

The future for central bank balance sheets and their use for macroprudential policy

Richmond University presentation

Paul Fisher

**Visiting Professor @
Richmond University ,**

Wellbeing Research Centre

(www.wellbeingcreates.org)

**Senior Research Fellow
King's College London,**

**Data Analytics for Finance
and Macro Research Centre**

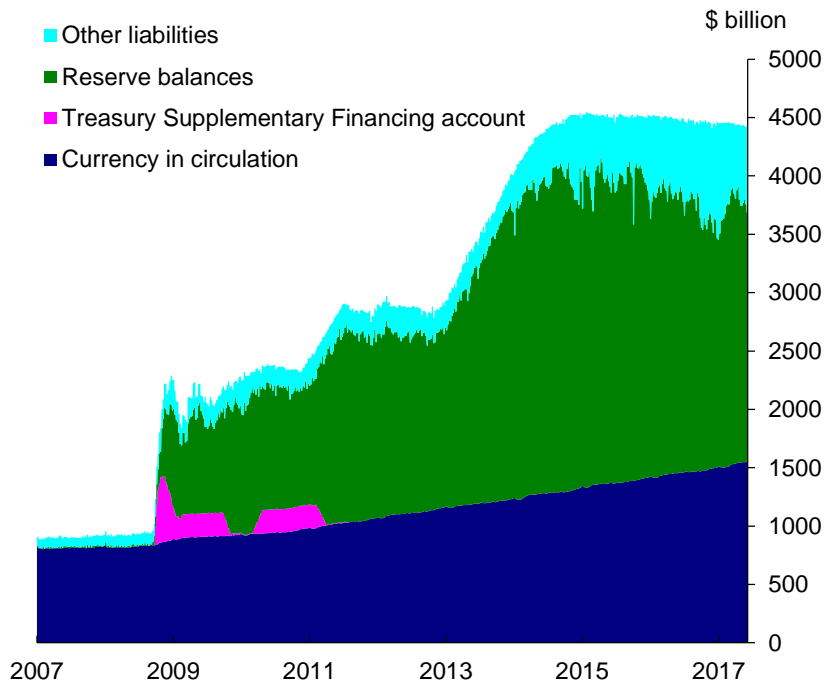
(<https://www.kcl.ac.uk/business/research/centres/dafm.aspx>)

