

Brandeis

INTERNATIONAL
BUSINESS SCHOOL

LIMITING CENTRAL BANKING

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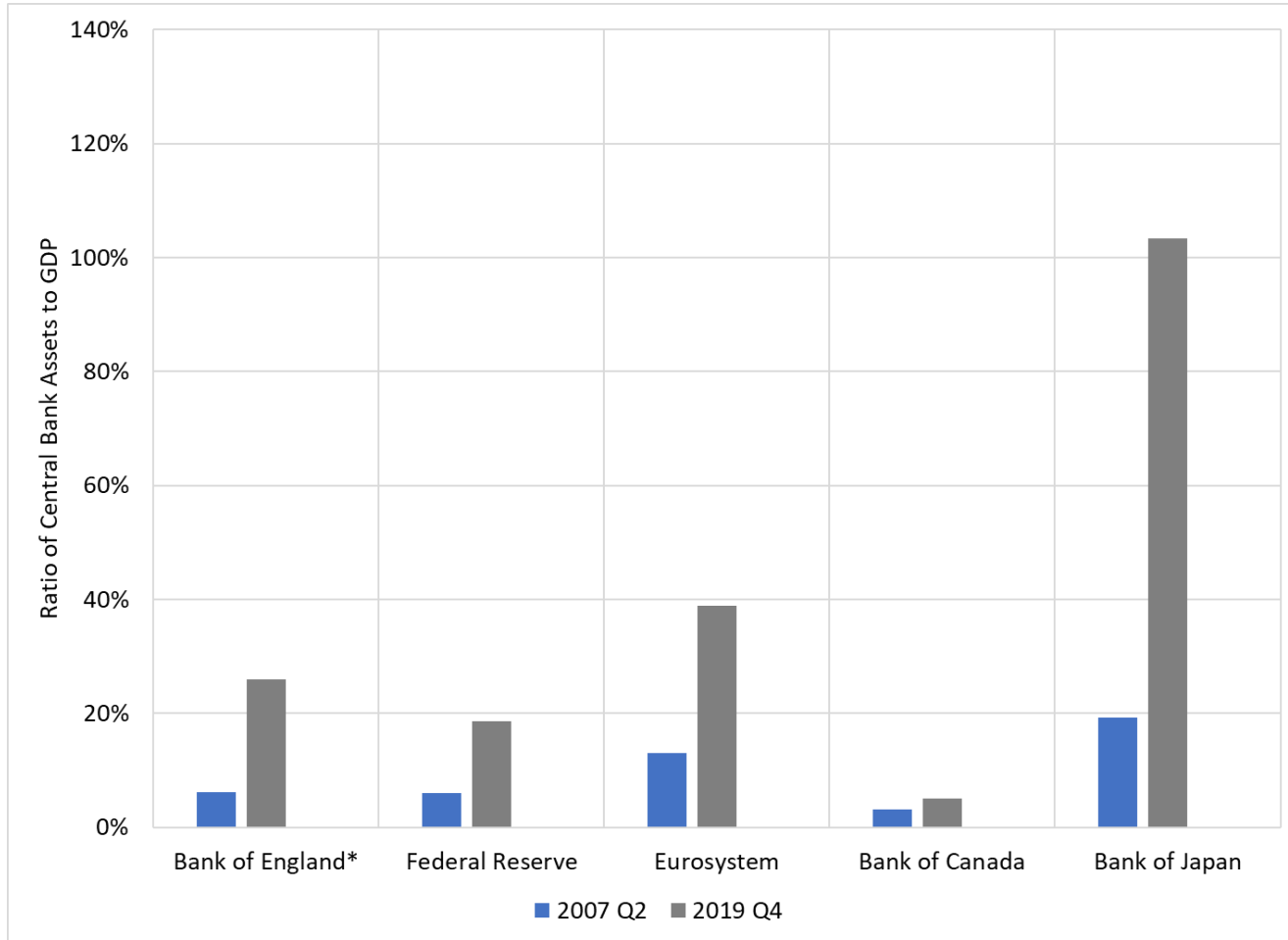
Central Banks of the Past

- Financial conditions influence the real economy
- CBs control the price of reserves:
 - Safest, most liquid asset.
 - Actions are neutral with respect to maturity, liquidity, and credit risk.
- All other assets priced off the price of reserves
- CBs control financial conditions \Rightarrow real economy

Stage 1: 2007 to 2019

- Frictions: Δ safe asset prices $\not\Rightarrow$ Δ risky asset prices
- Financial conditions can change without CB action
- CB response:
 - Intervene in other assets to promote transmission
 - Substitute for failing private intermediation
 - Operate through financial intermediaries wherever possible

Central Bank Balance Sheet Expansion



Increase in CB Assets (percent of GDP)	
	2007-19
UK	20pp
US	13pp
EA	26pp
CA	2pp
JP	85pp

