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 <u>mostly</u> 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.**

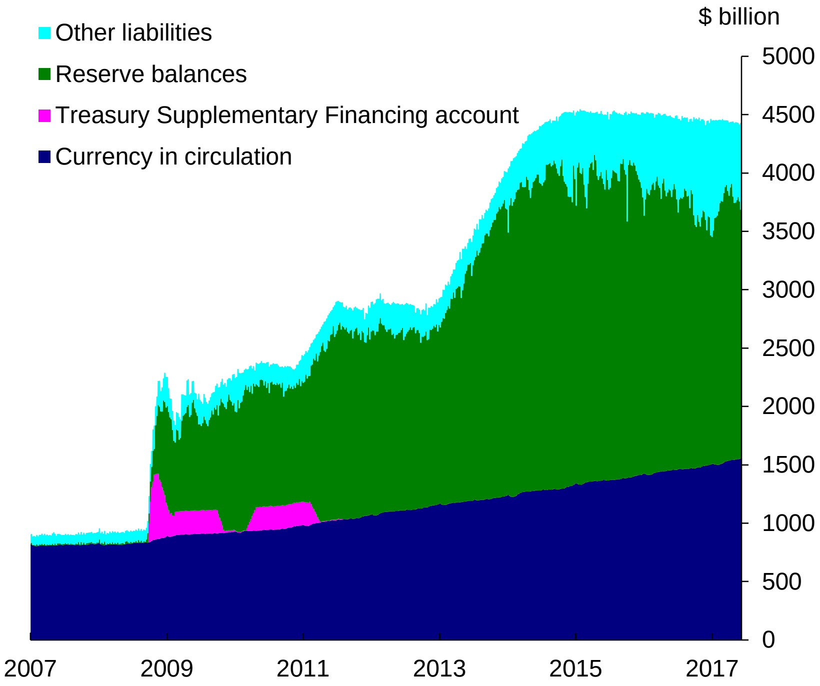
What is the optimal size of a central bank balance sheet?

- 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 <u>always</u> 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.

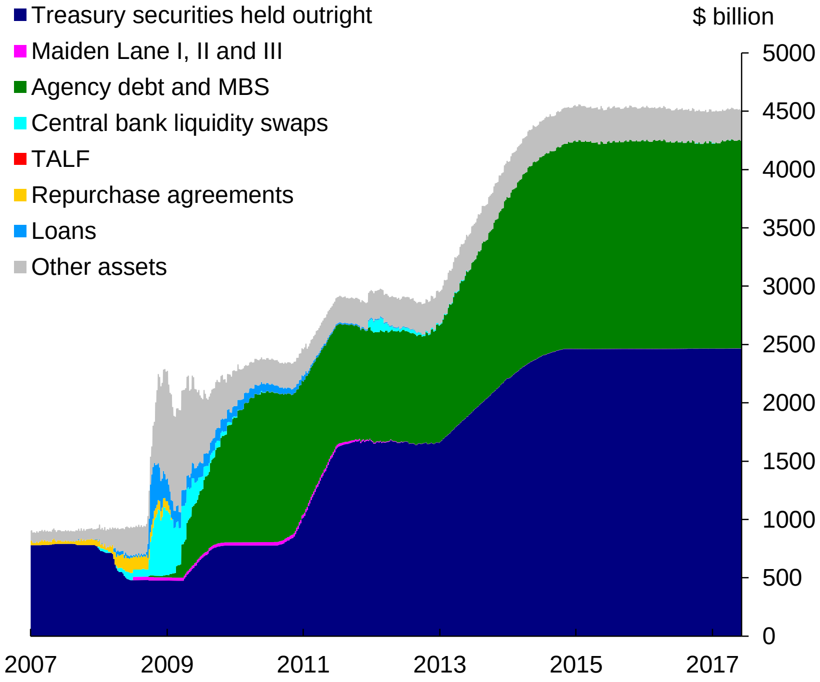
Expanded central bank balance sheet

Federal Reserve

Liabilities



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.