London, Oct 10 2018

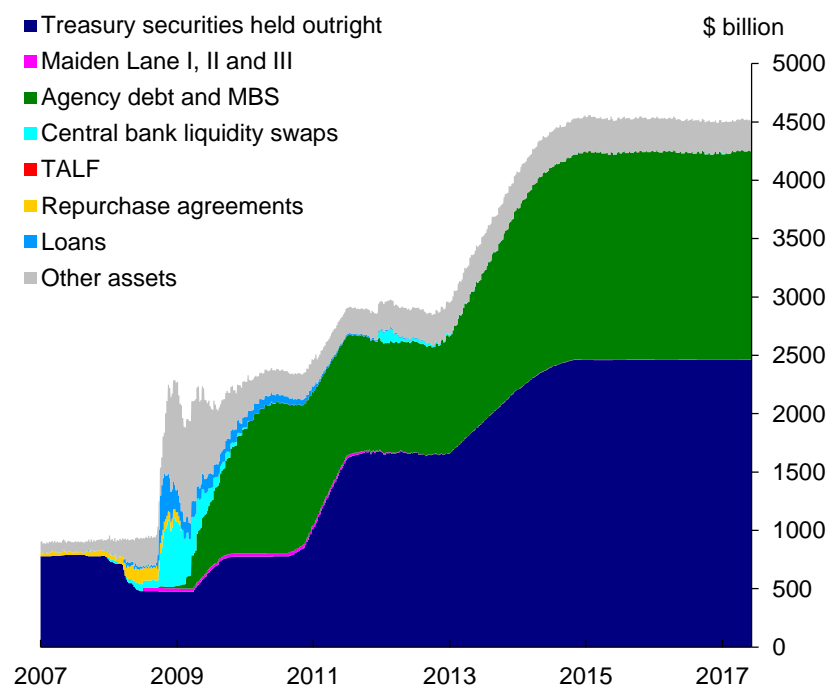
Expanded central bank balance sheet

Federal Reserve

Liabilities



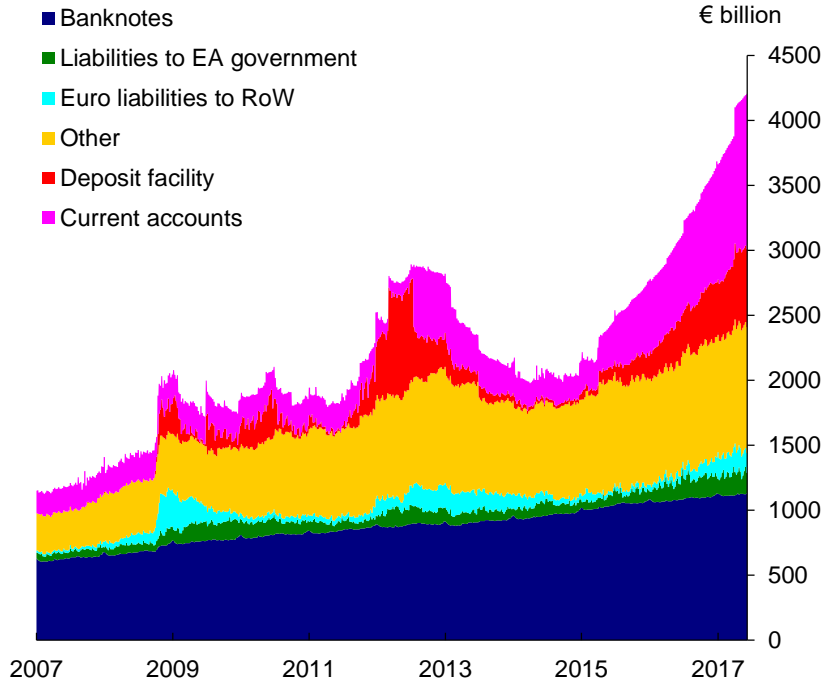
Assets



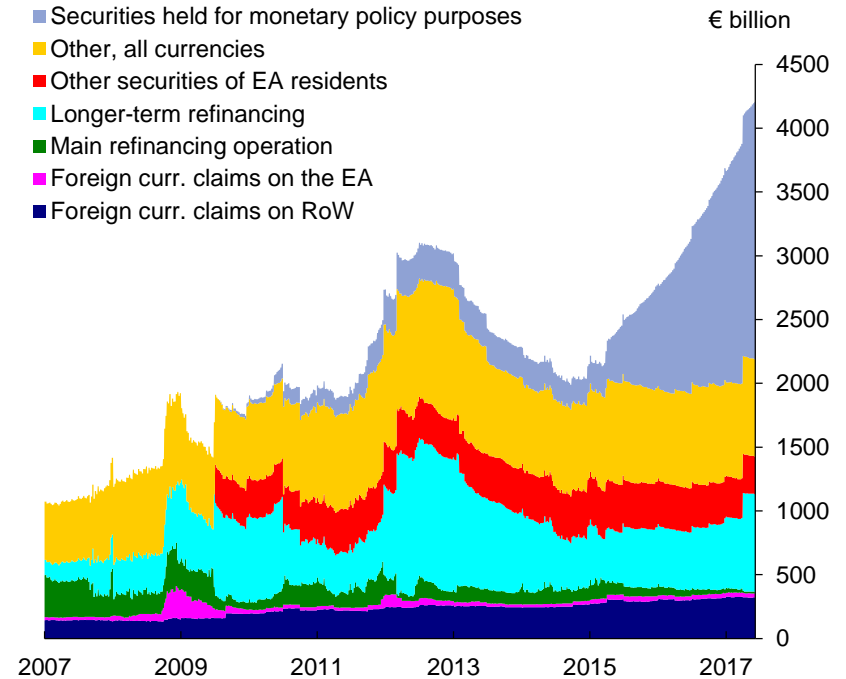
