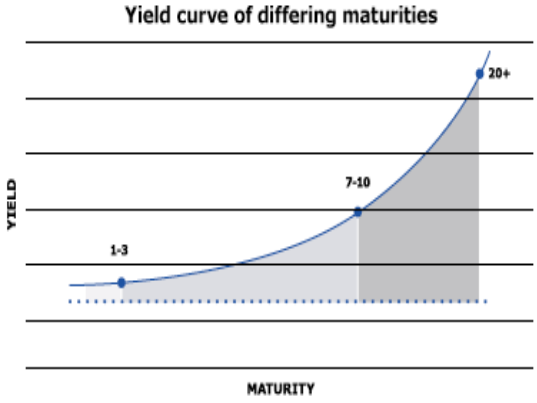
Financijski klub

DANGERS OF MATURITY AND CURRENCY MISMATCHING IN A FRACTIONAL RESERVE BANKING SYSTEM WITH THE EXAMPLE OF ICELAND AND A LOOK AT AN ALTERNATIVE BANKING MODEL

MISMATCHING EFFECTS ON THE STRUCTURE OF PRODUCTION

In every normal functioning economy, banks play a pivotal role as financial intermediaries funneling voluntary savings of citizens into investment endeavors. The bank is obligated to return the funds of the saver after agreed upon time with interest hoping that the entrepreneur using those funds was in a position to obtain a certain profit by which he will repay the loan with interest. The difference between the interest rate of the loan and the liability of the bank is its margin or interest differential.

Banks are rewarded with this interest differential since they are the ones who are able to find willing borrowers of the funds and the saver who trusts the bank will be good on its commitment. The coupling of myriad market information is its reward. This form of banking provides benefits to the whole society for it doesn't breach any legal or contractual obligations and it is noninflationary as well as the duration matching of the asset (loan) and liability (time/savings deposit). Modern banking practices, on the other hand, have gone on a different route to obtain profits. The yield curve is according to Bagus (2010) a slope, showing different rates of interest at different time horizons. The yield curve is predominately, positively sloped for it contrasts the difference between time preferences of individuals in the marketplace. Time preferences, relating to the writings of Eugen Böhm-Bawerk (1921) are time differences for every individual regarding desired pattern of consumption and savings. The higher the time preference, the more individuals are less willing to consume today and they are shifting their time-consumption patterns into the future.

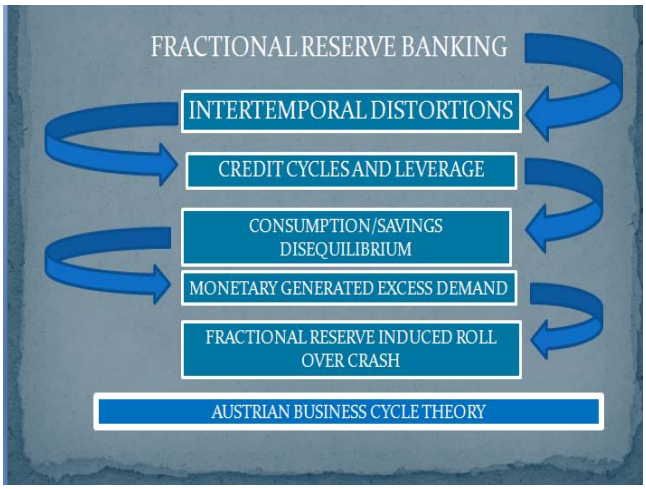


EFFECTS OF MODERN BANKING ON MATURITY MISMATCHING

Monetary Irregular Deposit	Monetary Loan
Economic differences	
1. Present goods are not changed for future goods	1. Present goods are exchanged for future goods
2. There is a continuous availability for the depositor	2. Full availability is transferred from lender to borrower
3. There is no interest since no present good is traded for a future good	3. There is interest since present goods are traded for future goods

When observing the real economy, loans generated from demand deposits act as a concealment of true marketable and available funds, for a greater demand of deposits entail a rise of short term rates of interest and a fall in long rates, making it appear that the lines of production, referencing the capital goods industry, can be expanded.

