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mBaer Necessities

Central bank losses matter: credibility, independence and public trust.

Central banks' objectives are maintaining price stability and financial stability and do not include a profit motive. That said, last financial year will be remembered as a shocking year for central banks' finances, as they reported large losses and will accumulate further losses this year. From a financial perspective, central banks had bad years in the past, but they recovered the losses, as their business is simple and profitable in normal times.

As shown in Table 1, the US Fed posted unrealized losses of USD 1.2 trillion, the estimated losses for the ECB and the Eurosystem are at about EUR 758 billion, the SNB posted a loss of CHF 132 billion and the BoJ losses swelled to JPY 10.5 trillion (USD 71 billion). The financial performance of other selected central banks is shown in the *Annex*.

Table 1: Selected Central Banks financial positions in 2022.

Central Bank	Balance Sheet	Net Income
US Fed	USD 8.6 trillion	USD 58.8 billion, (USD -1.2 trillion)*
ECB	EUR 698.9 billion	EUR 0 (EUR -758 billion)*
Bank of Japan	JPY 685.8 trillion	JPY 1'592 billion (USD -71 billion)*
SNB	CHF 881 billion	CHF -132.5 billion
Sveriges Riksbank	SEK 1.5 trillion	SEK -80.7 billion

Source: IMF. *Unrealized losses and IMF estimates

The concept of central bank losses is so alien to central banking that its occurrence may be interpreted as a failure of financial discipline by central bankers and, ultimately, may cast doubts about the stability of the financial system. This is not the case.

The key issue is whether considerations of central banks' finances may compromise the achievement of their main policy goal that is to keep inflation under control. It is intuitively plausible that central banks with a weak financial position may face a serious loss of credibility, independence and public trust.

In fact, a central bank facing losses and operating with a low level of equity may be forced to abandon its inflation target if it needs to generate more revenues and more profits. Or, as a last resort, a central bank may need a capital injection from the government, although it is unlikely that this option will be undertaken for the stigma it would carry on the central bank.

There is no bankruptcy procedure for a central bank

Central banks cannot become bankrupt, as there is no bankruptcy procedure for these government agencies. In addition, the national governments are central banks' beneficial owners, so central banks are ultimately backed by taxpayers. Bankruptcy does not apply to central banks with *private shareholders*, including the US Federal Reserve (which is fully owned by private banks), Banca d'Italia, National Bank of Belgium, Bank of Greece, Swiss National Bank, Bank of Japan, Central Bank of Turkey.

Academic research shows that central banks with private shareholders do not appear to differ from public central banks in their profitability or in the share of profits distributed to the shareholders. An inconvenient truth is that the authors of the research do not rule out the possibility that private shareholders may influence supervisory or interest-rate setting decisions.

Seigniorage and the true cost of Quantitative Easing

Central banks earn monopolistic profits, *seigniorage*, from issuing currency and bank reserves. Such profits are generated on a stable basis – printing fiat money is a very profitable activity.

Since central banks started deploying their balance sheets to counter the effects of the great financial crisis (GFC), the Covid pandemic and other events, they took financial positions, taking substantial interest rate, credit, equity and currency risks. Basic finance rules apply also to central banks' investments.

As balance sheets expanded and interest rates collapsed near zero starting in 2008 (see Chart 1 in the Annex), the yields on the long-term government and corporate bonds (assets side) largely exceeded the interest rates on the excess reserves (liabilities side), generating sizeable profits for central banks.

Correspondingly, the cumulative transfers to governments substantially increased during this period. Balance sheets grew even at an accelerated pace in 2020, forcing central banks to invest in expensive government bonds with low or even negative yields, hence increasing the fragility of the balance sheets that became exposed to additional interest rate risk.

As central banks started hiking interest rates and shrinking their balance sheets in 2021 in response to inflation (see Chart 1), profits and equity decreased. From the liabilities side, central banks started paying higher interest rates on the deposits of private banks, even perhaps exceeding their seigniorage profits, whilst reporting substantial capital losses on their bond holdings from the assets side. Ironically, central banks that invested in the highest rated bonds, such as the Bundesbank, are experiencing the largest nominal losses. Taken together, these facts suggest that central banks may consider prioritizing their finances in their policy conduct, leading to a sharp rise in inflation expectations.

