

Discussion of:

Non-Neutrality of Open Market Operations

By Pierpaolo Benigno and Salvatore Nistico

Cédric Tille

Geneva Graduate Institute and CEPR

CEP-SNB-Gerzensee conference, November 9, 2017

Should we care about central banks' losses?

- Central banks have acquired large amounts of risky assets.
 - Mortgage-backed securities at the Fed.
 - Foreign bonds and stocks at the Swiss National Bank.
- Should we care if the central bank suffers losses on these?
 - Usual answer: No, the government can recapitalize it.
 - But what if it doesn't do so?
- The paper considers the impact of losses on risky assets (default, or lower price on long assets when interest rates increase).
- Conditions for neutrality (no impact on inflation and output).
- Neutrality breaks and inflation is higher if:
 - No treasury support (remittance never negative), including deferred asset policy. Requires large losses.
 - Policy avoiding negative profits (financial independence).

Cost of central bank independence

- Start from a liquidity trap with a negative natural interest rate.
- The natural rate unexpectedly turns positive, leading to losses on long term assets.
- To keep profits at zero, the central bank delays the exit from ZLB. Inflation increases temporarily, then remains persistently low.

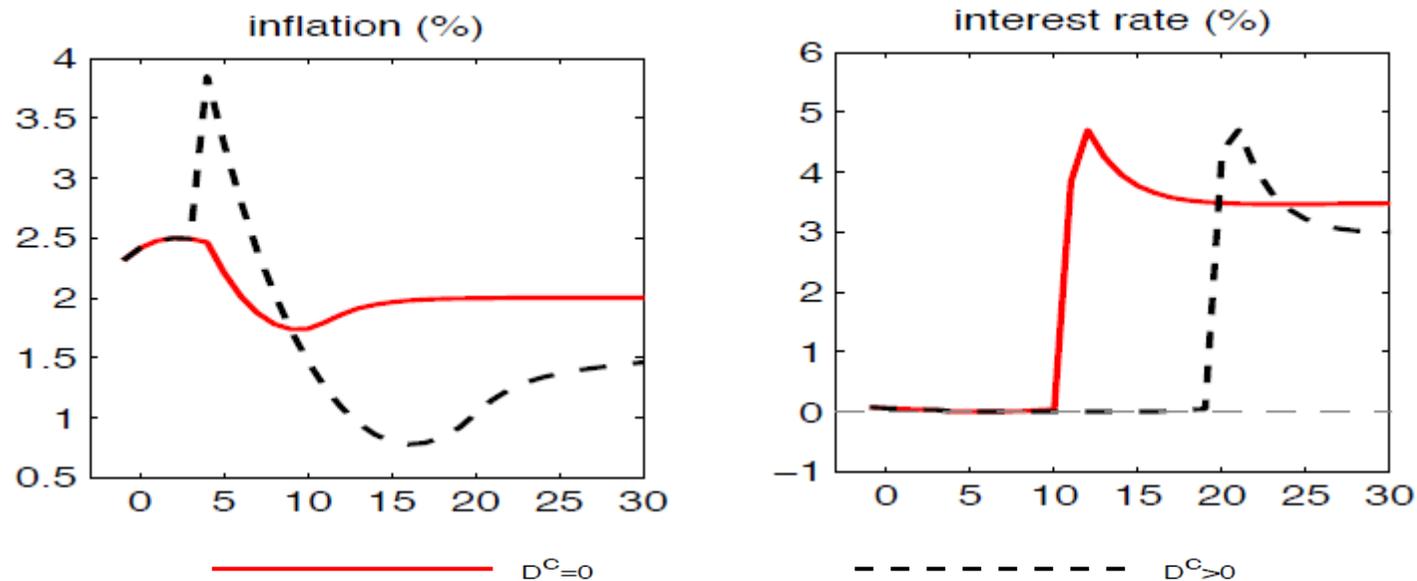


Figure 6: Equilibrium dynamics of selected variables under optimal monetary policy facing interest-rate risk. Regime iii): *financial independence*. The economy starts in a liquidity trap with a negative natural rate of interest; the latter turns positive unexpectedly after one year. Red solid line: central bank holds only short-term assets. Black dashed line: central bank holds also long-term assets. X-axis displays quarters.

ENEVA

Comment 1: magnitudes and default shock

- Shocks are large: the natural rate increases by 6 percentage points (interest rate shock), default losses on risky assets are 40 or 80 % (default shock).
- Do smaller more realistic shocks give also generate problems for the central bank's balance sheet?
- Under the default shock the loss is permanent.
- A loss reflecting impaired markets is more realistic.
 - StabFund set up by the Swiss National Bank for UBS assets in 2008 generated profits (about 7 billions CHF).
 - The central bank has time.

Comment 2: interest rate shock

- Interest rates are now increasing in the United States. Has the Fed suffered losses as the model predicts?
- Are losses from the interest rate shock really losses?
 - Valuation losses, provided the central bank marks to market (the Fed does not).
 - Not a problem if assets are held to maturity.
- Holding to maturity does not work for foreign reserves, as the exposure is to the exchange rate.
 - Exchange rate moves are more likely to reverse than interest rate changes. Losses may be short-lived.

Comment 3: why hold risky assets?