Expanded central bank balance sheet

ECB

Liabilities



Assets

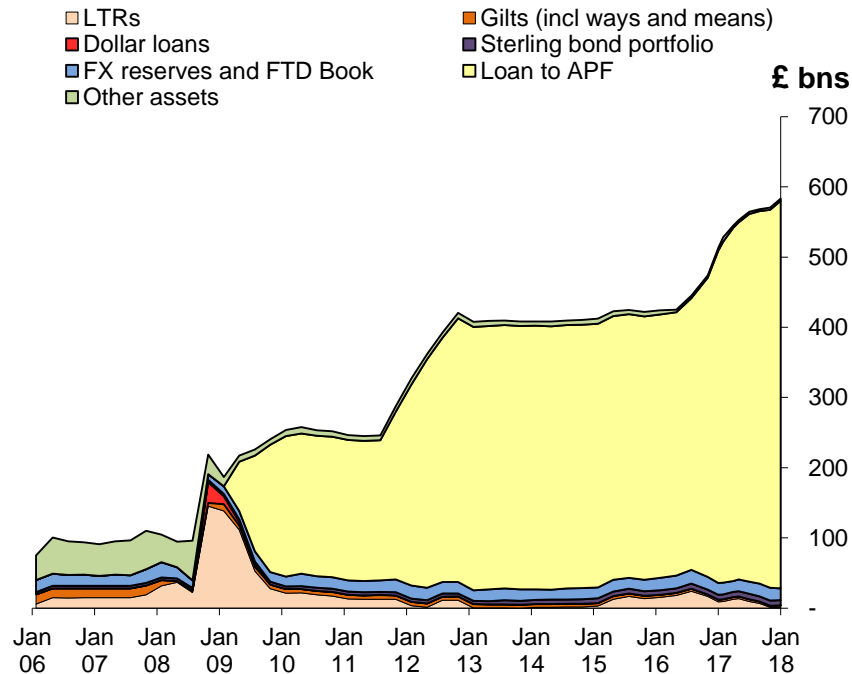
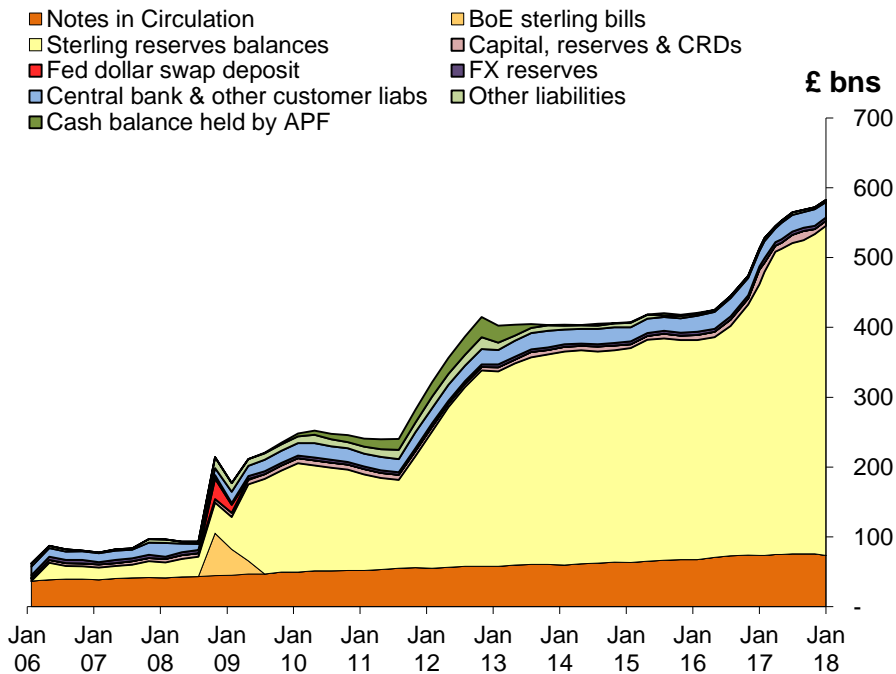


Expanded Central Bank Balance Sheets

Bank of England:

