

- How to separate banks from states

How can we govern

Europe?

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The feedback loop between banks and sovereigns

- States need banks as a funding source
- Banks need states as providers for catastrophe insurance
- In EMU, both states and banks need the ECB as lender of last resort
- The ECB's role as ~~ultimate backstop~~ for EMU is controversial

Three steps to break the loop

- Step 1: Define as safe asset deposits fully backed by central bank reserves
- Step 2: Create a hierarchy of loss-absorbing bank liabilities
- Step 3: Divest banks from governments and treat government debt as „credit“

Creation of a safe deposit: Starting point

Bank and Central Bank today

Bank

Assets	Liabilities
99 K	99 ID
1 MR	1 ZBC
100	100

Central
Bank

Assets	Liabilities
1 ZBC	1 MR
1	1

K = Bank Credit; ID = Investor Deposit + EQ; MR = Minimum Reserve; ZBC = Central Bank Credit

(1) Separation of Bank in credit- and payments department

Bank	
Assets	Liabilities
Credit department	
99 K	99 ID
1 MR	1 ZBC
Payments department	
0	0
100	100

Central Bank	
Assets	Liabilities
1 ZBC	1 MR
1	1

K = Bank Credit; ID = Investor Deposit + EQ; MR = Minimum Reserve; ZBC = Central Bank Credit

(2) Creation of excess reserves

Bank		Central Bank	
Assets	Liabilities	Assets	Liabilities
Credit department			
99 K	99 ID	1 ZBC	1 MR
1 MR	1 ZBC	9 ZBC	9 ÜR
9ÜR	9 ZBC	10	10
Payments department			
0	0		
109	109		

K = Bank Credit; ID = Investor Deposit + EQ; MR = Minimum Reserve; ZBC = Central Bank Credit

(3) Creation of the safe deposit

Bank		Central Bank	
Assets	Liabilities	Assets	Liabilities
Credit department			
99 K	90 ID	1 ZBC	1 MR
1 MR	1 ZBC	9 ZBC	9 ÜR
0	9 ZBC		
Payments department			
9 ÜR	9 SD		
109	109	10	10

K = Bank Credit; ID = Investor Deposit + EQ; MR = Minimum Reserve; ZBC = Central Bank Credit

(4) Separation of states and banks

Bank		Central Bank	
Assets	Liabilities	Assets	Liabilities
Credit department		1 ZBC	1 MR
94 K (-5 GB)	90 ID	9 ZBC	9 ÜR
1 MR	1 ZBC	5 GB (+5)	5 ÜR (+5)
5 ÜR (+5)	9 ZBC	15	15
Payments department			
9 ÜR	9 SD		
109	109		

K = Bank Credit; ID = Investor Deposit + EQ; MR = Minimum Reserve; ZBC = Central Bank Credit; ÜR = Excess Reserve; GB = Government Bonds

(5) Redemption of government debt

Bank		Central Bank	
Assets	Liabilities	Assets	Liabilities
Credit department			
94 K (-5 GB)	90 ID	1 ZBC	1 MR
1 MR	1 ZBC	9 ZBC	9 ÜR
5 ÜR (+5)	9 ZBC	5 GB (+5)	5 ÜR (+5)
<hr/>		<hr/>	
Payments department		15	15
9 ÜR	9 SD		
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109	109		

Position disappears with repayment of bonds

K = Bank Credit; ID = Investor Deposit + EQ; MR = Minimum Reserve; ZBC = Central Bank Credit; ÜR = Excess Reserve; GB = Government Bonds

Consequences of the separation

- **Common deposit insurance:** The safe deposit is fully covered with reserves held at central bank
- **Straightforward bank resolution:** Payments department of the bank is safe, even when credit department defaults
- **Public debt redemption:** Government bonds disappear from central bank balance sheet when they are redeemed

Thanks