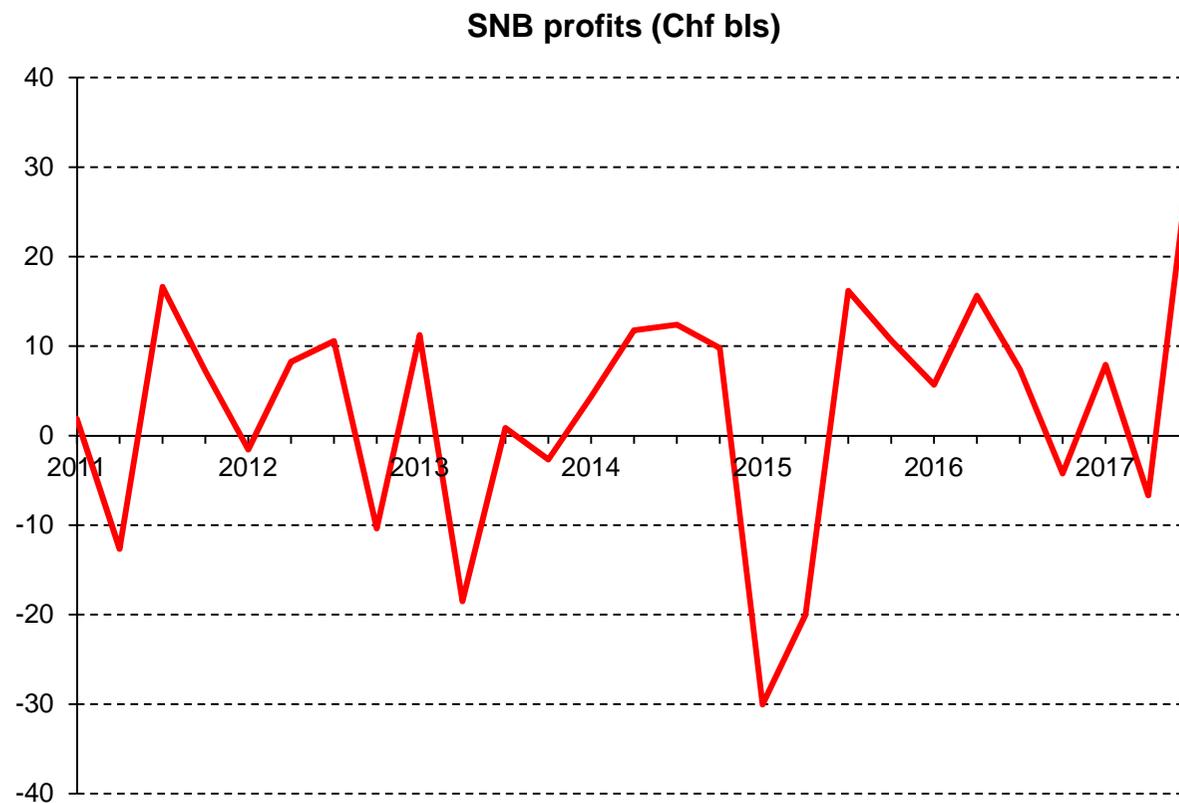
- Central bank profits come from two sources.
 - Spread between interest bearing assets and non-interest liabilities (money).
 - Risk premium in return on risky assets.
- Losses can only come from holdings of risky (and long dated) assets.
- Why does the bank bother holding them?
 - No role for credit easing, where the central bank would substitute for a constrained financial sector (Gertler and Karadi).
 - In a richer model, trade-off of losses against benefits of CE.
- There should be an initial level of equity where exposure to losses is not a problem.
 - Trade-off with cost of taxes needed to replace CB payments.

Comment 4: is higher inflation a problem?

- Losses affecting the central bank induce it to let inflation increase.
- This seems like a good idea as inflation remains stubbornly low in advanced economies.
- Losses on foreign reserves cannot be handled by «hold to maturity».
 - Losses – and subsequent inflation – when the domestic currency appreciates.
 - But pass-through of appreciation to import prices lowers inflation.
 - By how much do the two channels offset each other?
- If anything low inflation (after the initial burst) under the financial independence regime seems more problematic.
 - Could financial prudence be a bad idea?

Comment 5: the Swiss case

- The SNB marks to market, and is exposed to exchange rate risk.
- Still, even in the crisis, it made money.



2010-2017 (bls CHF)	
Profit	65
On FX reserves	53
On gold	4
On CHF holdings	4
On Stabfund	7

Comment 6: who sets the payment to Treasury?

- The SNB made money, but some quarters drive the results.
 - Large loss following the abandonment of the euro floor.
- Equity and reserves consist of:
 - Share capital (Chf 25 million end 2016).
 - Monetary policy reserve (MPR, Chf 62.8 billion end 2016).
 - Distribution reserve (DR, Chf 20 billion).
- Payments to the Confederation and Cantons set on a simple rule, renewed every 5 years, with little change.
 - Increase the MPR by 8 %.
 - Add the remaining profits / losses to the initial DR.
 - No payout if the DR is negative.
 - CHF 1 billion payout (or lower if $DR < 1$ bls).
 - CHF 1 billion extra if $DR > 20$ bls.

Conclusion

- The paper provides a rigorous analysis of the impact of losses by central banks.
- In the absence of fiscal backup, this can lead to temporary increases in inflation.
- Is this such a problem with smaller losses?
- Is higher inflation a problem?
- Providing the central bank with enough equity and reserve capital should solve the problem.
- And transfers can be done following simple rules.