Liabilities

Assets



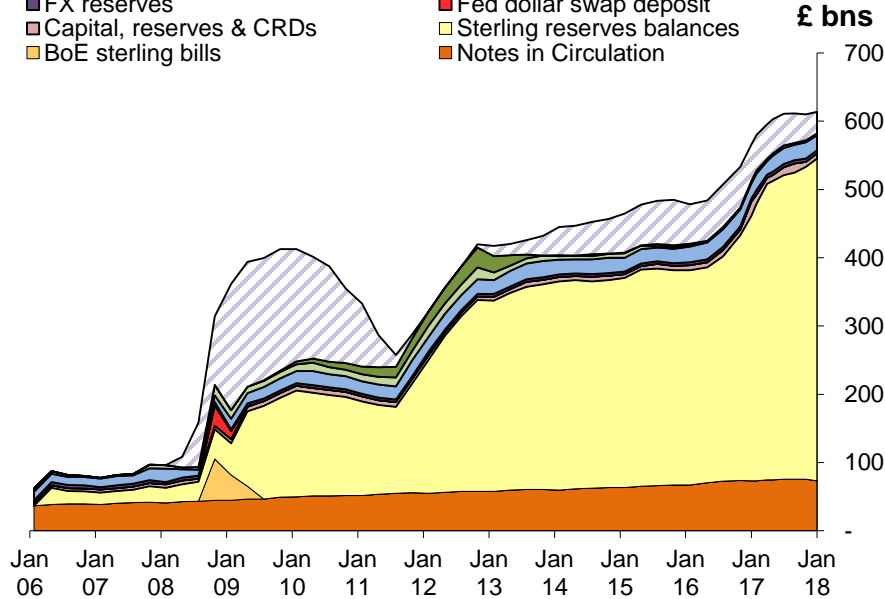
Source: Bank of England data

Expanded Central Bank Balance Sheets

Bank of England:

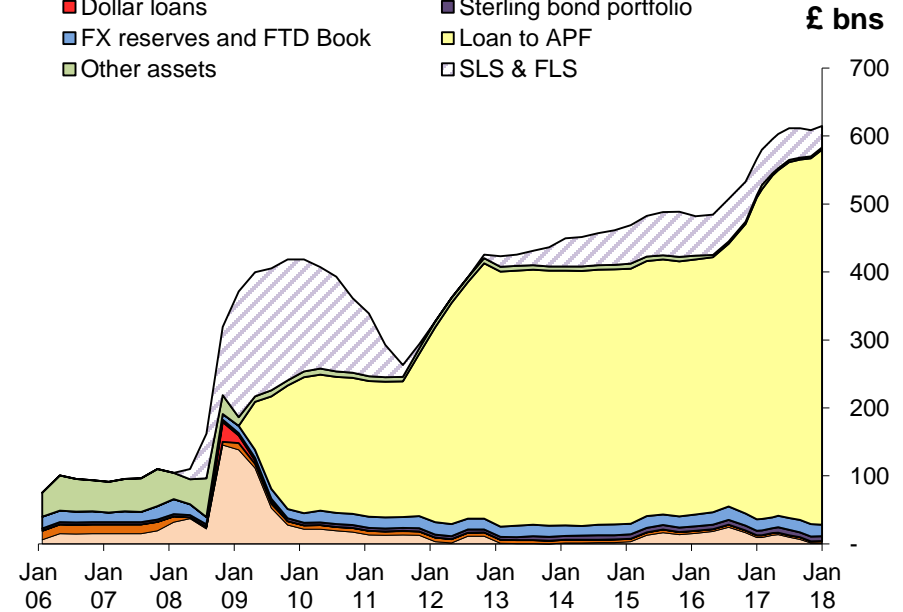
Liabilities

- SLS & FLS
- Other liabilities
- FX reserves
- Capital, reserves & CRDs
- BoE sterling bills
- Cash balance held by APF
- Central bank & other customer liabs
- Fed dollar swap deposit
- Sterling reserves balances
- Notes in Circulation



Assets

- LTRs
- Dollar loans
- FX reserves and FTD Book
- Other assets
- Gilts (incl ways and means)
- Sterling bond portfolio
- Loan to APF
- SLS & FLS



To what extent will central banks unwind QE?

