CENTRAL BANKS

Doing it their way

Differing balance sheet structures reflect the contrasting philosophies of central bankers, suggests Tim Congdon

appearances can be deceptive, in central banking as in other walks of life. The Great Financial Crisis has been accompanied by a ballooning of central bank balance sheets, which have expanded in size by about a fifth of national output in the US, the eurozone and the UK. Given the similar size of the change, a logical interpretation would be that much the same forces have been responsible in all three jurisdictions.

I would argue that, on the contrary, the types of asset acquired by the three relevant central banks have been completely different. Even stranger perhaps, the "philosophies" of the central bank heads have had a big impact on the acquisition strategy of these organisations. Believers in the Cleopatra’s nose theory of history – the idea that chance, such as Antony happening to find Cleopatra fetching, is what shapes the world – will chuckle. On the face of it, the personal preferences of three key individuals can determine the balance-sheet structures of institutions that are among the largest and most powerful in the world.

My main polemical objective will be to highlight the contrasting philosophies of central banking of Mario Draghi, president of the ECB, and Sir Mervyn King, governor of the Bank of England, but let me start with the Federal Reserve.

At the beginning of the crisis, in August 2007, the Fed had some outstanding loans via its discount window to banks but its assets were dominated by government securities. It had no involvement in US housing finance whatsoever, and its holdings of agency securities (i.e., securities issued by Fannie Mae, Freddie Mac and so on) and other mortgage-backed paper were zero. The situation at the end of 2011 was quite different. While its government securities (at almost $1.7 trillion) were larger than its agency and mortgage paper (about $950 billion), the leap in mortgage assets from zero to almost one trillion was remarkable. Indeed, for much of 2010 the Fed had more mortgage paper than government securities.

The Fed’s intervention in housing finance has been controversial, with some critics arguing that it has assumed a role in credit allocation that properly belongs to the private sector. According to Robert Hetzel in his new book, The Great Recession, this role is a “radical departure... from traditional central bank practices”. At any rate, earlier this year two of the Fed’s own economists, Diana Hancock and Wayne Passmore, jointly authored a working paper that identifies “channels” of downward influence from the Fed’s credit decisions to the yields on agency securities and, hence, on mortgage rates.

Obviously, the meaning of ‘long term’ becomes critical

For those versed in central bank argot the word “channel” acts as a prompt for the phrase “the credit channel”, first proposed by Ben Bernanke and Mark Gertler in a much-cited 1995 paper. Bernanke is, of course, the current chairman of the Fed. According to this paper, the credit “channel” opens up “the black box” of how monetary policy works. The message has to be that the Fed’s involvement in credit allocation can be attributed, at least partly, to Bernanke’s long-held academic beliefs and research agenda. It is consistent that, in late 2008, he wanted it to be known that the Fed’s asset purchases should be regarded as “credit easing”, not “quantitative easing” (i.e., purchases to boost the quantity of money).

Bernanke has, however, been relatively orthodox in his attitude towards the central bank’s lender-of-last-resort responsibility. He has said it is the Fed’s job to make loans to cash-strapped, but solvent, banks in financial emergencies.

By contrast, the attitude of King at the Bank of England has been ambiguous and sometimes hostile to lending of this kind. In practice, the Bank did during the crisis extend large loans to, among others, Northern Rock, Royal Bank of Scotland and HBOS. But King let it be known that he did not view the central bank as having any obligation to provide long-term finance to banks. In evidence to the Treasury Committee of the House of Commons and elsewhere, he insisted that such lending should be done only by the government or the private sector.

Obviously, the meaning of “long term” becomes critical. Events in the Northern Rock crisis clearly indicate the understanding about this matter among UK officials.

The run on the Rock, which began in September 2007, had willy-nilly to be met by a large and immediate Bank of England loan if customers were to continue to receive cash as they redeemed deposits. Despite Northern Rock’s embarrassments, several private parties were interested in acquiring it in late autumn 2007. But the Bank – in tandem with the Treasury and the Financial Services Authority – told potential investors that they would have to replace its loan by February 2008 if they wanted to be taken seriously. The implied cut-off period for central bank money is six months, which accords with, and may even be justified by, one interpretation of the EU’s state aid rules.

King’s aversion to central bank lending to commercial banks has had a definite and obvious effect on the kind of assets acquired by the Bank in the past five years. The Banks, at times, significant loans to banks have all proved temporary. They have been shuffled off to the rest of the state sector, particularly of course to UK Financial Investments, which was set
up in November 2008 and is effectively an agency of the Treasury. In fact, the Bank's loans to the banking system are lower now than in mid-2007.

So why has the Bank's balance sheet nevertheless expanded by about 20 per cent of national income since then? The answer is that, since March 2009, the Bank has engaged in enormous operations to boost the broadly-defined quantity of money (technically, the M4 measure) by purchases of government securities. For the most part, these purchases have been of medium- and long-dated stock, and so have been from private sector non-banks and have increased their bank deposits. (Note that banks rarely hold medium- and long-dated securities, because of their capital volatility and high risk.)

Now let us compare the ECB with the Bank. In late 2007, it openly took a different line from the Bank, letting the eurozone's banks know that they could borrow from it on a "long-term" basis at a cost of only 1 per cent. One faction in the ECB disliked these facilities, or "non-standard measures" as they were called, and in mid-2010 they were withdrawn. But since Draghi's appointment last year the "long-term refinancing operations" have been restored on an enormous scale. The eurozone's banks applied for almost £1.000bn of LTRO finance in two rounds in December 2011 and February 2012. "Long-term" is defined in these arrangements as "up to three years", deliberately giving banks a comfortable period of time to sort out their balance-sheet problems.

So, approaching the fifth anniversary of the start of the Great Financial Crisis, no consensus prevails among the leading central banks about how they should have responded to the banking system’s woes. Like Frank Sinatra, they did it their way.

True enough, each jurisdiction has had its own assortment of difficulties. A reasonable comment is that the awkward assets in the US were largely mortgage-backed paper, whereas in the eurozone they were particularly Club Med sovereign debt. All the same, the changes in assets have reflected, to an astonishing extent, the personal philosophies of central banking held by a few individuals at the top.

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