Reviews

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On the essence of a central bank

Review of Andrzej Slawinski's book, *Central Banking. Evolution and the Future*, CeDeWu Publishing House, Warsaw 2024

In Andrzej Slawinski's book entitled 'Central Banking. Evolution and the future' (CeDeWu Publishing House, Warsaw 2024), references can be found to the 17th century, when the first central banks were created to control the war spending of kings, as well as to the early 20th century, when the Federal Reserve System, or the US central bank, was established, and finally to the turn of the 20th and 21st centuries, when the Bank of Japan decided to apply *quantitative easing* (*QE*). However, the book should by no means be regarded as a historical study. The author has discussed selected events from the past in order to make a convincing case for, the origins of modern central banks, the most important objectives of their activities and the most difficult challenges they face.

The argument opens with a clear presentation of the mechanisms of money creation, the relationship between the creation of deposit money by commercial banks and its exchange for liquid reserves and cash, which is done at the central bank. It is the commercial banks that create money, but their liquid reserves are in accounts at the central bank. And it is only the withdrawal from these accounts that allows some of the reserves to be converted into paper money. At first glance, therefore, the central bank's role in money creation may appear limited, but upon deeper analysis it reveals its crucial nature.

The next step in the consideration is the question of the settlement of mutual obligations between commercial banks. Back in the nineteenth century, this could be done through private clearing houses, but in situations of shaky confidence between commercial banks and growing concerns about their mutual solvency, these clearing houses proved too weak to cope with a liquidity crisis. The example of the Federal Reserve System has been used to portray it as a nationwide clearing house with the power to create unlimited liquid reserves. In this view, the central bank becomes the lender of last resort, able to protect the economy from a sudden credit crunch and individual commercial banks from bankruptcy.

The different approach to commercial bank balance sheets and central bank balance sheets was illuminated from the perspective of government bond purchases. Cash deposits held at commercial banks can be used as a source for purchasing government bonds for their portfolios, and a sufficient supply of savings ensures that even large budget deficits do not create strong inflationary pressures. In contrast, central banks in many countries are prohibited from buying government bonds in the primary market, i.e. directly from the government. This is due to the fear that payment funds from the central bank, going via the accounts of the Ministry of Finance to the accounts of businesses and households, could be spent on purchases of goods and services and consequently intensify inflationary pressures (so-called helicopter drops). Analysing this issue through a discussion of the quantitative easing that took place in response to the global financial crisis of 2007–2009, Andrzej Slawinski points out that such a danger was limited under conditions of recession and weak credit, and subject to the moderating effect of the growing excess savings of large enterprises.

The consideration of the means of payment going from the central bank to the government's accounts is supplemented by the extremely important issue of the transfer to the government of profits earned by the central bank. This should apply to those profits derived from interest on foreign exchange reserves held in the form of foreign currency bonds and deposits. On the other hand, balance sheet profits arising from the depreciation of the domestic currency – in which the foreign exchange reserves are accounted for – should be used to create reserves to cover possible losses if the domestic currency appreciates.

Andrzej Slawinski devotes the middle, most extensive part of his book to the issue of central banks' stabilisation of inflation (monetary policy) and their care for the stability of the financial system (macroprudential policy). Here, too, we find a discussion of a number of past events, and it serves to show the processes that gradually led to the actions taken by central banks today.

With regard to monetary policy, the gold currency system (from the 1870s to the First World War), in which fixed exchange rates were used, was taken as the starting point. Fixed exchange rates as a means of stabilising inflation also characterised the Bretton Woods system created after the Second World War. From the 1970s onwards, control of money supply growth came to the fore in stabilising inflation (a key change in Bundesbank policy in 1974), and from the 1990s this was replaced by a direct inflation targeting strategy. Finally, the global financial crisis of 2007–2009 prompted central banks to turn to the instrument that quantitative easing programmes had become. The crisis was a consequence of excessive risks taken by commercial banks, hence the need for central banks to simultaneously incorporate macroprudential policy – the use of supervisory instruments that would allow for the reduction of systemic risk. The approach presented by Andrzej Sławiński allows us to understand contemporary central banking as the result of a process, lasting some 150 years, of providing answers to successive challenges arising in a changing economy. In this light, central banks are institutions capable of transformation, constantly seeking new solutions to emerging problems or crises.

The final sections of the book attempt to reflect on the future of central banks. An important place is occupied here by considerations of the possibility of them issuing electronic money (*CBDC – Central Bank Digital Currency*), which would compete with the proliferating cryptocurrencies. Andrzej Slawinski is inclined to the view that, at the current stage of technological development, the risks associated with the implementation of CBDC could prove to outweigh the opportunities. He predicts that in the scenario when central banks do move in this direction, it will only be in the form of limited-scale pilot programmes.

On the other hand, the book does not leave the slightest doubt that central banks will only be able to find answers to the challenges of the future in truly democratic countries, only where their institutional independence is respected and the political and social norms in place allow them to appoint competent people to their authorities, guided by a sense of responsibility for keeping the economy in balance. Public protection of the independence of central banks is as important as in the case of the courts and the media.

Andrzej Slawinski's book "Central Banking. Evolution and the future" deserves to be recommended to all those who wish to better understand what the European Central Bank, the Federal Reserve in the US, and the National Bank of Poland do. An additional incentive is that it has been written in a reader-friendly manner – even very difficult problems it tries to present as simply as possible.