Maybe less than you think. 3 reasons:

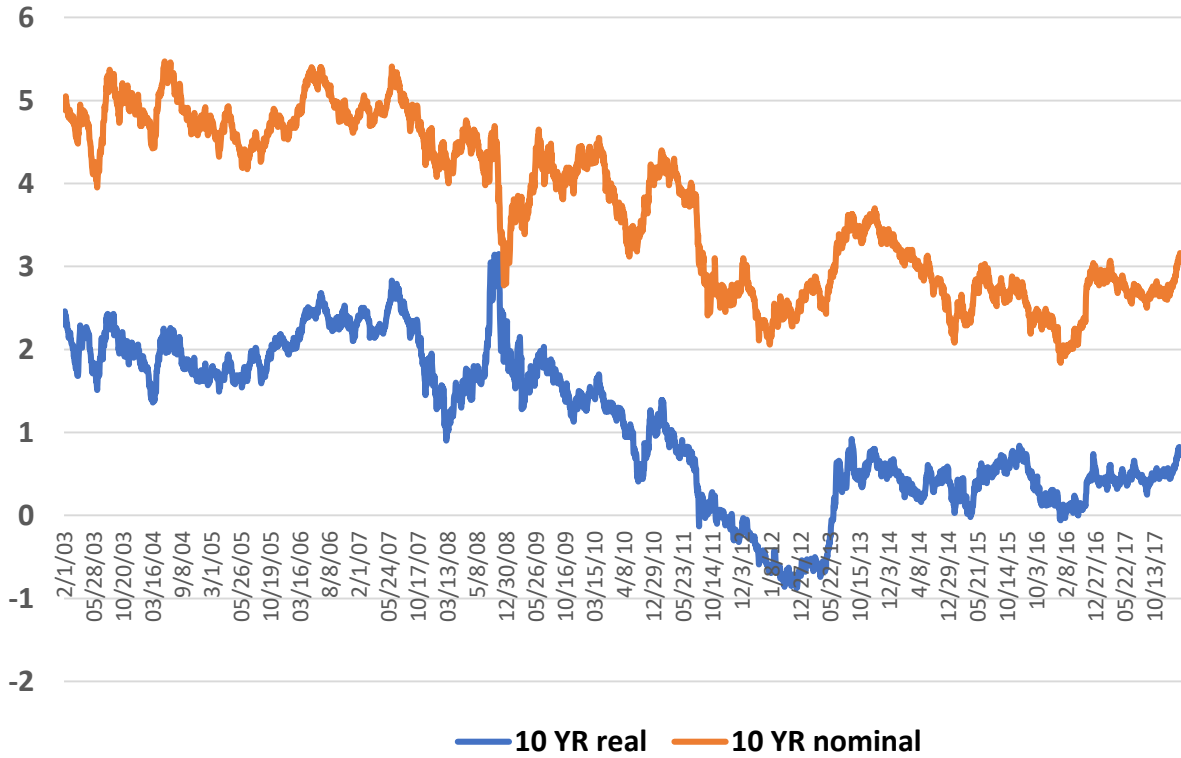
- Monetary effects already unwound?
- Financial system no longer dysfunctional?
- The effect of the new liquidity and capital regimes.

This presentation is mainly focused on the latter.

What is the optimal size of a central bank balance sheet?

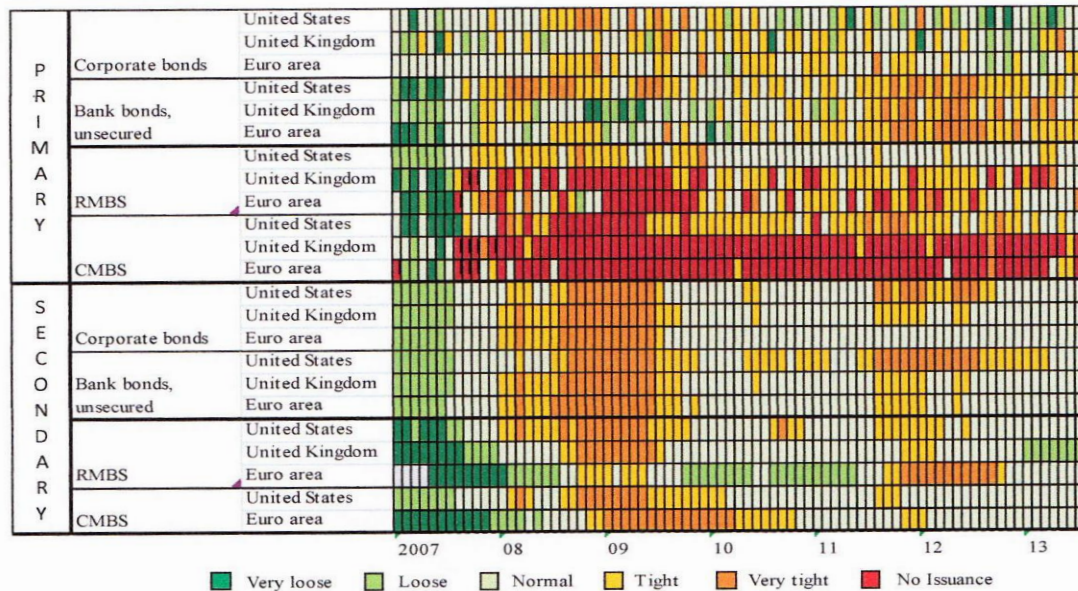
- Normally liability driven. But under QE has been asset driven with central banks choosing the supply of money and not caring much about interest rates going lower.
- Case for doing that has long since passed:
 - Real effects of increases in supply of money are mostly temporary. Most should have unwound by now.
 - Impact of changing asset composition in system was most powerful ie temporary effects may have been sustained - when markets were dysfunctional. That's no longer the case.

