Economic Insight

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ECB: A permanently bloated balance sheet?

It should go without saying that the ECB will at some point reduce its bloated balance sheet back to the lean pre-crisis level. But within the ECB not everyone seems to share this view. We show how far-fetched the arguments for a permanently large ECB balance sheet are and that it would weigh on the euro zone's trend growth.

Recently, Bundesbank President Jens Weidmann felt compelled to recall that the ECB should not operate with a huge balance sheet in the long run.[1] But the consensus for a gradual return to a lean balance sheet seems to crumble. In the spring of last year, Vitor Constancio, then Vice-President of the ECB, argued to permanently keep a large ECB balance sheet.[2]

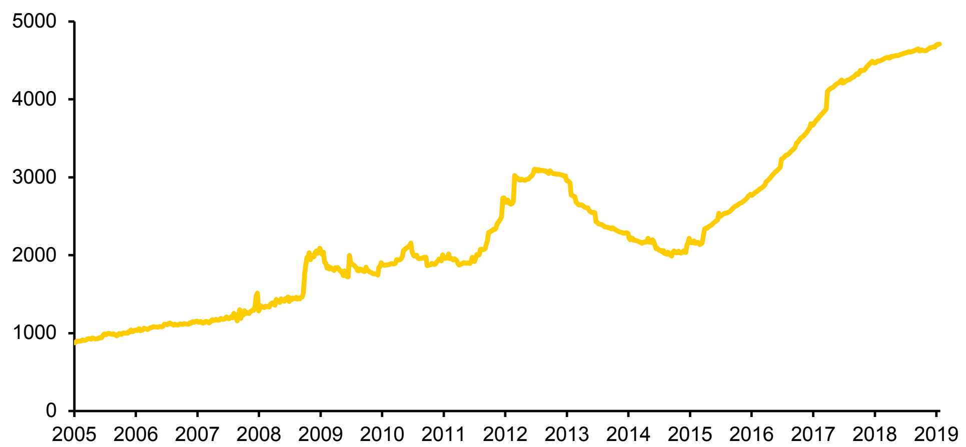
This conflict is about a lot of money. The ECB has bought government and corporate bonds from the banks on a large scale and credited the equivalent amount to their ECB accounts. It also lent unlimited central bank money to banks against collateral. As a result, the ECB's balance sheet has quadrupled since the outbreak of the financial crisis to 4670 billion EUR (chart 1), equivalent to around 40 percent of the eurozone's GDP. Other central banks have also inflated their balance sheets. The US Federal Reserve's balance sheet, for example, accounts for 19 percent of GDP and the Bank of Japan's for 100 percent. In this respect, discussions are also taking place outside the euro zone as to how these huge balance sheets should develop in the long term.

A big balance sheet for more financial stability?

Those who want a permanently large central bank balance sheet argue with structural changes, which supposedly require a lot of central bank money and a large balance sheet. Harvard economists Robin Greenwood, Samuel Hanson and Jeremy Stein, for example, stress that banks must now hold more safe and liquid assets due to new liquidity regulations.[3] These should allow banks to remain liquid if bank customers in a financial crisis become nervous and want their money back. The bank's increased demand for liquid assets could be met by private investors who issue corresponding bonds. But with the proceeds