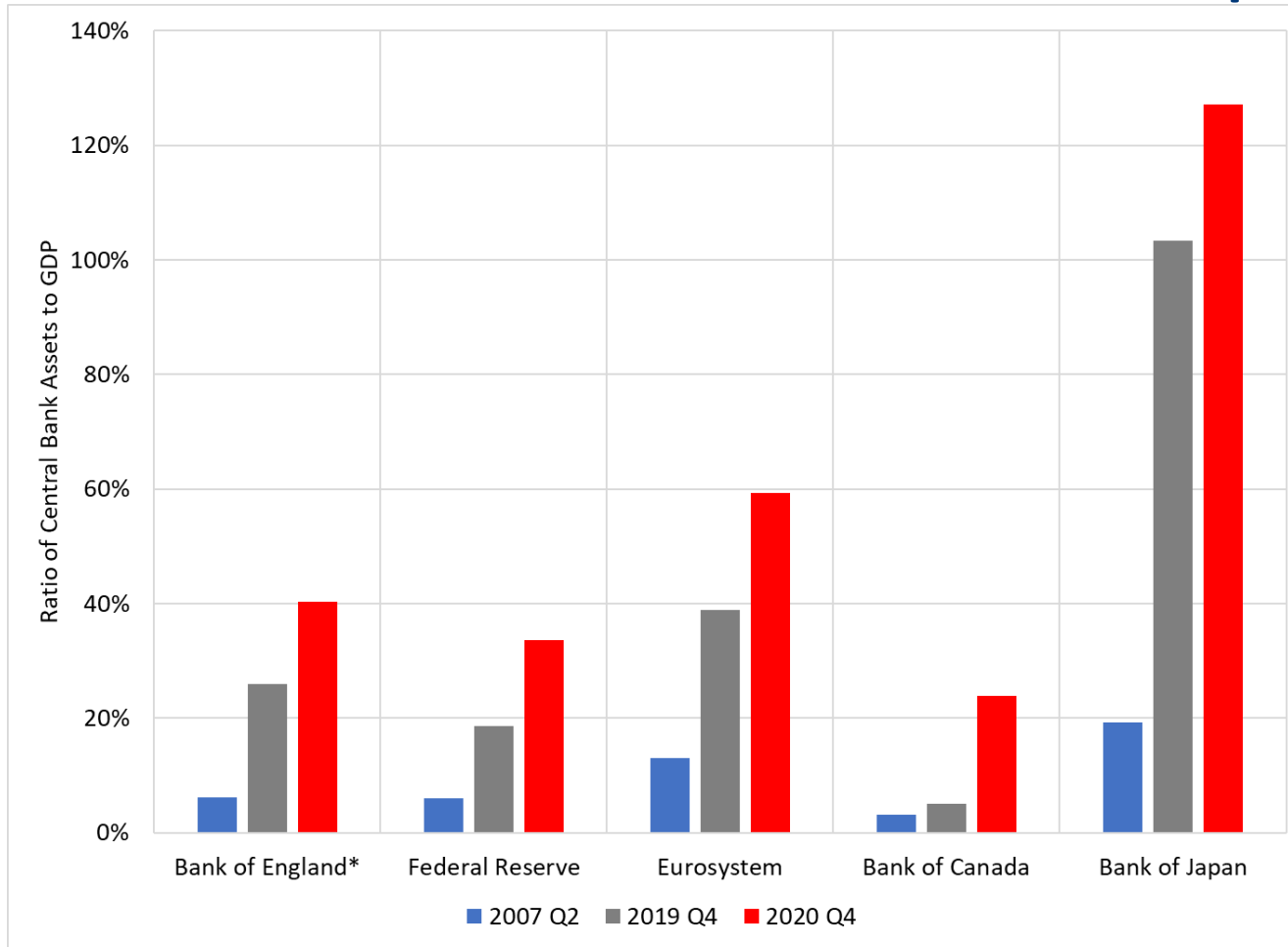
*Numbers the Bank of England for 2019 and 2020 are likely understated for technical reasons.

Source: Bank of England, Federal Reserve, Eurostat, Bank of Canada, Bank of Japan, and FRED.

Stage 2: 2020

- Pandemic shock \Rightarrow further obstacles to transmission
- CBs shift toward direct credit provision
- CBs shift to directly to the nonfinancial sector

