Tuomas Välimäki: What is the optimal size of central bank balance sheets?

Introductory remarks by Mr Tuomas Välimäki, Board Member of the Bank of Finland, at the OMFIF seminar " The New Era of Central Bank Policy and Operations", Frankfurt am Main, 19 March 2023.

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Introductory remarks of the session on Navigating quantitative tightening

First, I would like to thank the organizers for inviting me here today to discuss a topic close to my heart: monetary policy implementation. The timing for this discussion is excellent, as last week the ECB Governing Council took some important decisions on the way forward on this frontier. Not only did it make this subject extremely topical, but had the preparation still been ongoing, I believe it would have been simply impossible for me to participate in this event.

Now, I will briefly introduce the basic logic behind my thinking on one of the topics of this session: the natural size of central bank balance sheet. In addition, as the Eurosystem's current balance sheet seemingly exceeds its natural size, I will reflect my views on the future path for the balance sheet: Does our original thinking still stand after some 25 years.

The fundamental building blocks of a central bank balance sheet result from the core tasks pledged to the central bank itself. In addition to maintaining price stability and supporting financial stability, these tasks often include functions like the issuing of banknotes as well as holding the country's official foreign currency reserves. These elements are also the ones that determine the natural size of the central bank balance sheet. As they are not directly related to the making of monetary policy, we often call them autonomous liquidity factors, and take their developments as given.

In a large economy that issues a reserve currency, the demand for banknotes is likely to exceed the level of foreign reserve holdings needed. In such a case, the autonomous central bank liabilities tend to exceed assets, and so, the liability side determines the size of the balance sheet. This is certainly the case for the Eurosystem. The demand for euro cash is currently more than 1 500 billion euros, whereas the level of FX holdings is less than 300 billion euros.[1] The case is even clearer, if one takes into account that we have always asked banks to hold minimum reserves with the Eurosystem, the public sector is allowed to hold deposits with National Central Banks and some foreign central banks hold part of their euro reserves with the Eurosystem.

Based on this, I would conclude that the liability side dominates the determination of the natural size of the Eurosystem balance sheet size. Thus, it would be natural for the euro area banking sector to operate in a liquidity deficit, and for the Eurosystem to cover this structural liquidity gap by providing central bank reserves with its monetary policy

instruments. Accordingly, originally the Main Refinancing Operations were used as the marginal tool for liquidity provision, and the MRO rate was setting the starting point of the euro yield curve. This framework lasted until the global financial crisis.

Now, even if we can derive rather easily this kind of a natural starting point for the central bank balance sheet, it is not the end of the story. Natural balance sheet size does not need to equal its optimal size. From time to time, the quest for price stability and the need to facilitate financial stability, may call the central bank to make non-standard monetary policy interventions, resulting in liquidity provision beyond the structural liquidity needs of the banking sector. In such a case, at some point, the asset side starts to dominate the size of the balance sheet, and the rate at which the excess liquidity is drained becomes the instrument for setting the interest rates.

This has been, as you well know, the case for the Eurosystem for a decade or so. First to address the risk of entering into a deflationary spiral, and then to address the financial stability concerns posed by the pandemic, the Governing Council engaged in large scale asset purchases. Accordingly, for more than a decade now, the asset side has dominated our balance sheet, and we've been steering money market rates with the rate applied to banks' deposits with us.

The switching from liquidity provision to draining it, was not a deliberate decision based on monetary policy implementation aspects nor the optimal balance sheet structure. Monetary policy implementation changed fundamentally as the world around us changed, requiring monetary policy responses that strongly shaped our balance sheet. The need to guarantee financial stability when the global economy is being hit by a pandemic clearly increased the optimal central bank balance sheet to levels significantly larger than the natural size would imply.

Now that those forces are no longer prevailing, we've been able to return to setting monetary policy stance with our standard tool (interest rates), and to scale back the extraordinary provision of credit to banks. This has been an opportune moment for us to reconsider, what type of monetary policy implementation framework suits best for the Eurosystem in the longer run.

As a result of our framework review, the Eurosystem will move back towards a system in which marginal liquidity is eventually supplied through short-term credit operations at a fixed rate and with full allotment procedure. Hence, the new framework can be seen as a move from a supply-driven balance sheet towards a demand-driven one. In some sense, this marks a natural return towards our original thinking that led us to design a demand-driven system based on refinancing operations, and a liability driven balance sheet.

We have started a journey to normalize our balance sheet, but its size will be different from what it was before the series of crises started some 15 years ago. The natural size of our balance sheet has doubled thanks to the increase in the autonomous liquidity factors. Furthermore, we will continue meeting the banks' demand for reserves in full also in the future. Hence, this demand will be an important driver of the overall amount of liquidity and thus also the size of the central bank balance sheet. Yet, even if there

are uncertainties in the way, our direction is clear, we will be unwinding the legacy monetary policy outright portfolios, and this process will take quite some time before we introduce new ways to provide the banks with their structural liquidity needs.

As there are many uncertainties around the monetary policy implementation landscape today, we must stand ready to react and calibrate the size and composition of our balance sheet also in the future if and when monetary policy does not transmit smoothly. After all, monetary policy operational framework needs always to serve our monetary policy ultimate goals – price and financial stability needs will always dominate in our thinking about the optimal balance sheet. So, in the Eurosystem, we will carefully monitor the evolution of all the relevant markets and indicators and stand ready to adjust the framework design and parameters if necessary.

Thank you for your attention. I am looking forward to our discussions in which we may dig deeper into the design of central bank operational frameworks.

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[1] One could add Gold and IMF receivables to the natural central bank assets, but when netted with their liability side counterparts (revaluation accounts and IMF Special Drawing rights), their volume would not change the big picture.