# FINANCIAL ACCOUNTING FOR CENTRAL BANKS:

# WITH SPECIAL REFERENCE TO CARICOM

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## Introduction

In an earlier Paper, "Towards a Theory of Central Bank Management - With Special Reference to the Caribbean", I grappled with the problem faced by Central Bank Management in measuring the performance of the institution. I attributed this to the fundamental problem that, whereas the inputs into the Central Bank's operations were costed by the market, i.e. wages, supplies, services, etc., its outputs of advice to Government and information and other services to the public, for which it received no fees, were for the most part not costed by the market. This situation derives from the unique function of a central bank in the economy.

The managerial approach which I suggested was to disaggregate the activities of the Central Bank according to classes of clientele, e.g. Government, and according to functions, e.g. exchange control, bank supervision, etc., and then develop appropriate measures of performance for each activity. I acknowledged the difficulty of designing any measure of central bank performance, but I insisted that Management would have to do its best to obtain some indication of how well or badly it was doing.

I observed along the way that "profits" represented a most unsatisfactory overall measure of performance for central banks. For example, I have no reason to believe that the $30 million profit of the

Central Bank of Barbados in 1992 represented a superior performance than the $4 million loss in 1989.

It also occurred to me that profit was not only a misleading measure of performance in the case of central banks, but frequently a perverse one. A central bank might very well record splendid profits when its operations actually contributed to dysfunction in the economy, but report a loss when it did contribute to superior economic results. For example, there is little doubt that by financing two/thirds of the record Government deficit in 1990, the Central Bank of Barbados contributed much more to the economic malfunctioning of the national economy than it did in the year before; yet it earned $4 million in profit in 1990, $8 million more than in 1989.

Even if, for various reasons, the central bank's financial records provide an imperfect measure of managerial performance, they should certainly provide the public with some meaningful index of the central bank's relative contribution to real economic progress, whether positive or negative. At least, the more egregious distortions produced by current accounting conventions might be mitigated, even if not eliminated. This Paper represents a first attempt to do so.

Section 11 clears away the confusion surrounding the issues of the measurement of central bank performance. Section 111 explores the phenomenon of seignorage, a concept which lies at the heart of central bank financial operations. Section 1V explains the potential contribution of central banks, whether positive or negative, to the growth of the real economy. Section V offers a critique of the

monetary arrangements of central banks within CARICOM, especially in regard to their financial operations. The final section suggests changes in financial reporting designed to provide a more accurate picture of the central bank's contribution to the real economy.

SECTION 11

## Issues of the Measurement of Central Bank Performance

This Paper makes the point that the financial reports of central banks should provide a more realistic idea of their contribution to real economic output/decline. Such an index might or might not measure the performance of the Management, depending on the degree of independence from Government which the central bank enjoys. This is an issue which Professor Compton Bourne thoroughly obfuscates in his Paper, "Performance Evaluation and Accountability of Central Banks", delivered to this Conference last year. He writes, "Performance accountability of central banks is closely related to but not identical to the question of central bank independence from the political system."

In fact, an individual or institution can only be held accountable for its performance if it has the legal authority and the means to carry out the functions assigned to it. In the case of the Federal Republic of Germany, we may conclude with considerable justification that the low level of inflation prevailing in that country since World War 11 is a positive index of the Bundesbank's performance. The Act establishing the Bundesbank unequivocally charges it with the responsibility of price stability and empowers it to implement monetary policies independently of the Administration, and on occasion policies opposed to those of the Administration, if that is necessary to fulfill its statutory responsibilities.

After his introductory remark that Caricom central banks "are subject only to the authority of the political directorate to whom they are legally answerable and from whom they may receive directives", Professor Bourne continues: "The reality, as distinct from the constitutional formality, of political control and accountability is the subject of this paper." Accountability is a legal concept, and if Caricom central banks behave as if they are not accountable to the political directorate, that reflects poorly on the political directorate. In fact, the frequency with which Caricom central bank directors and governors are removed or hounded from office when Administrations change, does not suggest the absence of political control. It does suggest, however, that central banks are held accountable for political rather than technical ends.

