

THE PREDICAMENT OF BLOATED CENTRAL BANK BALANCE SHEETS

ROUNDTABLE BULLETIN¹

IN A NUTSHELL

Central banks in the major industrial countries are grappling with a serious problem: how to conduct policy when their balance sheets are far larger than they have ever been in peace time. Reducing them poses challenges, but retaining these swollen balance sheets carries significant risks for combating inflation, ensuring financial stability, and preserving central bank credibility, independence, and effectiveness. Arguably central banks are now facing their most precarious period since politically independent monetary policy became fashionable some thirty years ago.

INTRODUCTION

The balance sheets of central banks in the main industrial countries have reached sizes unprecedented in peace time. In Japan and Switzerland these exceeded 100% of GDP at the end of 2022. Balance sheets of central banks have historically varied in size – on the liabilities side reflecting the demand for banknotes, and on the assets side mainly reflecting the extent of foreign currency reserves held at the central bank. Oil exporting countries tend to have large balance sheets, as do the large entrepot economies of Singapore and Hong Kong. In Saudi Arabia for example, SAMA's balance sheet stood at around 46% of GDP at end 2022.

Table 1: Central Bank Balance Sheets normalized by GDP

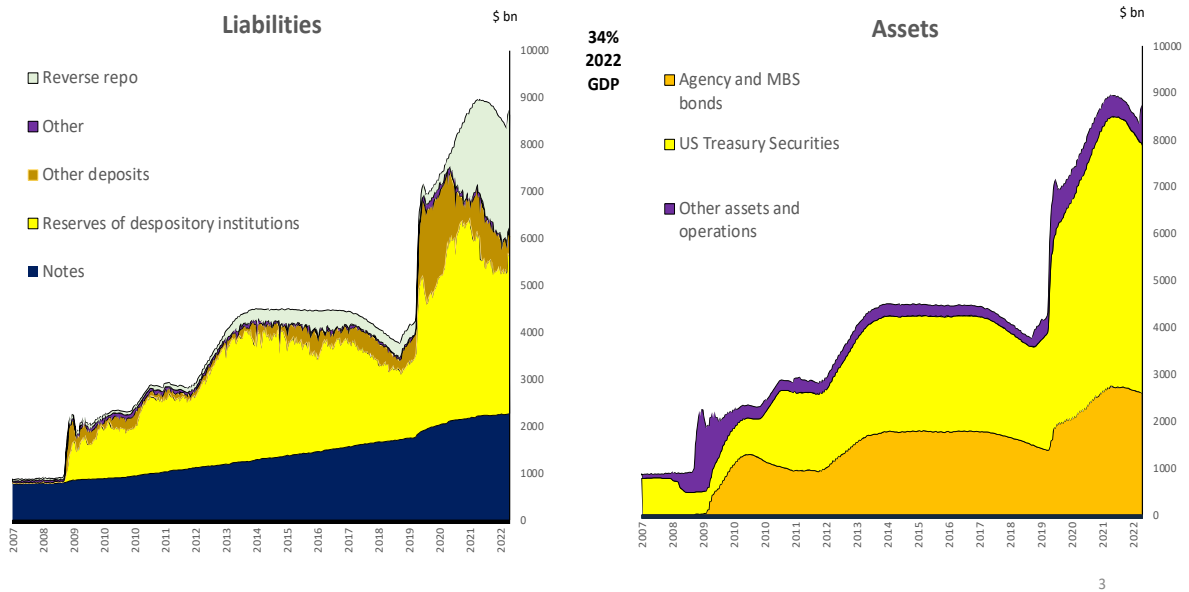
Country/Currency Zone	End 2022 ² B/S as % of 2022 nominal annual GDP
Japan	127%
Switzerland	114%
Eurosystem	60%
UK	43%
US	34%

¹Synopsis of themes considered at roundtable discussions on 21st June 2023. The views expressed do not necessarily reflect those of the participants. Roundtable discussions take place semi-annually. Participants have included Vitor Constancio, Stefan Ingves, Jacques de Larosière, Erkki Liikanen, Donald Kohn, Guillermo Ortiz, Raghuram Rajan, His Highness Mohammed Sanusi II, Andrew Sheng, Masaaki Shirakawa, Sir David Walker and Dr Zeti Aziz. The discussions are moderated by Dr Gavin Bingham and Sir Andrew Large.