Central Bank Balance Sheet Expansion

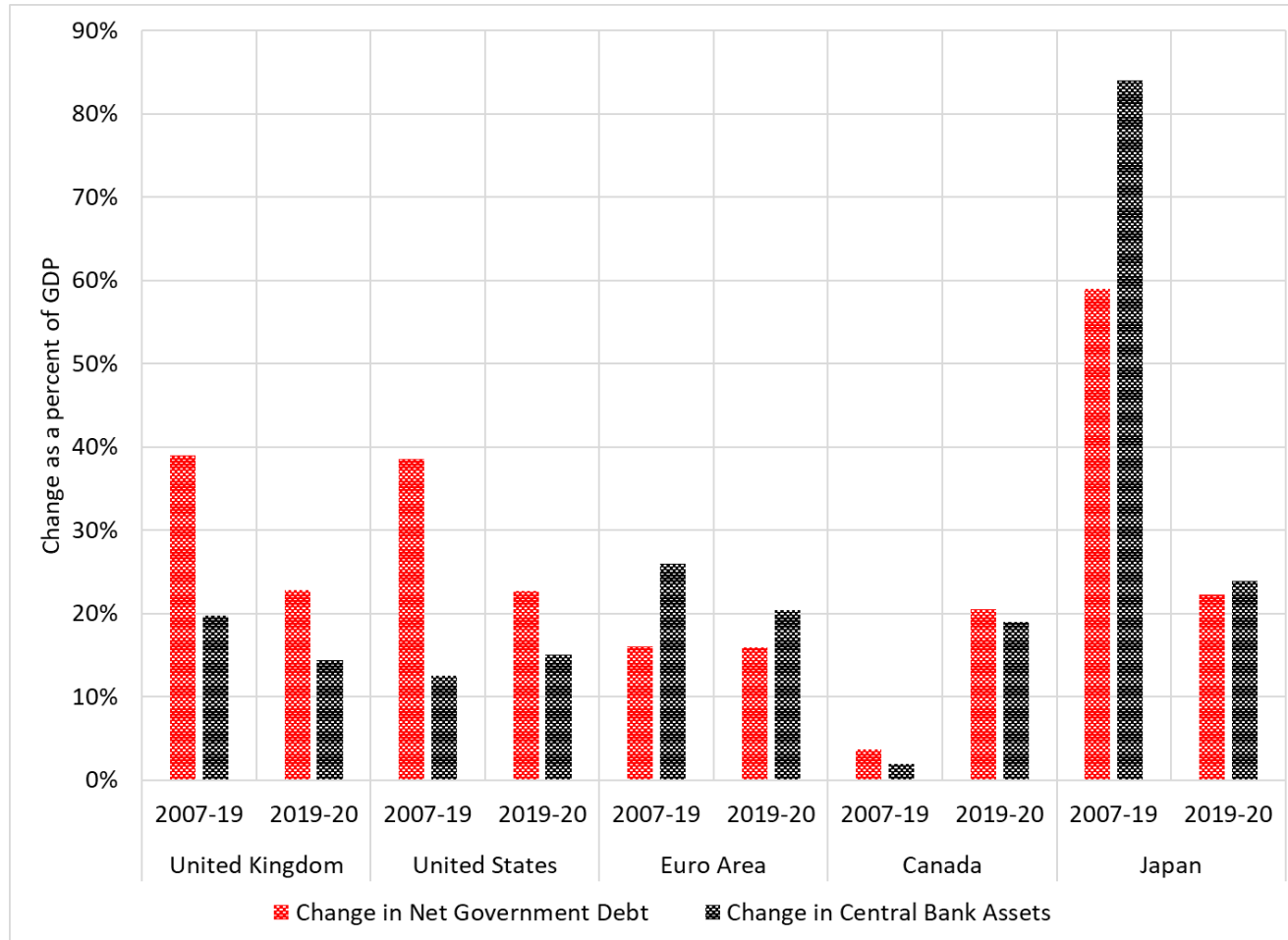


Increase in CB Assets (percent of GDP)		
	2007-19	2020
UK	20pp	14pp
US	13pp	15pp
EA	26pp	19pp
CA	2pp	20pp
JP	85pp	24pp

*Numbers the Bank of England for 2019 and 2020 are likely understated for technical reasons.

Source: Bank of England, Federal Reserve, Eurostat, Bank of Canada, Bank of Japan, and FRED.

Changes in Gov't Debt and CB Balance Sheets



Source: Various central banks, IMF World Economic Outlook Database, and FRED.

Ratio of Change in CB Assets to Change in Net Gov't Debt		
	2007-19	2019-20
UK	51%	63%
US	32%	66%
EA	162%	128%
CA	51%	92%
JP	142%	108%

Rapid expansion of CB balance sheets absorbs big gov't debt increase.

Where does this trajectory lead?

- Central bank sets all asset prices
- State allocates credit
- Risks destroying dynamism damaging long-run growth
- Blurs line between debt management & monetary policy

Temptation to Expand CB mandate

- **CB independence less important now**
 - Inflation is low, interest rates are low, fiscal policy is primary stabilization tool
 - Tempting to use the CB as the fiscal agent for government financing
- **The lure of new tools**
 - Provide credit directly to nonfinancial businesses
 - Support market prices of debt and equity directly
 - Distort prices through eligibility and haircuts in CB collateral framework

Risk to the Central Bank

- **Expanding tools threatens key CB mandates**
 - Price stability through influence on financial conditions
 - Financial stability through lender of last resort
- **Do not confuse CB balance sheet & expertise**
 - CB can always provide technical assistance
 - Credit operations should not be on the central bank's balance sheet (or SPVs)

What now?

- Fiscal authorities allocate resources in a democracy
- Governments have institutions for credit allocation
(US: housing, farm, and student credit all have loan-guarantee programs)
- Do not conceal public support in the central bank
- Return to asset neutrality and stop directing credit

Limit what central banks can do
to ensure they do it well!

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