Only a roll-over of legitimate short term funds, may the production process in the capital industry be successfully completed, as entrepreneurs understand that the market has the capability of delivering these funds. Since demand deposits are used as a *monetary multiple*, it seems that the roll-over risk is greatly reduced, since the banks are able to work as a joint unit, some might even say a cartel, and limit the loses through inflationary policies.



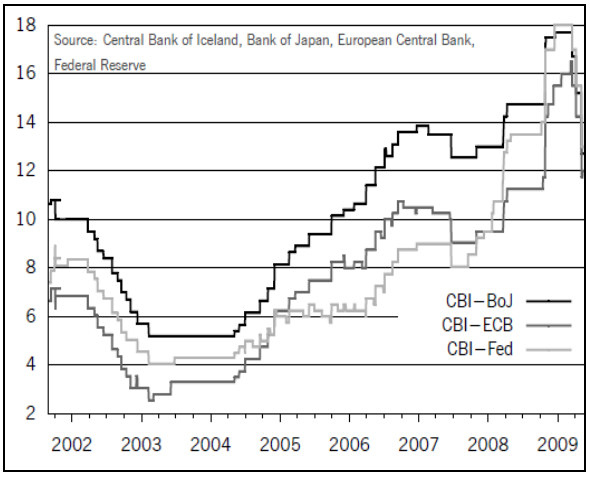
THE FROZEN ICELANDIC ECONOMY

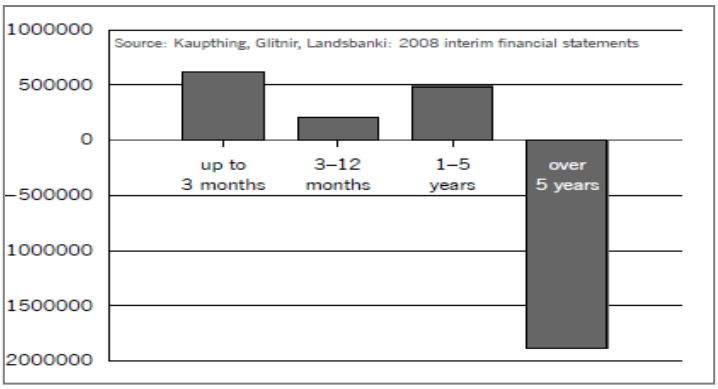
1. CREDIT CYCLE EXPORTED TO ICELAND

2. NEW ACT OF THE CENTRAL BANK OF ICELAND

3. INTEREST RATE DIFFERENTIAL AS A DECEPTIVE CARRY TRADE

4. MASSIVE CURRENCY AND DURATION MISMATCHING





Massive maturity mismatching

The fact that the global credit expansion was shifted toward Iceland, and central banks around the world decided that cheap money was the answer, Icelandic banks had no problem rolling over short term debt. One way Iceland decided to hedge against the risk of a default occurring though the outflows of foreign monies, was with the help of currency swaps.

A currency swap helps protect a bank facing adverse fluctuations in the exchange rate. To do this, one must peg his cash inflow in a currency, as well as the receiver must peg his currency to offset the outflow. Iceland thought that this was an ideal solution. They didn't however contemplate what might occur in case of a spike in short term rates, what ironically did happen, as the business cycle went into its final phase. The banks now faced a roll-over problem, not in their own currency, but in Euros, Francs, Yen and etc. Since the Icelandic central bank could only print kronur, the banks were in need of a bailout.

GOING BEYOND A PARADIGM

HAYEKIAN SYSTEM

WHITE -SELGIN SYSTEM

MISES -ROTHBARD SYSTEM

There are various free banking models brought forward by various theoreticians, ranging from Friedrich von Hayek's fiduciary model of inconvertible notes, that are linked to a basket of commodities, Selgin-White's model of redeemable notes (redeemable in gold) but based upon fractional reserves and the most purest free banking form, the Rothbard-Mises full reserve and 100% gold backed standard with gold coins in circulation. Other forms have also been discussed, such as the Yeager model, but are nothing more than variations of the previously mentioned models.

Distinguishing differences between certain free banking models are interesting and should be explored. It is therefore not to say which model should be implemented as the *one and only*, since central banking, "[…] contrary to central bank officials" (Sechrest, p. 168), has not been a spontaneous evolutionary banking practice.