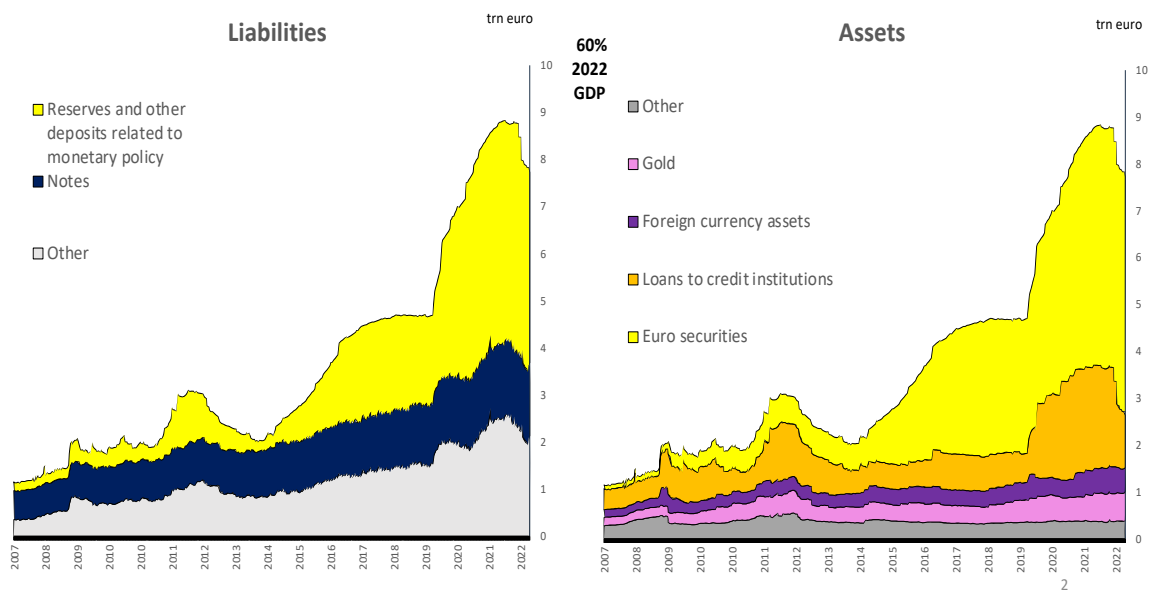
² BoE B/S from end Feb 23.