In opposing central bank "independence" Professor Bourne shows how captive he is to the British concept of parliamentary democracy which supports the tyranny of the Cabinet. A republican regime deliberately embodies checks and balances. "Government" and the Cabinet are not synonymous, and it is quite normal for different elements of "Government" to pursue fundamentally different objectives, a situation which Dr. Bourne finds unacceptable. That the Bundesbank has sometimes found itself in conflict with the Chancellor does not make Germany any less democratic than Guyana or Jamaica, where the Central Bank has operated mostly as a money printing machine for the Minister of Finance. My own preference is for central bank

independence within a democratically determined political system which limits the power of the Administration to destroy the economy through central bank financed fiscal deficits.

Increasingly, enlightened Administrations in countries as varied as Chile, South Africa and New Zealand (and soon France) have taken steps to free their central banks from the political direction of the Ministry of Finance, and to make them statutorily accountable for price stability, which is made the unequivocal measure of their performance. In the absence of such action within CARICOM, we have to develop financial conventions which at least indicate whether central banks are contributing positively or negatively to real economic output.

## SECTION 111

## The Phenomenon of Seignorage

Seignorage may be defined as the rent earned from the right to issue currency. The means of realization of such rent depends on the monetary regime in operation. There are two basic types of monetary regimes, (1) commodity money and, (2) symbolic money. In the first case the intrinsic value of the circulated currency is equal to its face value; in the second instance the intrinsic value of the circulated currency bears no relation to its exchange value.

It was notorious in the era of gold and silver coinage that the King would clip the coinage and reissue the clipped coins at their original face value. The proceeds from clippage would be melted down to mint new coins. It was only after 1660 that the edges of English coins were embossed so that any filing down was plainly visible.

The move to symbolic money began when it was realized that the public was quite indifferent to the state of the coinage as long as there was price stability. However, if the King overdid the clippage, growth of the money supply would exceed the increase in national output, leading to inflation. This would lead the public to lose confidence in the domestic currency.

Excessive clippage would also lead to currency devaluation. Whereas the locals might be tolerant of the circulation of clipped coinage, foreign merchants always insisted on "true" coinage. With moderate clippage, the local merchants could always hoard enough true

coinage to meet their external liabilities. When they were forced to pay with clipped coins, the sophisticated foreigners would demand an increased coinage of an increased face value to compensate for the reduced intrinsic value of the clipped coins.

A Currency Board's currency issue is analogous to commodity money in that it is convertible for hard currency on demand. The Currency Board earns its seignorage from the interest earned on the foreign securities which "back" the issue - after the operational expenses are covered. The Currency Board usually maintains foreign investments in excess of its domestic liabilities to serve as a cushion against the vagaries of the international capital market.

With the Currency Board system the money supply is a direct function of the trade balance and foreign capital flows, and the foreign payments problem is eliminated. There is still some scope for domestic inflation, via the increase of money velocity, or through the credit creation process of the commercial banking system. However, the balance of payments effects are self-limiting, as the draw-down of foreign exchange reserves to purchase imports leads automatically to a contraction of the money supply and a consequent reduction in the demand for imports.

Most modern economies use symbolic money. The advantage of symbolic money is that it does not involve the sacrifice of real commodities or foreign assets for its "backing". Another advantage is its flexibility; its supply can easily be expanded or contracted to the desired level through the operations of the Central Bank. The

inflexibility of commodity money was a serious drawback, so that the expansion of the money supply, and hence the growth of the economy, depended heavily on imports of bullion and ultimately on the discovery of new lodes of gold and silver. The integrity of symbolic money depends on the appropriate balancing of its supply and demand. Its over-supply leads to inflation with its consequent economic pathologies. (We might also observe that its undersupply might lead to falling prices, recession and even depression, as in the 1930s.)

Countries whose currencies are "hard" currencies settle their foreign deficits through the purchase of other foreign currencies on the international foreign exchange markets. Equilibrium in the collective foreign exchange markets is brought about by changes in the relative external values of various traded currencies. Countries with "soft" currencies, like those in CARICOM, utilize a mixture of symbolic and commodity currency, and must maintain stocks of commodity money (gold or foreign exchange assets) to settle their external debt. This is because their own foreign exchange markets are too thin and shallow to "play" in the international "big league". It is not surprising that attempts to float Caricom currencies have usually led to rapid and disruptive currency depreciation.