Central banking taboos have been crumbling in recent years: they experimented with negative interest rates and became active in large-scale asset purchases, as instruments for managing crises. The combination of these policies amplified the interest rate risk associated with the debt held on central banks' balance sheets.

As inflation hit, the costs of such policies became apparent as central banks accumulated substantial losses. All this may have a serious impact on the central banks' credibility in achieving their inflation targets.

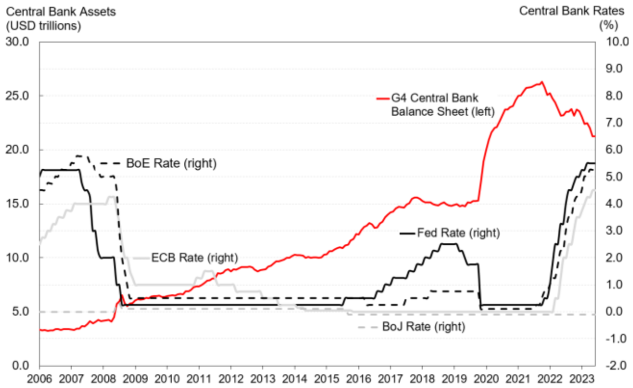
Francesco Mandalà, PhD

Annex 1: Financial Performance of selected Central Banks

Central Bank	Balance Sheet	Net Income
The Federal Reserve, US	USD 8.6 trillion (2022)	USD 58.8 billion, (USD -1.2 trillion)*
Bank of Japan (BoJ)	JPY 685.8 trillion (Sep-22)	JPY 1'592 billion (USD -71 billion)*
Bundesbank, Germany	EUR 2.9 trillion (2022)	EUR -172 million (2022)
Norges Bank, Norway	NOK13.2 trillion (2022)	NOR -10.6 billion (2022)
Bank of England (BoE)	GBP 1.03 trillion (2021Q3)	GBP 7 million (Mar-21 - Feb-22)
European Central Bank (ECB)	EUR 698.9 billion (2022)	EUR 0 (EUR -758 billion)*
Swiss National Bank (SNB)	CHF 881 billion (2022)	CHF -132.5 billion (2022)
Central Bank of Taiwan PoC	NTD 19.4 trillion (2022)	n.a.
SG Monetary Authority (MAS)	SGD 696.8 billion (Mar-22)	SGD -7.4 billion (Apr-21 - Mar-22)
HK Monetary Authority	HKD 4.0 trillion	HKD -249.5 billion (2022)
Bank of Korea	KRW 582.8 trillion (2022)	n.a.
Bank of Canada (BoC)	CAD 410.7 billion (2022)	CAD -1.1 billion (2022)
Reserve Bank of Australia (RBA)	AUD 538.1 billion (Jun-22)	AUD -36.7 billion (Jul-21 - Jun-22)
Bank of Israel (BoI)	ILS 826.3 billion (2022)	ILS 14.9 billion (2022)
Sveriges Riksbank	SEK 1.5 trillion (2022)	SEK -80.7 billion (2022)
Danmarks Nationalbank	DKK 625.4 billion (2022)	DKK -8.5 billion (2022)
Reserve Bank of New Zealand	NZD 93.9 billion (June 2022)	NZD -86 million (Jul-21 - Jun-22)
Czech National Bank (CNB)	CZK 3.2 trillion (2022)	CZK -411.9 million (2022)
Central Bank of Iceland	ISK 874.6 billion (2022)	ISK -18.4 billion (2022)

Source IMF. Central banks with negative equity are: BoC, BoI, CNB, and RBA. *Unrealized losses and IMF estimates

Chart 1: Fed, ECB, BoJ, BoE balance sheets and policy rates.



Source: Bloomberg, MBaer's calculations.

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