Charts 1- 4: Balance Sheets of Selected Central Banks

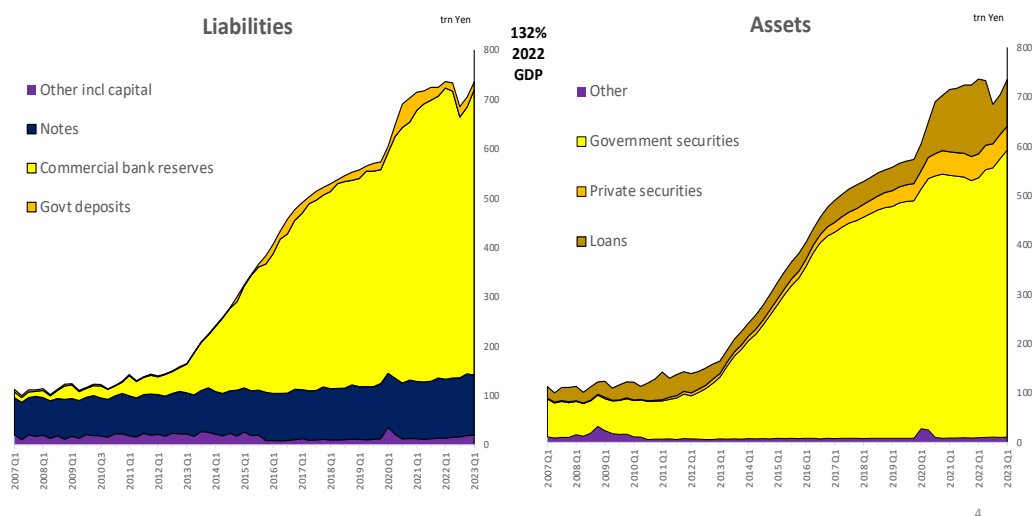
Balance Sheet of the US Federal Reserve



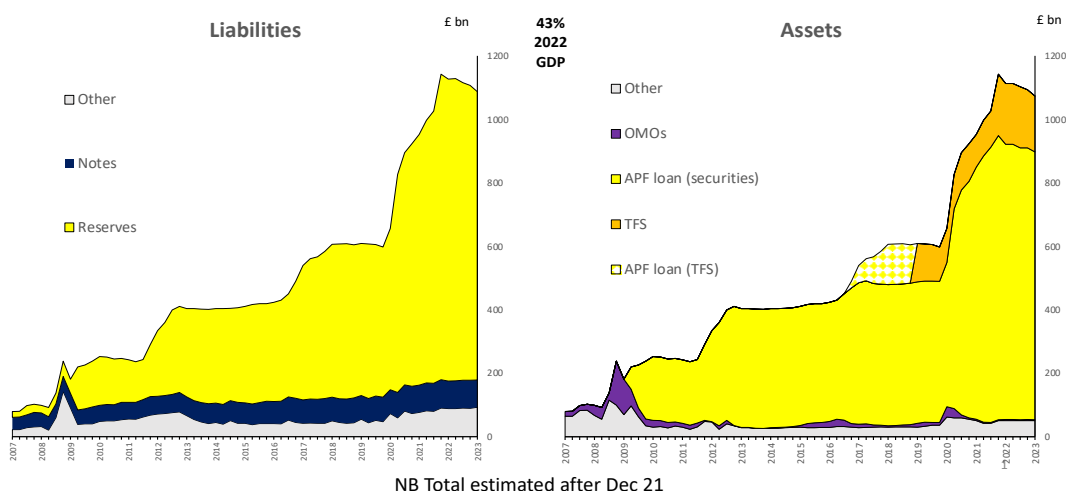
Balance Sheet of the Eurosystem



Balance Sheet of the Bank of Japan



Balance Sheet of the Bank of England



Charts 1-4 show that there has been a massive expansion in these balance sheets over time. The patterns through time are not identical and the immediate causes differ – the BoE expanded after the Brexit referendum for example, whilst the ESCB reacted in response to the Greek crisis. Nevertheless, three commonalities stand out: 1) the response to the global financial crisis of 2007 to 2009 that led to the expansion of both sides of the balance sheet (emergency liquidity assistance and market maker of last resort transactions on the assets side and increased bank reserve deposits on the liabilities side); 2) conducting monetary policy at the zero lower bound through quantitative easing (QE) and similar operations; 3) actions to combat the ill effects of the Covid pandemic. Notably in that instance the Bank of Japan expanded somewhat less, proportionately.

This great increase in the size of central bank balance sheets is largely confined to mature economies and has been avoided by jurisdictions, including many EME's, where foreign exchange bulks large in central banks assets and where exchange rates are of a matter of

policy concern. Except for a few pathological cases (Argentina, Turkey), the balance sheets of emerging market central banks did not expand as much or as rapidly as those of central banks in these mature economies, and inflation has generally risen somewhat less.

Bloated balance sheets are not in themselves a major policy problem, although they do pose operational issues in their management. And they reflect many of the challenges that central banks now face. It is imperative for central banks to get inflation down or to keep it from emerging where it has not yet surfaced. In doing so they need to avoid financial instability in the face of significant bank failures (as seen in the US and Switzerland) that have the potential to trigger global financial instability. And the fact that central banks have, unwittingly perhaps, acted in ways that have eased the fiscal challenges of their governments could have engendered an element of ambiguity as regards their autonomy and their ultimate ability to fulfil their core mandates.

Balance sheets have remained swollen not so much because of a deliberate choice but because of a desire for low interest rates to combat disinflationary pressures and interest rates remain the policy instrument of choice for combating rising inflation. Although QE was the only game in town when the zero bound approached, QT (quantitative tightening) is not the sole or even the primary tool to be used when reining inflation in: it is hard to use and its impact is difficult to assess.