The Gold Standard and its successor, the Gold and Dollar Standard, were hybrids of the commodity and symbolic monetary systems. Under the pure Gold Standard, the national currency was theoretically redeemable in gold. However, this did not necessitate a 100 per cent backing of gold bullion, since all the currency notes and coins in

circulation could hardly be tendered simultaneously at the Central Bank. Indeed, in times of crisis, the commitment to redeem currency for gold might be temporarily suspended. Under the Gold and Dollar Standard (The Bretton Woods Agreement) the national currency became entirely symbolic, in that nationals could not redeem their local currency for gold, while net foreign deficits were settled between central banks in gold or acceptable "hard" currency. The need to settle in gold or hard currency imposed a discipline on monetary authorities and motivated them to keep a tight rein on the growth of their money supply, since the consequence of delinquency was a "shameful" devaluation of the national currency.

In a monetary regime using symbolic currency, seignorage is earned by the Central Bank when it lends new money to Government or the commercial banking system or, indeed, when it purchases goods and services for its own use. Typically the operating expenses of a central bank are so small that they constitute a negligible portion of the available seignorage. The same cannot be said for fiscal deficits which, if financed by the central bank, could threaten the integrity of the national currency. But, there is a point at which seignorage ceases to be a harmless source of income, and becomes an agent of inflation and currency depreciation, setting off a downward spiral of economic decline.

SECTION IV

Effects of Money Creation in Developed and Underdeveloped Countries

One of Sir Arthur Lewis' most important insights was the distinction he drew between developed and underdeveloped countries:- developed countries possess unlimited supplies of capital; underdeveloped countries have unlimited supplies of labour. In the current intellectual climate where the same free market model fits all countries, this distinction is frequently disregarded by policy makers with baleful consequences for their clientele. Another egregious error of policymakers in developing countries is the application of the Keynesian closed model to their typically highly open economies. These two distinctions have important implications for policies of money creation in these respective types of economies.

In the Keynesian-type closed economy with unlimited supplies of capital, recessionary conditions reflect the idleness of already installed capital accompanied by high unemployment. This unemployment reflects the deficiency of aggregate demand in the economy, so that the creation of new money to fund government expenditures serves to expand aggregate demand and so bring idle resources of capital and labour back into use. In these circumstances money creation by the central bank contributes to the expansion of real output. However, since supplies of capital are unlimited, it is the full employment of labour which is first achieved, and continued expansion of aggregate demand creates inflationary pressures and, in time, balance of payments

disequilibrium, as both consumers and capitalists are forced to import goods and services which the fully employed labour force can no longer produce. This explains the propensity of industrial countries to import labour in the upswig of the business cycle.

In the case of developing countries, the creation of new money by the Central Bank to fund government expenditures quickly brings all idle capital into use long before a dent is made in the unlimited supplies of labour. This is why Sir Arthur Lewis recommended the importation of foreign capital and technology to exploit the idle or underemployed labour from the traditional sector. The alternative model, employed by the Soviets and Japanese during their early development, required the ruthless extraction of savings from the peasant class to finance imports of physical capital and technology. Failure to appreciate the inelasticity of real savings in LDCs, has led international financial institutions to impose McKinnon's high real interest rate policies on some Caricom States in a futile attempt to bring non-existent capital into play. Such policies have led to the bankruptcy of several small businesses, but have brought about only negligible increases in real savings. We should note that financial capital (savings) are not the same thing as capital (savings).

Once the limits of production imposed by the sparse supply of capital are reached in developing countries, excess purchasing power generated by money creation can only be satisfied through imports. This process is halted only by the exhaustion of the nation's foreign

exchange reserves and the drying up of its credit and foreign aid sources. The chronic shortage of foreign exchange precipitates economic collapse, as the cases of Guyana and Jamaica so vividly demonstrate.