10 year US real interest rates



Market Dysfunction 2007-13

Chart 2: Market functioning 'heat map' based on issuance and spreads data ^{(a)(b)}



Sources: Bloomberg, Dealogic, JP Morgan Chase & Co, Bank of America Merrill Lynch and Bank calculations.

(a) Shading is based on a score that reflects gross issuance (relative to nominal GDP) and spreads in primary markets, and spreads in secondary markets, expressed as a number of standard deviations from its historical averages, using as much data as available data from January 1998. Primary market indicators reflect the past three months, so smooth volatility. Where spreads are not available, indicators are based solely on issuance.

(b) Latest data point is August 2013.

Source:
2013 speech by
Paul Fisher
Bank of England

What is the optimal size of a central bank balance sheet?

- Normally liability driven. Demand function for central bank money should determine balance sheet size, given a policy rate and level of transactions in economy.
- Issues:
 - Interest elasticity of demand for notes has always been measured imprecisely.
 - Structural break caused by QE - proportion of notes vs reserves dramatically altered.
 - Structural shifts & trends in demand for notes.
 - Structural shifts & trends in demand for reserves.

The new liquidity regime will have increased demand for reserves

- **Liquidity Coverage Ratio** – hold HQLA to meet stressed cash outflow over 30 days
ie hold liquid assets against liabilities that might run.
- **Net Stable Funding Ratio** – hold stable funding for illiquid assets
ie hold long-term liabilities against assets that could not be sold.

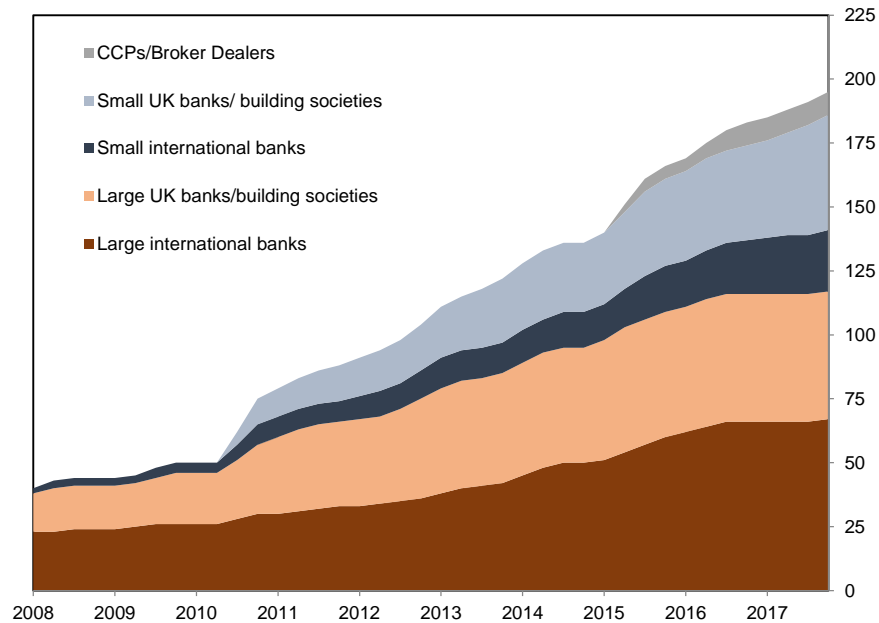
Interact with capital regime via:

