Investor Feature - ABC of Economic Literacy: 'B' is for banking

The New Zealand Initiative | 12 March 2014

It is a wonderful convenience to be able to buy almost anything we want, offering nothing in exchange but flimsy paper or an electronic claim on our bank account. We experience this convenience every time we go to the supermarket and pay by cash, ATM or credit card.

The entire system depends on the seller's confidence that the means of payment being offered is of real value. Counterfeit cash or fraudulent ATM or credit card transactions potentially undermine every honest person's ability to transact.

For most of human history, confidence has been greatest in coins made of gold and silver. Ancient rulers who secretly debased their coins cheated their people and eroded that confidence.

Today, we transact in a world of monopoly government paper money, backed only by trust in government. Like the rulers of old, today's governments can cheat their people by creating unanticipated inflation through issuing too much paper money.

The diverse interest rates paid on borrowings by banks and governments illustrate how confidence varies in the value of each issuer's promise to pay future interest and principal. Higher interest rates mean higher risk.

The modern, government-controlled central bank is banker to the major commercial banks. It accepts their deposits (which count as banking system reserves) and may lend them money or buy some of their assets when they need more cash. The perceived soundness of a commercial bank depends, in part, on its perceived central bank support.

The soundness of a commercial bank also depends on the quality of its loans, the degree to which it matches deposit and lending risks, the level and quality of its reserves, and the financial strength of its major shareholders.

In contrast, the soundness of a central bank is dominated by the government's ability to inject more taxpayer money into it when needed.

Governments may oblige central banks to lend unwisely, perhaps by forcing them to fund government deficits, or perhaps to support institutions that have made bad loans in a politically worthy cause, such as housing loans to uncreditworthy borrowers. Such situations can easily induce booms and crashes, banking crises and prolonged unemployment.

These roles and pressures place heavy responsibilities on central bankers. They stand at the apex of the confidence pyramid and play a pivotal role, for better or for worse, during any general banking crisis.

Central banking has mystique, but no magic wand. It cannot insulate the public from the consequences of collective fiscal and financial follies.

The New Zealand Initiative is a Wellington-based think tank formed by the merger of The New Zealand Business Roundtable and The New Zealand Institute. www.nzinitiative.org.nz. CEO Dr Hartwich is a regular speaker at PortfolioConstruction Forum programs.