If a central bank's operations lead to economic decline and dysfunction, its operations can in no useful sense be termed "profitable". Indeed, except for buildings, equipment and meagre holdings of foreign exchange, the assets listed in the balance sheets of the Banks of Guyana and Jamaica, comprised primarily of a vast volume of non-marketable securities, may properly be described as fictitious. The Auditors may confirm the arithmetic of their financial reports as correct; they should not represent their accounts as being a "true and fair" record of their operations.

The balance sheets of the Banks of Jamaica and Guyana are to be contrasted with that of the Eastern Caribbean Central Bank, whose assets are primarily comprised of foreign balances and securities, all realizable in the international market place. The Bank's holdings of treasury bills are relatively small and liquid, and its holdings of long-term government securities limited. Seignorage is earned primarily through returns on the foreign assets which "back" the currency and ensure that the Bank's liabilities are readily exchangeable for foreign exchange.

Utilizing the well-founded accounting principle of conservatism, we may distinguish between the "real" and "nominal" transactions of central banks. The criterion is whether or not the

financial operations represent values realizable in the capital or money markets. According to this criterion, the accounts of the ECCB would overwhelmingly represent realizable values, while those of the Banks of Jamaica and Guyana would not. In the case of the Central Banks of Barbados and Trinidad and Tobago, the accountants would have to sort the chaff from the wheat.

SECTION V

Critique of Monetary Arrangements in CARICOM

At the root of the current monetary disarray within CARICOM is the failure to recognize the limits of seignorage; or, put another way, to recognize that you can only clip the coinage so many times before public confidence in the currency is lost.

The governments of Guyana and Jamaica have resorted heavily to central bank credit for the financing of their fiscal deficits. In Barbados episodes of excessive money creation have been restricted to pre-election budgets. The consequent abasement of the Guyanese and Jamaican dollar has extinguished the usefulness of those currencies as "units of account" and "stores of value". They remain media of transactions only through the force of law.

Secondly, most Caricom governments overlook the critical importance of adequa foreign exchange reserves in the context of small and open underdeveloped economies. It is the level of foreign exchange holdings which determine the limit to which seignorage can be extracted. Once the banking system and, ultimately, the Central Bank are unable to meet the public demand for foreign exchange, public confidence in the domestic currency is lost, and once lost, this confidence is very hard to restore. Both the Guyanese and Jamaican currencies have suffered this fate.

Thirdly, misguided by the free market ideology of the World Bank, IMF and IDB, some Caricom States have set off in search of the holy grail of the "equilibrium exchange rate". The monetary instability created by exchange rate fluctuations makes measurement of the financial operations of central banks even more difficult. In fact, no Caricom country possesses foreign exchange markets with the depth and breadth to sustain a floating exchange rate regime. Furthermore, as I have explained in the First Adlith Brown Memorial Lecture, once foreign exchange markets have collapsed, as they did in Guyana and Jamaica, the equilibrium value of the exchange rate becomes indeterminate.

Commenting on the case of the industrialized nations, Professor Peter Kenen has this to say:

> Exchange rates should be managed, not left completely to market forces, but informal arrangements such as those exemplified by the Plaza and Louvre agreements may not suffice. To manage exchange rates effectively over the long term, it may be necessary to manage them systematically, not periodically, and thus to devise a pegged rate system resembling the EMS.

What makes the governments of tiny countries like Trinidad and Tobago or Jamaica believe that they can go it alone?

Fourth, central banks themselves have failed to distinguish in their financial reporting between real and nominal transactions, and have thus contributed to further economic dysfunction. Indeed, the balance sheets of some Caricom central banks read like a fairy tale. This is especially so in respect of recognition of income and the reporting and distribution of profits.

In some cases Caricom central banks purchase vast quantities of government paper to fund runaway fiscal deficits which, far from expanding real output, sets off inflation, currency devaluation and economic decline. Although their loans to Government actually contribute to economic dysfunction, central banks yet treat interest on these loans as income, and take them into the profit and loss account. In contrast to a commercial bank, which treats bad loans as losses, Caricom central banks report profits in spite of the real economic losses resulting from their credit extension. What is worse, they redistribute these "profits" to Government and other institutions, injecting more high-powered money into the economy, and thus setting off a further round of price increases and currency depreciations. Indeed, the Central Bank is perceived by some Ministers of Finance as convenient sources of credit and income, rather than as regulatory institutions.