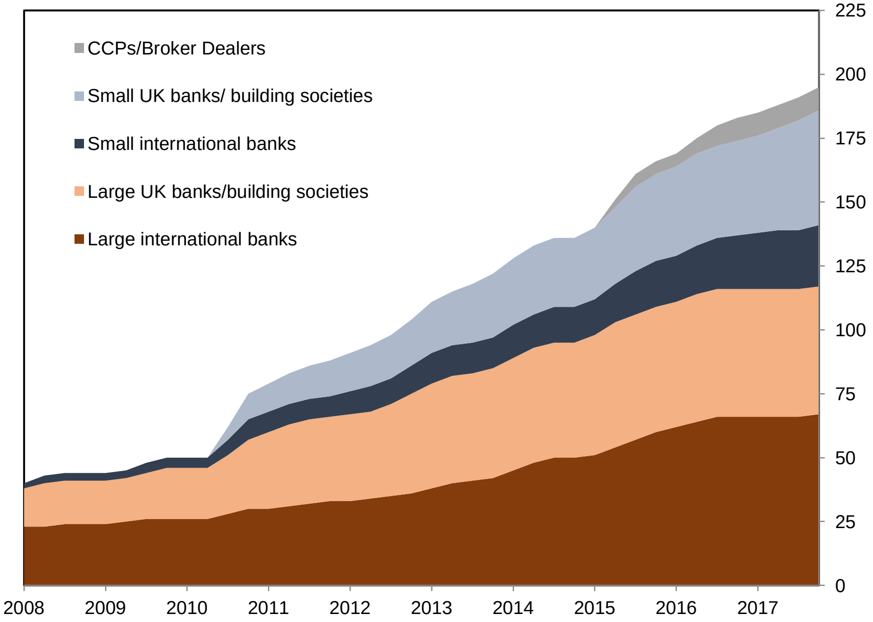
Interact with capital regime via:

- **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

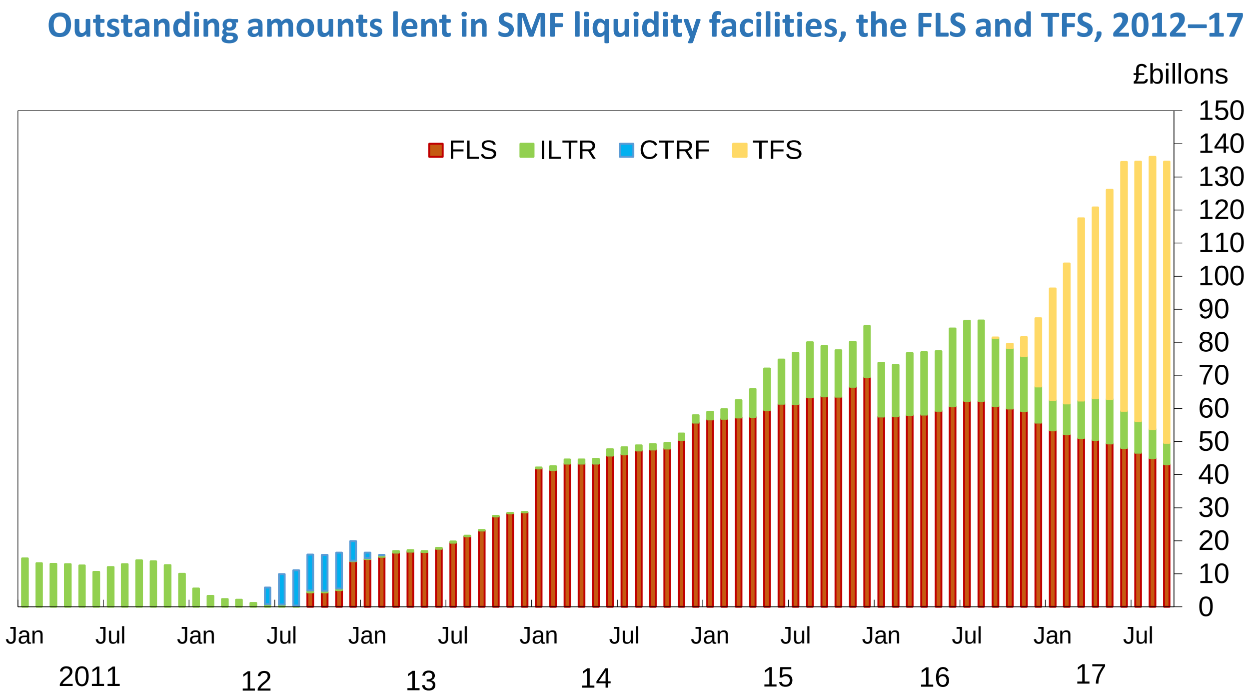
- Size = demand for reserves? (LCR, LR) Unknown.
- Excess vs shortage. Floor system vs corridor. Access (next chart).
- Composition: loans vs outright purchases.
- Purchases: bank assets vs non-bank, HQLA vs non.
- Collateral eligibility: HQLA vs non-HQLA.
- Term of loans (chart).
- Do reserves count 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



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.