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

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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.
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.
Expanded central bank balance sheet
Federal Reserve

Liabilities
- Other liabilities
- Reserve balances
- Treasury Supplementary Financing account
- Currency in circulation

Assets
- Treasury securities held outright
- Maiden Lane I, II and III
- Agency debt and MBS
- Central bank liquidity swaps
- TALF
- Repurchase agreements
- Loans
- Other assets
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.