For many years balance sheet expansion was consistent with pushing inflation up towards target but did not lead to above-target inflation. Balance sheet size and dynamics were consistent with the desired settings for interest rates. But the effects of the pandemic were to reduce both aggregate demand and supply, and the disinflationary pressures were uncertain and, with hindsight, relatively small. Hence, the expansion through the pandemic now looks excessive and has contributed to inflation. Basically, the mature economies expanded balance sheets greatly. The EME's didn't. And inflation is worse in those mature economies. Perhaps more tellingly, among the mature economies, Japan and Switzerland have both had less inflation in 2022/23 than the US/EU and UK and both had much smaller increases in their balance sheets during the pandemic.

Central banks failed to anticipate this inflation and to predict its persistence. The Fed's inflation forecasts were wrong, even worse than those of independent forecasters. And as its chairman has admitted, the Fed did not manage the risk of inflation well; its commitment to keep interest rates stable until full employment was reached was with hindsight a mistake. Similar criticism can be levelled at the Bank of England, and to some extent the ECB, though in all cases their subsequent actions have proved more credible. Arguably, those central banks have focussed too much on the energy price effects of the Ukraine war and not enough on their own policy actions as the cause for high and persistent inflation.

There is a range of views as to the importance of reducing the size of central bank balance sheets, especially relative to the use of interest rates in implementing policy. However, there is general agreement they ought to be smaller either by running off current holdings or through forms of QT.

There are four reasons:

1. It will reduce the risk of market distortions arising either from the unintended consequences of central bank transactions or from the effects of successful lobbying by special interests for central bank funding;
2. It will promote greater allocation of finance through markets rather than through administrative decisions, including those by central banks;
3. It will reduce the risk that central banks will be treated as a source of government funding: it will improve the transparency of sovereign debt markets and reduce the danger of the need for provision to the central bank of fiscal support to cover inevitable losses on their portfolios when interest rates rise; this in turn will reduce the danger of a loss of central bank independence, given the avoidance of the need to recapitalise on the one hand and of the political embarrassment at having to do so on the other;
4. It will make it easier for central banks to expand their balance sheets once again, if needed, to cope with an impending financial crisis or to offset a deflationary shock.

The questions are how far and how fast?

How far should balance sheets be reduced?

Central bank balance sheets will not and should not shrink to their pre-crisis levels. This is not simply the trivial consequence of nominal economic growth. There have been significant changes in the ways central banks conduct monetary policy and changes in the way banks behave and are regulated.

Banks are now required to hold much larger liquid asset portfolios than they were before the global financial crisis. The most liquid asset of all is their 'excess' reserves held at the central bank. It is neither likely nor desirable that these reserve holdings should shrink to the levels they were before this crisis.

The decision by both the Fed and the Bank of Japan in 2008 to pay interest on bank deposits was a watershed. It provided an incentive for banks to manage their liquidity in part by holding risk free deposits at the central bank. The interbank market suffered as a consequence.

It also led to the adoption of floor, as opposed to corridor operating procedures, which offer several advantages. They have in practice allowed central banks to exercise more direct control over short-term interest rates, and they are often simpler and more transparent. By establishing a floor rate, the central bank can influence market rates by adjusting the remuneration rate offered on excess reserves. However this implies a larger balance sheet because they presume some minimum holding of reserves. Recent proposals for heightened backing of banks' deposit liabilities would increase banks' deposits at the central bank – and the necessary size of central bank balance sheets – still further.

One factor that needs to be taken account of is the reaction of the banks. Their response to measures that change the size of central bank balance sheets is not always symmetrical. In

the United States the counterpart to the increase in bank reserves at the Fed was an increase in uninsured demand deposits. The increased liquidity was part of the intended consequence of QE as an expansionary policy, but it was never very clear ex ante how the banks would use that liquidity. In part they seem to have used it, not to expand traditional lending for which demand was anyway subdued, but to engage in riskier and more lucrative activities such as providing credit lines, backing for CDOs etc (Acharya et al, 2023). When The Fed started to reduce the size of its balance sheet before the outbreak of the Covid pandemic in autumn 2019, banks increased their holdings of long-term securities. The system then looks, and becomes, less liquid. And it may be more fragile if the banks' new business models rely on the continued provision by the central bank of ample liquidity. It remains to be seen how persistent these changes in banks' business models are or whether they are endogenous to the policy pursued.

