Klaas Knot: Central bank capital - of capital importance?

Speech by Mr Klaas Knot, President of the Netherlands Bank, at the DNB-Risk Management Workshop on "Central bank capital in turbulent times", Amsterdam, 12 April 2024.

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Good morning everyone. Welcome to the second day of this workshop on 'central bank capital in turbulent times'.

And this title really does sum it all up. Central banks around the world are going through some pretty turbulent times these days. With huge losses. And the Dutch central bank is no exception.

The last time the Dutch central bank faced a similar turbulent situation was roughly a century ago, in 1931 to be exact.

The turbulent times that caused significant losses back then, had to do with the gold standard.

After the First World War, the Netherlands and the United Kingdom agreed that, for the Dutch gold held in the UK, the Dutch central bank would accept pounds sterling. As a result, the Dutch central bank had a vast amount of British pounds on its balance sheet.

But by the 1930s, the British economy was in stormy weather – with high unemployment and an overvalued currency hindering export.

And even though the Dutch central bank got guarantees from the Bank of England that they would not leave the gold standard – they did so overnight, and effectively devalued the pound.

As a consequence of this devaluation, the Dutch central bank was left with huge losses. Losses that were one and a half times the size of its capital.

Today, almost a hundred years later, in a world that looks a lot different, we find ourselves again in a situation with huge central bank losses.

The Dutch central bank had to report a loss of 2.3 billion euros for 2023 – and our projected cumulative losses over 2023 until 2028 are 9 billion euros. Our neighbours at the Bundesbank reported a loss of 21.6 billion euros in 2023. And across the Atlantic, the US Federal Reserve published a loss of 114.3 billion dollars last year.

We know how we got here. And we know we have lessons to learn. So, let me begin by taking a step back.

Up until a few years ago, and especially since the 2008 Global Financial Crisis, inflation was persistently low. In response, and with the aim of countering deflation risks, stabilising our economies and safeguarding monetary policy transmission, central banks around the world expanded their toolkits to include a range of new and

unconventional measures – like large-scale asset purchases and targeted lending programmes. These new measures provided central banks with policy options to pursue their price stability objective, at a time when interest rates were at their lower bound.

But these new tools – as has become apparent – have a flipside. They come with a price tag in terms of increased risks that may lead to substantial losses.

While quantitative easing did help to stave off deflation risk, it also reshaped central bank balance sheets. Because, essentially, QE locked in low returns on a significant portion of central banks' assets – the so-called 'buy high' strategy. In the final phase of QE in particular, we bought vast quantities of bonds at relatively high prices, with very low and often negative yields. As rates on our liabilities could eventually go up, this strategy would then generate some losses. What materialised, though, was the worst case scenario. Namely, a sudden and massive spike in inflation leading to an increase in policy rates. Leading to the current huge losses.

And so, as the profitability of these new, riskier, and by now conventional monetary policy tools has proved to be lower than the profitability of traditional instruments, central banks should critically asses their capital levels. They should be forward-looking and build up their capital accordingly. In short, more risk means more capital.

Especially since central banks are not expected to return to their lean balance sheets of the pre-QE era any time soon – which means that they will face heightened financial risks for quite some time to come.

So, as we shift from a decade dominated by unconventional monetary policy to a phase of normalisation, it is imperative to consider a few key factors that influence central bank capital.

First, with its recent review of the operational framework, the Eurosystem aims to maintain structural liquidity in the financial system.

Besides weekly refinancing operations, part of this liquidity provisioning will be established through long term refinancing operations as well as a structural portfolio of securities. In implementing these operations, it is crucial for the Eurosystem to consider its capital position in relation to these structural operations.

Second, in its Strategy Review, the ECB categorised QE as a monetary policy instrument near the effective lower bound. This necessitates proactive risk assessment for potential future use of QE (note 1). But, obviously, concerns about central bank profitability must not result in a less effective monetary policy.

Third, in currency unions like the European Monetary Union, risk and income-sharing mechanisms can help achieve a fair re-distribution among national central banks. These mechanisms are essential for promoting stability and cohesion within the monetary union, as they ensure that the costs and benefits of membership are distributed equitably among all participating central banks.

In transitioning to a phase with a normalised monetary policy, these considerations will also help to normalise central bank capital adequacy. And the importance of sufficient capital goes beyond the mere accountancy aspect.

If we were a commercial bank, large losses that erode capital would lead to bankruptcy. But central banks cannot go bankrupt. One reason for this is that a central bank can create money. Thus, it cannot default on liabilities denominated in its own currency. A second reason is that, implicitly, central banks have the support of their respective governments as systemically vital national authorities.

Under extreme circumstances, a capital injection by the government may be considered. But as long as there is a realistic expectation that the net present value of future revenues – mainly from seigniorage – will be large enough to compensate for the current and projected central bank losses, financial support from a government seems unlikely to me.

