Central bank (in)solvency

Washington and Old Europe face off. Billions of dollars are at stake. The issue? Central bank accounting standards. Prop up those drooping eyelids and read on. These debates could affect the financial independence of every central bank.

So what is going on? To understand the "perfect storm" breaking over central bank financial reporting, some background is in order. Turn the clock back to 1998 and remember the brouhaha surrounding IMF loans to the National Bank of Ukraine. Concerns that the National Bank had been careless with IMF funds led Washington to require an audit of the bank. Two salient facts emerged: first, as suspected, financial reporting at the National Bank of Ukraine was weak, to say the least; second, the Fund had not noticed because they were not paying attention to the nuts and bolds of where monies were deposited. Because Fund lending was basically seen as a contract between governments, almost no due diligence was done on the central bank which held the account.

All this has changed. The Fund established its safeguards assessment programme under which its treasurer's department scrutinises the accounts and control systems of borrowing country central banks. For central banks and their governors, the challenge is tough. If you flunk this test, you need to think up a good excuse for the minister of finance, or start dusting off the resumé, because failure here can stop fund disbursements.

So, having opened the bonnet and looked inside, can the Fund tell us how central bank financial reporting is working? Yes they can, and it isn't. The Fund took a look at 36 borrower central banks. They found 86% lacked robust accounting standards, 83% suffered from deficiencies in internal audit, and more than half (64%) did not perform an external audit. Understandably the Fund is demanding improvements. A recent survey suggests this is already having an effect[1]. Top of the checklist is a requirement to "implement credible accounting standards", most obviously the international financial reporting standards (IFRS) produced by the international accounting standards board.

Here the problems begin. IFRS require assets on the balance sheet to be shown at "fair value". This includes valuations of foreign reserves, gold and government debt – all must be fairly valued and gains and losses recognised as income and passed through to the profit and loss account. For central banks, which run large unhedged foreign exchange positions and

1 "Accounting Standards for Central Banks", Central Banking Publications (2003) forthcoming.

typically hold a lot of domestic government debt, this threatens to be a roller-coaster ride. As currencies and interest rates rise and fall, central banks make huge unrealised losses and gains on their assets. Under IFRS these are supposed to be reported as income. With a bit of bad timing, central banks could find themselves forced either to pay out huge dividends to hungry finance ministries or to go begging for a capital injection. The first could be unduly expansionary, the second threatens central bank independence.

So what is the answer? Historically, central banks have found refuge in opaque accounting and hidden reserves – hardly conducive to transparency. There is another solution. Neither the Fed nor the Eurosystem count unrealised gains as income. The ECB on grounds of "prudence" makes a clean break from international accounting standards, and squirrels away unrealised gains into reserve accounts, ready to be drawn on if gains turn to losses. The Fed has another system all together. So why are developing-country central banks under pressure to be more transparent than their bigger, richer cousins?

In part because there is currently no accepted standard other than the IFRS. While the Fund has accepted the Eurosystem rules for central banks in Eastern Europe, there are obvious drawbacks. While greedy treasuries are a problem, so are hyper-cautious central bank governors.

Another international standard, a central-bank-specific accounting standards, really is called for. Central banks need to be able to show they are adopting a benchmark and not just building reserve accounts for the sake of it. Finance ministries need a mechanism for getting their proper share of the profits of a government-granted monopoly. The problem with this solution is that any simple formula for dividing central bank profits and for appropriate levels of inner reserves is going to be controversial and conceptually tough.

But there is another problem. As Mario Blejer and Liliana Schumacher pointed out in *Central Banking* journal a few years ago, central banks have a tough job to account properly for their contingent liabilities. Some of these – like derivative contracts – are explicit and are by now pretty familiar. Others, for instance the central bank's commitment to defend an exchange rate or to act as lender of last resort, are implicit. If however, these implicit liabilities are accounted for a problem emerges: "In general, the value of the central bank portfolios, when properly accounted for, is negative and, as a rule, it becomes more negative as contingent liabilities are added to the portfolio."

On a true accounting basis, virtually all central banks are probably insolvent. Which only goes to show that exceptions to the usual accounting standards need to be made on public policy grounds. If the capitalist system cannot function without the backing of a public institution, it is absurd to demand that that institution adhere to the same rules as the commercial entities and markets that it exists to protect. But it is far from absurd to demand that whatever rules they are required to adhere to should be clear and transparent. □