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# Can central banks go bust?

## A look at monetary policy's paradigm shift and the impact on central bank balance sheets

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Around the world, central banks have aggressively hiked interest rates in an attempt to tackle record-high inflation and to bring inflation expectations back to where they were at the start of the Covid-19 pandemic. In Europe, this shift in monetary policy implied a shift from negative interest rates to positive interest rates but still with abundant liquidity. As central banks are moving into a more 'normal' world for monetary policy, this also means that bank reserves will again be remunerated at positive interest rates. Some market participants might have forgotten about this, but this new normal has always been the reality. It is not that banks are suddenly getting remunerated for their deposits at central banks – they always have and there has hardly ever been any speculation about central banks going bankrupt because they only pay interest rates on bank reserves. Admittedly, the current situation is different from anything we have seen in the past as excess liquidity as a result of quantitative easing (QE) and negative interest rates is extremely high.

In the period of asset purchases and negative interest rates, national central banks (NCBs) did not hedge their interest rate risk but built reserves to address these risks. Still, with the unexpectedly sharp rise in policy rates, potential losses are arriving faster and exceeding existing buffers. Eurozone central banks running down their buffers, and their equity turning negative, has now become a possible scenario for the years ahead.

Central banks that can print money can never fall short of money. Central banks can make losses but they don't go bust. Instead, central banks can roll over losses into the next year, have reserves or need to be "bailed out" by the governments via capital injections or an increase in their own capital.

In the eurozone, losses by the European Central Bank (ECB) can first be absorbed by a strategic reserve. If this is not enough, losses will have to be paid by the national central banks according to their share in the ECB's capital. The ECB's capital can also be increased, as was the case during the euro crisis when it was increased from €5bn to €10bn. National central bank losses do eventually end up with taxpayers as they transfer their net profits to national Treasuries.

In its June 2022 Convergence Report, which covers EU member states that are not yet members of the monetary union, the ECB states that "any situation should be avoided whereby for a prolonged period of time an NCB's net equity is below the level of its statutory capital or is even negative... Any such situation may negatively impact the NCB's ability to perform its European System of Central Bank (ESCB)-related tasks but also its national tasks. Moreover, such a situation may affect the credibility of the Eurosystem's monetary policy. Therefore, the event of an NCB's net equity becoming less than its statutory capital or even negative would require that the respective Member State provides the NCB with an appropriate amount of capital at least up to the level of the statutory capital within a reasonable period of time so as to comply with the principle of financial independence." A clear hint at how the ECB probably looks at the current situation with national central banks running the risk of negative equity.

Credibility is obviously key when talking about potential negative capital cases of central banks. Particularly in a situation in which central banks are trying hard to restore their credibility as inflation fighters, negative equity would be counterproductive. Even more as in a phase of policy rate hikes, printing their own money will not work. The option to print money in order to offset central bank losses would mean purchasing assets while hiking rates. A combination that hardly works.

## What can be done to reduce excess liquidity

**Reversed reserve tiering.** The ECB introduced a reserve tiering system to deal with the impact of negative deposit rates on banks. Banks were only required to put a fraction of their reserves in the ECB's deposit facility, the rest could be parked at a zero interest rate in the ECB's current account facility. Now, a reversal of such reserve tiering makes sense as it allows central banks to not remunerate all reserves. My colleagues Antoine Bouvet and Benjamin Schröder have written an excellent piece on the recent developments of excess liquidity and central banks' options for how to deal with it in the UK, Switzerland and the eurozone. Read it here: Tiers of joy: European central banks adjust their liquidity settings

As mentioned in the piece, the Swiss National Bank (SNB) was the first European central bank to actually implement a reserve tiering system at its September meeting. In a nutshell, banks' sight deposits at the SNB up to a certain threshold will earn the SNB policy rate, currently 0.5%, and 0% on balances above that threshold. This, however, is only part of the story. In parallel, the SNB announced it will conduct liquidity-absorbing operations (Open Market Operations or OMOs).

The question is how to determine the threshold. This could be done by either determining a fixed amount or a multiplier of the reserves (as the ECB did for its first tiering).

**ECB could change the terms of targeted longer-term refinancing operations (TLTROs).** As policy rates rise, the interest banks earn by placing liquidity at the ECB will gradually rise above the rate they are paying on their TLTRO loans, presenting them with an interest rate gain. If this is the sole problem it is intending to solve, one option would be to retroactively change the TLTRO terms by raising the applied interest rate. The ECB would then 'earn' a higher interest rate than it has to pay on banks' deposits. However, such a change in terms would be detrimental to the predictability and attractiveness of future TLTRO operations. With the brunt of TLTRO loans due to expire by the middle of next year, one could also question the need to come up with risky solutions to a problem that will disappear in nine months' time.

A design similar to the one described above for the Bank of England, where a fixed amount earns 0% and balances above that threshold earn the policy rate, would guarantee some interest rate saving but wouldn't provide an incentive for banks to repay TLTRO funds if the threshold is set low enough. If the threshold is set high, then the risk is that 0% becomes the marginal interest rate for many banks and that some countries end up being net lenders, and others net borrowers. The result would be a drop in money market rates in some countries and a rise in others.

## Reducing excess liquidity is the first step in avoiding negative central bank equity

All in all, the rapid transition from negative to positive interest rates comes with unwarranted side effects, particularly as it (intently) coincided with ample liquidity. These side effects are losses for central banks which have triggered the first central banks to quickly withdraw excess liquidity and others are likely to follow. For the ECB, the easiest and least controversial way forward is a reversed tiering of the deposit facility. This option would not be as counterproductive to further rate hikes as offsetting potential losses by printing new money or asking governments for capital injections would be.

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