Hence, central bank independence – independence from our respective governments to do what needs to be done to safeguard price stability – is not in jeopardy.

From a trust perspective, it is important to be transparent about this.

We have a saying in Dutch that, in English, goes something like this: 'Trust arrives on foot and leaves on horseback'. Well, we don't want the current turbulent times, with the current losses, to make the public's trust in our independence take off on horseback. Because it would take much longer to regain it.

I think the Netherlands offers an interesting case study in central bank transparency. For instance, on losses.

Given the current central bank losses, you would expect critical press coverage. But in the Netherlands, coverage has been relatively sparse and mild.

Most of the news outlets covered DNB's losses in a balanced way. And I think this is partly, maybe even mainly, due to our transparency on this matter. We very deliberately took the time to announce the possibility of losses. We explained the source of the losses when they occurred. And we were transparent about how we expected them to evolve.

Transparency should be a guiding principle for central banks. They should be prepared to discuss their monetary policy decisions and clearly explain how their decisions safeguard price stability, and also not shy away from considering any link with public finances and the real economy.

Equally, they should not refrain from being transparent about the potential impact of their decisions on their balance sheets and, as such, emphasise their crucial role in absorbing losses in times of crises.

Looking at the future – if QE would ever be needed again – and I think that next time around the ECB will be much more cautious – but if it were to happen, I think central

banks should pursue transparency. They should clearly communicate the benefits of QE for price stability, for liquidity in the financial system, and for the economic welfare of society – and they should also proactively communicate about the impact these purchases might have on their balance sheets.

To do so, to be able to proactively communicate, central banks, of course, need to have an idea of the potential risks, of the potential impact of monetary policy operations on their balance sheets. And so, they should conduct comprehensive, forward-looking risk assessments. Assessments that take into account scenario analyses from their risk management departments. Assessments that may result in higher provisioning ex-ante.

Looking at QE again – from a scenario analysis point of view – QE aimed at boosting inflation may result in losses, because assets are purchased at high prices. Conversely, when asset purchases are deployed to stabilise markets, they tend to be more profitable. Because in that case, assets are not necessarily acquired at peak prices.

But the actual financial results of QE will depend on the actual timing and extent of the purchases, together with the actual interest rate evolution.

Indeed, there is a lot of uncertainty and in the end only one scenario will play out.

And although my colleagues from the risk management department ran through some extreme but plausible interest rate scenarios, we did not foresee the impact a pandemic could have nor did we factor in a Russian invasion of Ukraine. As such we did not anticipate the recent inflationary shock and the speed and intensity of policy rate increases. And so, we did not foresee the extent of the current losses. Had there been no such shock, and had policy rates risen gradually and to a lesser extent, QE losses would probably have been contained, and profits would even have been attainable.

But let me stress again, as much as we can't predict the future, we do need to imagine several extreme but possible scenarios. And this scenario analysis can guide us in maintaining sufficient buffers in terms of capital and provisions, and hence mitigate the impact on our balance sheets, and strengthen our resilience in case of a future crisis.

Now then, so far I have referred to central banks in general. As if there were only one type. But of course, central banks come in all sorts and sizes.

And faced with the same challenges that come with huge losses, our differences could become an asset.

Central banks could benefit from collaborating – for instance by sharing best practices or by establishing common principles. Principles, for example, on accounting standards, capital adequacy and risk management. Principles that could ensure regular evaluations and adjustments of capital levels, including provisions – all of this to maintain resilience, to absorb unexpected losses, to adapt to evolving risks, and to effectively fulfil our mandates, even in challenging economic conditions. Principles that should, of course, take jurisdiction-specific circumstances into account, as central banks have diverse mandates, operations, sizes and ownership structures.

So, going forward, central banks should establish robust risk management policies to address potentially large losses. For instance, by safeguarding structural profitability, or by establishing additional buffers, or by adopting a higher tolerance for periods with reduced or negative capital. And they should do so in a continuous and transparent dialogue with their stakeholders and the general public.

Let me wrap up.

Crises that have been overcome, like the Global Financial Crisis and the Covid-19 pandemic, and crises that are ongoing, like geopolitical tensions and global warming, pose a challenge to central banks – they test them to their limits. They test their ability to safeguard price stability, their resilience, and the public's trust in them.

At the same time, these very tests reaffirm the pivotal role an independent central bank plays in stabilising financial markets – in preventing or tackling deflationary or inflationary pressures – in safeguarding our economic welfare.

Nearly a century ago, my predecessor faced unexpected and huge losses. Losses that exceeded the central bank's capital. And that cost him his job as head of the Dutch central bank.

I have the pleasure of still being in office, which gives me the opportunity to speak to you today, and to wish you an interesting second day of this workshop – a workshop with, recalling the past, an aptly-chosen topic. I would almost say, a topic of capital importance.

Thank you.

Note 1: Announcement on the strategy review: The ECB's monetary policy strategy statement (europa.eu)