CHART 1: **The ECB's big balance sheet**

Balance sheet of ECB, in EUR bn

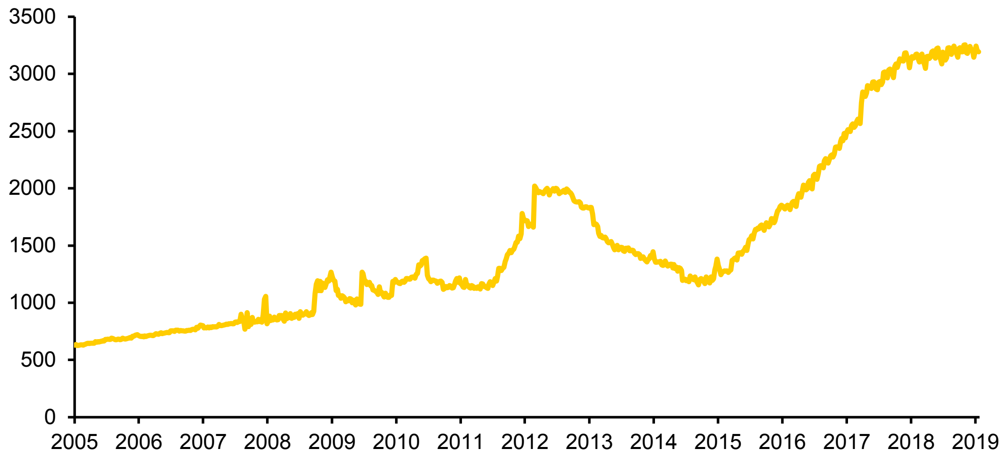


Sources: ECB, Commerzbank Research

[1] „From extraordinary to normal – reflections on the future monetary policy toolkit". Speech at the European Banking Congress, 16 November 2018.
[2] "Past and future of the ECB monetary policy", Speech held at the central bank of Malta, 4 May 2018.
[3] "The Federal Reserve's Balance Sheet as a financial stability tool". Speech prepared for the Federal Reserve Bank of Kansas City's 2016 Economic Policy Symposium in Jackson Hole.

Author:
Dr Jörg Krämer
Chefvolkswirt
+49 69 136 23650
joerg.kraemer@commerzbank.com

CHART 2: **The ECB's money flood**
Central bank money (Bank's accounts at the ECB, notes in circulation), in EUR bn



Source: ECB, Commerzbank Research

from the issuance they could allegedly finance risky investments – so the reasoning. In order to avoid this financial stability risk, central banks, not private investors, should create more safe and liquid assets and therefore lend more money to banks. This would enable banks to meet the stricter liquidity requirements. Vitor Constancio of the ECB endorsed this twisted reasoning. But it is not the task of the ECB to create more safe and liquid assets. After all, there are more than enough government bonds. If banks should doubt the creditworthiness of individual countries such as Greece, it is up to the finance ministers of these countries to dispel such concerns through a sound fiscal policy.

Do ECB interest rates really not reaching the real economy?

Other arguments in favour of a permanently large central bank balance with high deposits for banks are also far-fetched. Stanford economists Darrell Duffie and Arvind Krishnamurthy, for example, propose that the US Federal Reserve should lend central bank money not just to a few selected financial institutions, but to many. Then more banks would follow the Fed policy rates when setting their lending or borrowing rates which are ultimately decisive for the investment and consumption decisions of companies and consumers.[4] Vitor Constancio refers to unpublished ECB studies and sees a need for action also for the euro area. But his argument seems strange, because market forces make sure that the negative ECB deposit rate has reached every corner of the euro area's financial system.

In fact, it is about the south of the monetary union

When central bankers from the south of the monetary union use far-fetched arguments in favour of a permanently large ECB balance sheet, then it is reasonable to assume that there are other intensions behind it – such as the desire to help their banks. Many institutions in the South suffer from bad loans. In Greece, for example, 41 per cent of bank loans are at risk of default, 26 per cent in Cyprus and 8 per cent in Italy, while the figure in Germany is only 1 per cent. But if the ECB returned to a lean balance sheet and made central bank money scarce again, then the banks lacking liquidity would have to borrow from other banks while longer-term funding needs to come from private investors. In order to be sufficiently creditworthy, banks with borrowing needs would be forced to write off their many bad loans. But this means insolvency proceedings against over-indebted companies and job losses.

Large ECB balance to lower the euro area's trend growth

Banks can avoid such a clean-up of bad loans by borrowing money not from demanding private investors, but from the ECB, which provides any desired amount against reasonably sound collateral (see chart 2). Although this saves banks painful write-downs in the short term, it also

[4] "Pass-through efficiency in the Fed's new monetary policy setting". Speech prepared for the Federal Reserve Bank of Kansas City's 2016 Economic Policy Symposium in Jackson Hole.

prevents over-indebted and unproductive companies to exit the market. These continue to tie up labour and capital, which of course puts a strain on economic growth.

However, the ECB is helping not only banks but also the finance ministers of the highly indebted countries with a permanently large balance sheet. The ECB parks around one fifth of all member countries' government bonds in its balance sheet. In addition, it lends central bank money to banks for several years (LTROs), so that banks can use it to finance their huge holdings of government bonds.[5] Finance ministers are therefore less dependent on private investors and can borrow cheaper. But this also reduces the pressure to bring their economies and public finances up to speed.

ECB should return to a lean balance sheet

With a permanently large balance sheet, the ECB is removing the banks and the states from the healthy pressure of private investors. This lowers trend growth. Bundesbank President Jens Weidmann rightly compares this with mechanical ventilation which could cause the patient's respiratory muscles to weaken. To prevent this, doctors do not prolong the support unnecessarily. This should also apply to the euro area. The ECB must return to a lean balance sheet.

[5] We expect the ECB to announce new LTROs in coming months.

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Tel: + 49 69 136 21200	Tel: + 44 207 623 8000	Tel: + 1 212 703 4000	Tel: +65 631 10000	Tel: +852 3988 0988