Comments on A Durré and H Pill's paper "Central bank balance sheets as policy tools"

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Overview

This insightful paper explored "how central bank balance sheets can help contain financial crises [lessons learned from The European Exchange Rate Mechanism (ERM) crisis of 1992–1993, the Asian financial crisis of 1997–1998 and the global financial crisis of 2007–2011], although, given recent experience, the focus is on domestically generated and propagated crises."

In line with much of the existing analysis of non-standard central bank policy measures, focusing on the importance of portfolio balance channels in transmission, this empirical study argues that the main channel through which balance sheet policies have influenced macroeconomic outcomes is by supporting market functioning and, albeit to a much lesser extent, via portfolio balance effects.

Varying the size and structure of balance sheets serves to provide additional stimulus to the economy, support market function (particularly interbank trading) and manage cross-border capital flows.

Key findings and conclusions

Despite the different natures of the market segments facing these different crises, the crises have more similarities than differences, in terms of both market distortions and central bank reactions (in which central banks take on the market-based intermediation role and assume exposure to FX risks). In all these cases, central banks had to increase their intermediation role in order to furnish a substitute for market mechanisms that provide liquidity.

This study also reminds us to give further consideration to the pros and cons of using central bank balance sheet as policy tools. As the authors say on the side of the ***pros***:

- We have argued that the main channel through which balance sheet policies have influenced macroeconomic outcomes is by supporting market functioning and… via a portfolio balance effect.

And as they state regarding the ***cons***:

- There is the risk of offering the market confusing signals regarding policy intentions, [so that] communication on that monetary policy stance can become multidimensional and therefore more complex.
- [T]here is a danger that well-intentioned balance sheet policies to support market functioning (essentially liquidity operations) will end up as quasi-fiscal operations [and] sections of the financial systems become dependent on central bank support.

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- [The introduction of balance sheet policies may find itself] eroding over time the central bank's credibility as regards delivering on the explicit monetary policy objectives.

Relevance to Indonesia's case

This study is relevant for Indonesia's recent application of central bank balance sheet policy. Bank Indonesia has been varying the size and structure of its balance sheets over the last decade: since 1997 in response to the 1997–1998 Asian crisis, and subsequently in response to the 2005 and most recent global financial crises. The implementation of balance sheet policy tools in Indonesia has helped to contain the effects of crises characterized by the following fundamental challenges (and corresponding responses):

Challenges

- The main challenges facing Indonesia are a structural and permanent excess of Rupiah liquidity, and also volatile and increasing capital flows in underdeveloped financial markets and instruments.
- The measures used to control excess liquidity have expanded the liabilities side of the balance sheet. BI's liabilities are dominated by short-term monetary policy instruments, which increases monetary operation costs.

Policy responses

- To address the problems, the strategy of the monetary operations is designed to lengthen the maturity profile of the monetary instruments by exchanging Bank Indonesia Certificates (SBI) with term deposit (TD) facilities and conducting reverse repo of government bonds.
- Higher statutory levels for the rupiah reserve requirement target (LDR-based) and foreign currency deposits, a longer minimum holding period (more months) for Bank Indonesia Certificates (MHP-SBI), and a wider corridor of rates for the interbank call money market are macro-prudential policies designed to support the monetary operation strategy. On the other hand, Bank Indonesia also uses conventional operations, purchasing government bonds and conducting sterilised foreign exchange intervention to stabilise the movement of the rupiah exchange rate.

Closing observations

This paper is insightful, and inspires further and deeper observation related to solving the optimum-equilibrium "trilemma". Addressing the recent financial market developments implies dealing with capital flows and the accumulation of foreign exchange reserves, with exchange rate levels, with interest rates and inflation, and with surplus/deficit issues on the central bank balance sheet.

We are urged to further investigate the impact for financial institutions and the banking intermediation function, the effect on market efficiency, and the implications of deepening financial needs via a portfolio balance effect.