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# Origin and Relevance of Refinance as an Instrument of a Central Bank's Regulation

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***Abstract*—Refinance as an instrument of a central bank's regulation presents the subject matter of this paper. Its goal is to analyze this instrument in terms of its conformity with the nature of money under modern monetary system. Refinance, as a central bank's instrument, appeared in response to the gold-standard monetary system and, under present conditions, there is a market type of the system involving different instruments to regulate various market processes. A conclusion has been made in the result of the present review on a contradictory practice of refinance; it does not promote any balanced market development in the area of money circulation. The methods of investigation, which have been applied, included analysis and synthesis, the organic flow of presentation of the material and some other. The field of application of the research results is a central bank's regulative activities.**

***Keywords*—money; monetary system; central bank (CB); CB assets; refinance; central bank interest rates**

## I. Introduction

The origins of instruments applied by a central bank in its regulation and their limited use in the presence of modern monetary system are generally disregarded, while this makes the current specific nature of the instruments' contemplation. Such organicity (such compliance), however, is essential for both a central bank activities and operation of the entire national banking system and market at large. Refinance, the size of its rate (key interest rate) that private banks have to pay back when they are credited by a central bank, represents one of the most important instruments used by it in its regulation. The value of its interest rate is relevant both to commercial banks and to the majority of marketplace participants. That is why the consideration of this instrument's appearance and its benchmarking against the essence of money under the conditions of modern monetary system makes the question of present interest.

The appearance of the said instrument had been conditioned by the formation of the central bank's institution and the development of a two-level national banking system. In fact, in many world-leading counties a central bank was established as a private commercial banks' service corporation. Private banks' performance predates central banks' establishment. Prior to their appearance, many large commercial banks had been issuing own banknotes with fixed face value. Thus, banknotes of different banks differed in appearance, but had one scale of inherent value in each country, namely, the value indicated on different banks' paper money corresponded (were expected to correspond) the similar value of monetary gold. At any opportunity rivaling commercial banks had never stopped certifying their paper money represented the banks' strict obligations on their notes' conversion to gold, based on the existing scale of the national currency and the denomination stamped on banknotes1. In the vast majority of cases, the scale of the monetary units has been inherited from the time of the gold-coin monetary system. At the time when such system lived, a sovereign – a sovereignty maintained in all produced coins the initially established ratio between the figure of monetary units denoted on the coins and the quantity of gold they contained. If this ratio in a coin got distorted, such coin was considered counterfeit. Such diligent attitude toward the maintenance of the monetary unit standard had been around for centuries. Maintenance of the monetary unit's standard permanence was jealously controlled by marketplace participants. That is why a sovereign – a sovereignty had no way of disrupting this standard or committing forgery.

It has been an absolutely different story in a climate of the gold-standard monetary system. Within its context ordinary market participants had no chance to oversee the maintenance of the monetary unit's standard inalterable. The monetary gold reserves were kept in private banks' vaults that, as it has been already stated, did not stop assuring their notes marked their absolute obligation on their redemption in corresponding amount of gold. Nevertheless, before long owners of commercial banks figured out that their obligations before holders of their notes becomes not only rather burdensome but also almost unfeasible. The capitalist system of relations gave room for the development of entrepreneurism, boosting economy and the gross national

[1] Incidentally, the same positioning of notes, issued by commercial banks, can be found in works of the father of English political economics. Adam Smith wrote, "When the people of any particular country have such confidence in the fortune, probity, and prudence of a particular banker? As to believe that he is always ready to pay upon demand such of his promissory notes as are likely to be at any time presented to him; those notes come to have the same currency as gold and silver money, from the confidence that such money can at any time be had for them" [1].

income. This, in turn, raised the issue of enlarging the denomination of notes issued by private commercial banks. They, however, could raise is only providing the increase in the volumes of monetary gold in their vaults. Consequently, private banks found themselves on the horns of a dilemma to what preferably adjust the amount of issued paper money? Choosing an adequate increase in their gold reserves, market would face the problem of practical management of money circulation, i.e. there would be a shortage of funds for the maintenance of a trouble free market turnover; while choosing the increase in the substance of market, the increase in gross national income, the banks would face problems with actual maintenance of the currency unit's invariance. Eventually, commercial banks' speculation over this dilemma led them to quite an effective decision-making concerning the transfer of their issuer functions to an agency set up by them in a form of their service corporation, a central bank.

With almost no regret private banks transferred their available monetary gold reserves to a central bank and, besides the issuer functions, lodged a number of other functions related to regulation of the national monetary system. Filling up the gold reserves, a central bank had to issue notes of one standard to the entire market and issue them on credit base, which is to say, by crediting private banks at its interest rate. This is the origination of a central bank's activity instrument under consideration.