The Bank of Jamaica has its own version of this charade. Supposedly for the purpose of mopping up excess liquidity in the banking system, the Bank issues short-term certificates of deposit (CDs) at rates of up to 50% per annum. This means that a purchaser of a J$8 million CD (worth approximately US$300,000 today) would receive J$9 million at the end of three months, leading to an overall net increase of liquidity of 12.5% in three months, a dramatic rise in the money supply in a country experiencing chronic inflation. To prevent such an expansion in liquidity, the Bank would have to issue another CD to the value of J$9 million, and so on, and so on. In theory, the

interest cost of these issues are borne by the Jamaican Government. But what Government can afford to pay 50% on its loans? Not surprising then, a government debt to the Central Bank of over J$20 billion had built up by the end of 1991, representing a horrendous overhang of liquid assets in the economy. Certainly it would be simpler for the Bank of Jamaica to sell long term government paper in the capital markets at an appropriate discount so as to sterilize the funds over the long term. Or why not raise the cash reserve asset, or the proportion of Government securities to be held by the banking system? And why such high interest rates? Is it because these perfectly sensible measures are forbidden by the gods of financial liberalization?

It should by now be clear to even blind men that economic development will not proceed in the absence of a sound and stable currency. Within CARICOM, those countries such as the OECS, Belize, The Bahamas and Barbados, whose fiscal policies have warded off currency depreciation, have outperformed those countries whose policies led to currency depreciation - Guyana, Jamaica and Trinidad and Tobago. There have been a number of proposals for restoring public confidence in the national currencies. It is surprising that the strategy of currency reform has not occurred to the monetary authorities in Georgetown and Kingston. It is an historical fact that neither in 1923 nor 1948 did economic growth resume in Germany until after comprehensive currency reforms.

We have discussed above the issue of independence for regional central banks. Professor Stephen Hanke, in a Paper, "From Monetary Mischief to Sound Money", proposed that Jamaica should return to a Currency Board. I have frequently put forward the East Caribbean Central Bank as a model for a Caribbean Central Bank. Perhaps we might seek the assistance of the Accounting Profession and develop conventions which provide a fair financial picture of the real impact of central bank operations on the real economy.

PROPOSALS FOR NEW ACCOUNTING RULES

In proposing new accounting rules for Caricom Central Banks, we invoke the rapidly evolving accounting principle that financial assets should be marked to market and, secondly, the long established principle of conservatism. The first principle implies that central bank assets should be valued at what they would fetch in active foreign and domestic markets. The convention of conservatisum suggests that proceeds from seignorage should not be regarded as "real" assets and that income derived therefrom should not be regarded as "real". This is because of the uncertainty as to whether the proceeds from seignorage actually represent market values.

These parameters yield the following proposals:

(1) Only assets tradeable on the external or domestic market should be regarded as "real" assets. There would include securities traded on the international money and capital markets, and assets readily saleable on domestic goods and financial markets.

(2) All assets should be ~~traded~~ marked to markets.

(3) Only income from "real assets should be taken into the Profit and Loss accounts. Income from nominal assets should be desegregated in suspense accounts.

(4) Income derived from seignorage should not be taken into the Profit and Loss Accounts, but would be desgregated in suspense accounts.

(5) Profits should not be paid to Government, unless the Auditors certify that the external assets of the Central Bank are at a prudent level, given the Bank's external liabilities.

(6) The accounts of the Central Bank should be recorded in terms of an accepted "hard" currency or a basket of "hard" currencies. This would ensure comparability from year to year.

(7) Central Bank advances to Government should be limited to a fixed proportion of the external assets of the Central Bank, rather than related to the current expenditure of Government.

The above rules would ensure that the balance sheet profile of the Central Bank reveal the "true" state of the Bank's financial situation, and would limit the possibilities for compounding the effects of excessive credit creation.

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