And how fast?

There is a range of views about the speed and timing of actions to reduce the size of central bank balance sheets. QT has been attempted but it has proved hazardous in terms of interest rate volatility and market volatility. And any monetary policy impact – in reducing inflation - is hard to judge.

Increased fiscal deficits during and after the Covid pandemic mean that more sovereign debt is being issued when central banks will be seeking to divest, making the supply of sovereign greater than it would otherwise be. And the rise in long-term yields means that central banks will make significant and publicly visible losses on their holdings of long-term securities. Banks need time to re-establish the skillsets and infrastructure needed for a vibrant, deep and healthy interbank market needed in the absence of the ability to rely on central bank liquidity.

Central banks should therefore aim for a gradual and prudent unwinding of their balance sheets to avoid disrupting financial markets and economic stability. The appropriate speed of the reduction depends upon economic conditions (employment and growth), inflationary pressures and financial stability considerations. There is no reason to set a specific target date – or size - for the reduction of central bank balance sheets. It is the direction of travel rather than the destination that is important.

In addition, overly quick adjustment could lead to unnecessarily substantial losses, if assets are sold at what might prove to be temporary peaks in bond rates.

Consequences of 'too large' balance sheets

There are three areas where there may be adverse consequences. Firstly, interest rates may need to be higher for longer. Central banks seem to be prepared to rely proportionately more on interest rates than QT to combat inflation. The initial reaction to the first, tentative experiments with QT suggests that central banks will delay the use of measures that reduce balance sheets, ironically despite the fact that QE was introduced as such a tool at the zero bound. They will need to push rates higher than would have been the case if balance sheets could be reduced. In turn, this could make recession more likely – or at least more obviously a result of monetary policy -and politicians will need scapegoats for which central banks would be a target.

Secondly, and perhaps more seriously, there are dangers for efficiency and stability in financial markets. If banks adhere to strategies and business models that depend on a surfeit of central bank liquidity, and the secondary markets needed for the efficient re-allocation of liquidity remain dormant, then resilience in the face of shocks will suffer. At a minimum this might generate interest rate volatility.

Thirdly there is the danger of disillusion with the central bank in the eyes of governments and the public. If rates are raised too cautiously and if inflation stays too high for too long, central banks would certainly lose credibility. But equally, central banks will in all likelihood be blamed by the market and the media for the pain caused by higher interest rates e.g., on mortgages. Governments may even secretly like inflation and resent the high interest rates needed to get it down. Inflation increases tax revenue by stealth and it reduces the real burden of sovereign debt through opaque default. Central banks were accomplices and willing partners in enabling the government borrowing in the first place. This puts them in an ambiguous position when it comes to unwinding the debt.

CONCLUSIONS

Consensus exists that it is desirable for central bank balance sheets to come down. There are differences of views as to how far and how fast this should occur, despite agreement that central bank balance sheets will not and should not come down to where they were before. The wisest course will differ from country to country and case by case. Above all inflation needs to be brought back under control. But equally financial stability needs to be underpinned. Who decides over the relative virtues of lower inflation vs financial stability varies case by case? Some would argue that the interests of stability should in many cases be given some preference over the speed of reduction of inflation.

There is also the view that the independence needed by central banks to carry out their essential monetary policy and financial stability mandates is under threat, and that this threat becomes higher as the size of their balance sheets increases. Central banks will suffer a loss of credibility and become still more unpopular if interest rates go and stay high, particularly if this leads to the need for recapitalisation given the political costs related to it'. Fortunately to date the danger of independence being compromised by large balance sheets does not seem to be in evidence. Central banks may have been late in recognising inflation, but they have now acted decisively, raising interest rates in stages more aggressively than seen for many years. There have been calls to reduce their autonomy, but these are no different from those of the past.

We should remember that Paul Volcker was under the above sort of pressure when he slayed the inflation dragon in the early 1980's: but that when he had achieved the objective, he was considered something of a giant in central banking, literally and figuratively!