## II. Refinance in the Context of Gold Standard Monetary System

The specific character of the legal tender that a central bank began to issue is that ordinary participants of the marketplace continued to perceive it as their claim to the issuer for the corresponding amount of gold. In the meantime, the issue-refinanced assets as banks' obligation to the central bank to repay to the bank upon expiry at interest (the key interest rate). Thus, right from day one of the Central bank's issuance, its banknotes used in market turnover, began to have quite a complex, rather to say, an ambivalent nature. In order to somehow gloss over the contradictions, and to distract the marketplace participants' attention from the fact that the banknotes issued by the Central bank are the obligation of the latter to convert the notes to gold on demand, the Central bank have detached itself from these participants by a 'maze' of commercial banks and qualified the monetary gold stocks as 'reserves'. Such title was expected to make it clear that the Central bank's available gold stocks serve not so much for their use in daily routine as for emergency. Reserves are something that is as though inviolable in daily life. Additionally, the name of the central bank, the Federal Reserve System, derives from the word 'reserves'. And if in former times (under the one-level bank system), ordinary members of the marketplace had little control over the commercial banks' gold reserves amount, they became even more deprived of such possibility concerning the Central bank under the dual banking system. In the latter case they had to be satisfied just with their trust in the Central bank's good faith when it comes to maintenance of the monetary unit standard. The Central bank also, just as private banks did earlier, have been positioning itself as the most reliable authority, which can be trusted in the arrangement and functioning of the country's monetary system.

As practice shows, however, central banks of almost all Western countries had been acting through almost the entire existence of the gold standard monetary system, to say the least, quite unfairly. Sporadically at first and systematically after, they began to issue currency units not as much as to replenish the monetary gold stocks, but owing to the need to replenish commercial banks' and market's money resources in general. Understandably, such practice entailed an actual scale down of the national monetary unit. Once the gap between the declaratory and actual state of the facts, namely between the declared and actual scale of the monetary unit, had reached its crucial point, central banks of Western countries made a profit taking decision—disclaimed their undertaken obligations on conversion of their issued notes to gold. Accordingly, at the Jamaican Currency Conference, pretending for a long time to be reliable counterparts of marker relations, they had fairly admitted the fact of their deceit.

## III. Refinance under Modern Monetary System

Of course, the conference participants did not call things as they were; their statements were rather twilit. This, however, does not change the essence of the decisions made. The Jamaica monetary conference has called into existence a radically new monetary system, called in the neoliberal school of economic thought 'fiduciary', namely based on trust (to the Central bank) [2]. Obviously, such name is hypocritical.

In spite of gold's retrieval from the monetary system elements, central banks retained their issuing function, and therefore such instrument of their regulatory activity as refinancing at their set interest rate. That was another decision worthy of Solomon taken by those who set up central banks in their countries erstwhile, freeing themselves from the necessity to restock gold, and now they have disburdened their subsidiaries of the undertaken obligations; but along with this they have retained also the instruments typical of them under the gold standard monetary system. Sorting out differences between the declaratory and factual scale of the monetary unit through abrogation of this scale, they have detonated another contradiction – between the instruments of a central bank's regulation activity and the essence of money under the new (fiduciary) monetary system.

In reality, under the new type of monetary system the denomination of all legal carriers (currency notes, business accounts, plastic cards, digital wallets) began to represent "the substance of market in all its shapes and sizes" [3]. Authors of the new monetary system, however, did not want to admit this. Otherwise they would deprive their brainchild, the central bank, of seigniorage. Being caring parent corporations, they left this revenue to their service corporation on ground that some assets or another (and liabilities) of a central bank will now back the issuance instead of gold. Replenishing their volume, a Central bank could (can) still achieve an additional money issue and refinance it at its own interest rate. Whereas in the past this interest rate mainly served as the economic basis of the Central bank's income, namely its varying value began to be positioned as an instrument of countercyclical market regulation, market condition. Alongside this, refinancing began to be introduced as an instrument of funding banks' 'liquidity' and market at large.[2]

In countries, where the Central bank is the service corporation of private commercial banks and national money resources have the status of currency assets, government liabilities have started to take on the role of the Central bank's new assets. It started to print cash money for acquisition of treasuries. Accordingly, the cash money, injected into market turnover, represented treasury bonds acquired for the Central bank's printed money, rather than the monetary gold reserves. The key (basic) point in this endless vicious spiral is that amazing factory that makes nonstop the cash money put into circulations through the refinancing [5]. Apparently, the Central bank's production costs are pale in comparison with denominations denoted on the issued banknotes. In this day and age the difference between these two values comprises the Central bank's preferential profit basis, which the bank is not inclined to expose. Moreover, the bank does not let anyone on the specifics of its accounting records maintenance. The mentioned curious facts of the Central bank's activities often are the subject of genuine interest for persons, concerned about the fairness in the system of market relations. At the time when economic science goes beyond dry statement of the fact of the existence of the monopoly excess profit of the Central bank, carrying on the issuance, economic scientists underline that positioning of cash produced by the Central bank as its own and its introduction on credit basis, namely though refinancing, actually is illegitimate.

