interventions and the accumulation of junk assets due to indirect financing of the government, can impair the financial soundness of central banks and thereby also independence. This is analyzed for selected central banks in Central and Eastern Europe and the CIS countries and for Turkey. The article concludes that sterilization costs tend to be more important in new EU member countries, whereas junk assets play a more vital role on central banks' balance sheet in Turkey and in some CIS countries.

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1. Introduction

Central banks regularly publish financial statements, in particular balance sheets and income statements. While financial statements generally serve as a means by which management accounts for its financial performance, the main objective of central banks is not to maximize profits but to accomplish public goals such as price stability. However, because financial statements of central banks give information on their financial soundness, they can also provide information

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on independence. The availability of own financial resources enables the central bank to perform its tasks and a recapitalization typically leads to protracted and often convoluted negotiations between central banks and national treasuries. A growing literature has taken account of these weaknesses to central banks' balance sheets, recently for example several contributions to the *Bank for International Settlement* (2003), Bindseil et al. (2004), Gros (2004), Ize (2005) or Stella (2003). Avoiding losses and, ultimately, a recapitalization by the government is indispensable for central bank independence. A dramatic example of recapitalizing a central bank occurred in the Philippines in 1992, when a new central bank was established in order to have a clean start after the previous one had incurred large bad debts. Stella (1997, 2002) and Dalton and Dziobek (2005) analyse more cases of central banks in emerging market countries, which made chronic losses or even needed to be recapitalized and Vaez-Zadeh (1991) discusses the implications.

Quasi-fiscal operations are important factors impairing the financial soundness of a central bank. In this article, the analysis of quasi-fiscal operations of central banks concentrates on two prominent cases, (1) the accumulation of junk assets due to indirect government financing and (2) sterilized interventions in foreign exchange markets (Hawkins, 2003).

Junk assets are here defined as assets that bear substantial credit risk because the central bank regards repayment and/or interest service as doubtful. Usually these assets bear a rate of return below market rate or even below the current inflation rate and occasionally central banks have already deducted provisions. Accumulating junk assets often takes place due to the participation in restructuring the financial system. It is a form of indirect financing of the government, because without the support of the central bank, the government would have to show these costs in its budget and eventually in the level of public debt. Other channels of indirect government financing are rescheduled government debt or classified loans to state-related banks or enterprises. Because the accumulation of junk assets signals indirect financing of the government, it also carries information on the degree of central bank independence from public sector financing, even though direct central bank lending is often formally prohibited or seriously restricted according to central bank statutes. Sometimes, the accumulation of junk assets has originated from periods in which the central bank has had a lower degree of statutory independence or in which financial crises forced the central bank in its role as a lender of last resort. However, a truly independent central bank should be able to gradually decrease the amount of junk assets. If it is not able to do so, it can signal a lack of bargaining power of the central bank in negotiations with the national treasuries.

Sterilization costs, as defined by MacKenzie and Stella (1996), arise from operations to sterilize capital inflows by using open market operations and other market-based monetary instruments. If central banks are confronted with high capital inflows and are unwilling to permit either an exchange rate appreciation or an induced and possibly inflationary increase in base money, they will engage in sterilized interventions. Thus, sterilized interventions signal the desire to pursue two goals at the same time, an exchange rate target and internal price stability. A (hidden) conflict between the central bank and the government can lie behind the desire to pursue these two goals, if the central bank is primarily responsible for internal price stability and the government is interested in a particular exchange rate policy in order to protect some groups or sectors of the economy.

Sterilization through such market-based means as the sale of a government or central bank security has a direct fiscal cost, the difference between the interest cost paid by the central bank and the interest earned on the foreign assets acquired with the foreign exchange purchased. Central bank losses from this source also reflect the trend to indirect rather than direct methods of monetary policy. MacKenzie and Stella (1996) furthermore argue, that sterilization operations bear additional, though less transparent, indirect fiscal costs, because they can be seen as altering

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