- **Leverage ratio** – capital requirement based on unweighted assets.
Liquid assets may count in the latter

Balance sheet choices can impact on financial stability via LCR, NSFR, Leverage Ratio

- Size = demand for reserves? (LCR, LR) **Unknown.**
- Excess vs shortage. Floor system vs corridor. Access (next chart).
- Composition: loans vs outright purchases.
- Purchases: bank assets vs non-bank, HQLA vs non.
- Collateral eligibility: HQLA vs non-HQLA.
- Term of loans (chart).
- Do reserves count in leverage ratio? Shouldn't

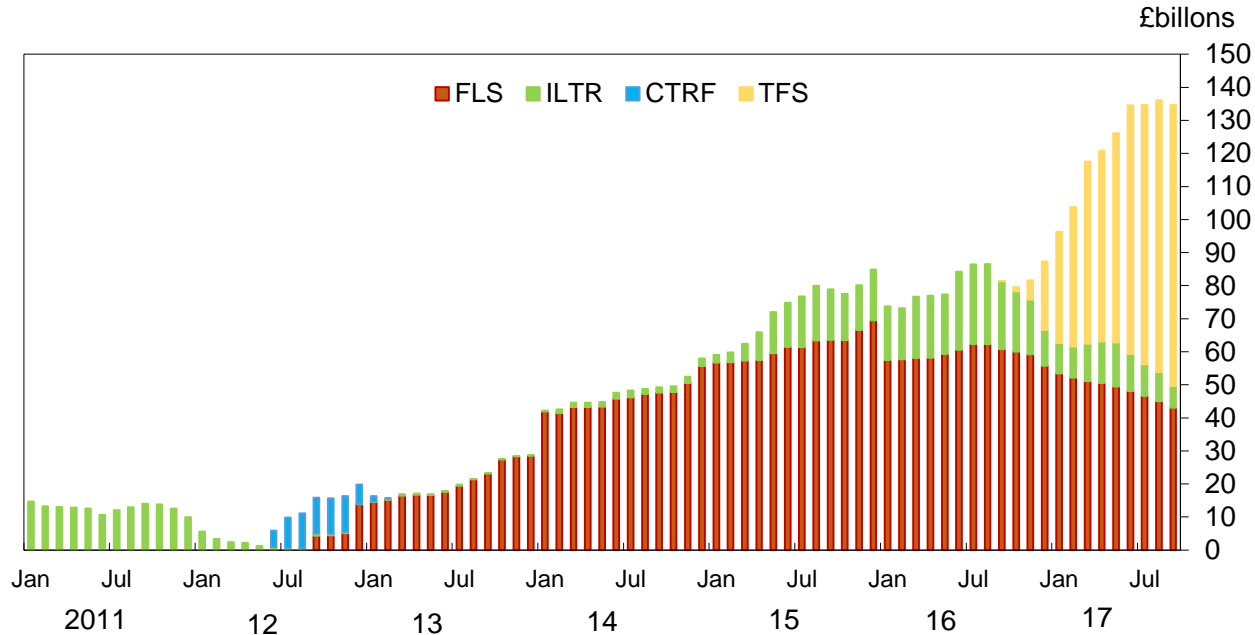
Expansion of access to the central bank balance sheet: Bank of England



Source: 2018
IEO report,
Bank of England

Term 'funding' from the Bank of England

Outstanding amounts lent in SMF liquidity facilities, the FLS and TFS, 2012–17



Source: 2018
IEO report,
Bank of England

Conclusions

- CB balance sheet choices will affect *monetary conditions* – but less now than when expanding ie much of the effect should have already worn off.
- Room to unwind may be determined by a structural increase in demand for reserve balances. May have to react to market signals.
- CB balance sheet implementation has become more important because of impact on regulatory metrics for banks and hence *financial stability*.
- So the central bank balance sheet has become a major *macroprudential* tool. (Which is helpful given a shortage of such tools.)
- All central banks need to be given, and be clear about, their *financial stability mandate* to guide these choices.