This actually leads to inflation. The truth is that the number of units indicated by the Central bank on newly issued notes has already appeared in market earlier in a non-cash form after creation of (a part of) the gross national income. The Central bank's challenge in the modern context should essentially be to convert into cash the funds appeared in a non-cash form. In such case, the privately-owned Central bank, however, would turn into a commercial organization, ownership of which has no economic sense to commercial banks that set up this affiliate. Turning the Central bank into a non-profit organization also does not fully meet interests of the government, getting considerable income from the bank and regularly selling to it its liabilities. Common interest in the actual state of things both on the part of the most powerful market participants – leading commercial banks, and on the part of the government acting through the finance ministry, is sweeping under rug the fact that a loan-based introduction into circulation of money, issued by the Central bank, namely through refinancing, is wrong and leads to inflation.

But, it is also fair to note that the current level of increase in cash price of goods in Western leading economies is relatively low – below 3-5% per year. The rationale of such paradox is simple enough – some part of the issued cash is put by central banks in turnover in the form of their shareholders' dividend disbursement, another part is allocated to government budget on a free-fee basis, while another part actually credits private banks at a quite low interest rate. Commercial banks, receiving funds from the Central bank as dividends disbursement, get a greater opportunity to issue loans and to boost investment activities and, by doing so, to prevent inflation. The government, directs issued funds it gets from the Central bank into state-funded organizations on a free-of-charge basis, and this money is often channeled abroad and its return to the national market space is under tight control. In turn, commercial banks, not a central bank's co-owners and therefore attracting the bank's funds as a credit, do this, we repeat, at quite a lower interest rate, which also curbs inflation. Therefore, the contradiction of the situation is that the refinance virtually provokes inflation, which in turn is curbed on a practical level. It is impossible for such contradiction to exist for long. It is not even that governments in almost all developed economies have exceeded the limit of government debt over 100% to the countries' national GDP, but that financial resources under current conditions cannot represent just a central bank's production facilities that print notes, as well as the Central bank's assets acquired for 'emission funds'. In reality, cash,—composing the quantitative definition of money, under present conditions stands for the substance of market – the quality-related determination of money, rather than the assets (and liabilities) of the Central bank. In this context the refinancing makes a rudimentary instrument of the Central bank's regulatory activity. This instrument contradicts with the essence of money and the contents of modern monetary system, namely its existence is ill-grounded and, therefore, this instrument must be reformed.

## IV. Alternative to the Refinancing

The Central bank has to issue cash on the equivalent basis, rather than as a loan basis, namely through simple conversion of banks' non-cash money into cash [6]. Indeed, in these conditions, the Central bank has to offset its costs of banknotes production; but it must not have the 'seigniorage' in the present context. Additionally, the Central bank should not exercise the so-called countercyclical regulation of market performance. Indeed, as any organism, the market has been developing cyclically. Behind this external appearance lies the opposite market behavior as capitalist system, continuously directed towards own expansion growth. The market's continuous expansion growth roots in the creation of the gross national income. Consequently, the market is developing not in a closed circle, but as a continuously unwinding spiral that looks a straight line in a short time, upward and forward. Correspondingly, in each such short-time period the market has a linear development

[2] This slang 'liquidity' is usually understood either as a corresponding capacity of the marketplace participants of some things, including monetary funds, offering quick exchange for other things [4]. The neoliberal school of economic thought most often limits its understanding of 'liquidity' by cash money.

trajectory, concealed behind the cyclic development trajectory. Accordingly, the Central bank's task is not so much to fight the external manifestation of market developments as to ensure an equilibrial market development, primarily, in the area of money supply through the maintenance of existing relation between the ratio of the cash and non-cash money. If the ratio of non-cash money increases due to the creation of the national gross income, the Central bank must maintain this organically formed proportion by an equivalent exchange of cash it produces for banks' non-cash funds, servicing private and corporate entities.

## V. Conclusion

The refinance presents a central bank's instrument, occurred in the framework of the gold standard monetary system. With the transition to the principally new monetary system, the instruments of a central bank's regulation should have changed. In the meanwhile, they remained unchanged and, therefore, are in contradiction with the essence of money under the current monetary system. This contradiction should be removed, in particular, concerning the refinance, and this instrument has to be reformed.

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