THE ELEPHANT IN THE ROOM: CENTRAL BANK BALANCES

Op Ed by Dr Rory Knight

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JOONGANG SUNDAY

JoongAng Sunday is the Sunday edition of the leading Korean language daily newspaper JoongAng Ilbo. It is one of the three largest newspapers in South Korea. The paper also publishes an English edition, Korea JoongAng Daily, in alliance with the International New York Times.

Stock markets are soaring to new highs, as are bond markets which many consider to be close to bubble levels. Are current prices justified or over-valued? Equities have enjoyed a run of positive returns since the low of the financial crisis in March 2009 when the Dow Jones Industrial Index (DJIA) touched its nadir of 6,627. By contrast August 2017 topped 22,000. It had taken approximately four years to regain the pre-crisis high of around 14,000, and one could argue that the last four years since has seen an over-exuberant bull-run. Given lack-lustre growth in the real economy since the crisis, current stock market levels seem unrealistic, especially given the increase in private and public debt around the world.

The bull-run has been chiefly fueled by the cheap money spawned by the loose monetary policy of central banks. However all major central banks face the same dilemma: what to do now. They have become captive to their own policies. After almost a decade of quantitative easing central bank balance sheets are unmanageably huge and there is no clear way out.

The scale of the increase is breathtaking. It is summarized in Table 1 which traces the growth in total assets held by seven of the most relevant central banks. In aggregate, these have grown from close to \$6.5 trillion in 2007 to nearly \$20 trillion in 2016 - significantly more than the total value of the New York Stock Exchange, the world's largest stock market. Nationally, the assets of these central banks now account for nearly 40% of annual GDP on average.

> "The bull-run has been chiefly fueled by cheap money spawned by loose monetary policy."

The Bank of Korea (BOK) embarked on a loose policy earlier than most and has pursued that consistently since. The change in \$ terms has seen an increase of 17%, which however masks a much larger increase in total assets of over 50% in Won terms. However compared to other central banks the BOK currently stands out as a relatively minor offender in that its total assets as a percentage of GDP are only 30%, down slightly from 31% and well below the average of 37%. The Korean position clearly needs attention however it seems manageable.

Incredibly, and by contrast, the Swiss National Bank (SNB) - formerly the gold standard for caution - holds assets worth 115% of GDP. The SNB has increased by 552% which is the largest increase of the seven in \$ terms. Such is their desire to keep a cheap Swiss Franc for competitive exporters. The balance sheet of the US Federal Reserve has similarly leapt by nearly five times. In the few weeks after the Lehman Brothers bankruptcy in September 2009 the Fed pumped over a trillion dollars into the market, resulting in a balance sheet of \$4.467 trillion by December 2016. The largest increase in local currency is the Bank of England (BOE) with an increase of 578% which represents 319% in dollar terms as reported in Table 1 reflecting the fall in the value of the pound post-Brexit. The balance sheet of the People's Bank of China (PBOC) more than doubled over the period although given China's growth rate it fell as a percentage of GDP. The European Central Bank System (ECBS) - the combined central banks of the Eurozone - has overtaken the PBOC to become the largest central bank with total assets worth \$5.384 trillion, see figure 1.

There is no sign of a policy change happening any time soon. Recent comments from the chairman of the Fed indicate caution in imposing rate hikes too frequently, and this month Mario

Draghi, President of the European Central Bank, indicated the ECB intends to continue to pump money into the Eurozone economy by continuing to purchase securities at the rate of €60bn ($70bn) per month for the rest of the year. The ECB balance sheet as a result will expand by close to an additional half a trillion dollars.

Lessons of the Great Depression, Right and Wrong

The author of the quantitative easing (QE) implemented by the Fed in 2008 was its then chairman Ben Bernanke. In the early eighties, based on his doctoral thesis he had published the definitive work on why Keynesian economics failed to avoid the Great Depression of the 1930's. The received wisdom was that, once interest rates had been reduced to zero, a liquidity trap was created which meant that no further measures were available to the Fed to stimulate the real economy. Bernanke provided the insight that the real failure was the breakdown of the credit mechanisms by which liquidity is provided from lenders to borrowers. Since these failed due to a loss of confidence the fiscal interventions were likewise doomed.

Bernanke implemented an unorthodox policy to ensure that the mistakes of the past were not repeated, leading a programme whereby the Fed pumped a trillion dollars into the market in the four weeks after the Lehman failure in 2009, since which an additional $1.5 trillion has been pumped in by the Fed. To promote growth interest rates were effectively lowered to zero and securities bought to avoid the breakdown in confidence that would have destroyed the credit mechanisms. These policies have been copied by most of the world's central banks.

There is no doubt they avoided another Great Depression. Cheap money and abundant liquidity have resulted in buoyant stock markets. However, the desired stimulation of the real economy has not materialized. Therein lies the problem. A significant expansion in the world economy would be necessary to enable the balance sheets of the central banks to be scaled back in an orderly manner. The quantitative easing was significantly greater in magnitude and duration than expected and with no prospect of significant real economic growth the central banks are effectively trapped in to holding outsized balance sheets that now represent potential risk to the world economy. For the moment the central banks are containing the fall out of the financial crisis but the disposal of the resultant 'radioactive waste' is still in question.

The Pitfalls

What could go wrong? Potentially everything. The fear is that running down balance sheets will be deeply disruptive. Equally doing nothing is not an option. A recent survey of leading asset managers by Bank of America Merrill Lynch indicates that central bank risk is now the most significant perceived tail risk to markets. The risks are threefold:

1. that any slight misstep by central banks could send a wrong signal to markets of their intended approach, as evidenced in the recent 'taper tantrums' in the US;

2. that in tightening monetary policy by increasing interest rates asset prices could suffer; and

3. that in the worst case selling off the trillions of dollars in securities held by central banks could precipitate another crash.

The scale of central banks' interventions raises concerns about their role. They were never intended to be these benevolent behemoths whose interventions have turned the markets into cheap-money addicts. Ideally, central banks should be independent, focus on the clear single target of managing the level of inflation with a limited number of policy variables and act as the lenders of last resort. But a new orthodoxy reigns. Unelected bureaucrats have extended their role to include so-called macro prudential supervision by means of regulation and market interventions to the point where they have become market makers. They have inflated their role as limited liquidity providers to become solvency providers of last resort. Their role is now political in as much as they use their own judgement to intervene in certain markets. Equally worryingly, they may have exhausted their ability to respond to another crisis should one arise. There needs to be a public discussion which could bring about a deconstruction of central banks paring them back to their original function and transferring their massive holdings to other agencies better suited to handle the scaling down.

It is clear that financial markets are extremely complex, and the inter-relationships among institutions was not well understood at the time of the Lehman bankruptcy. In hindsight it would have been a lot cheaper to have bailed out Lehman. The "too big to fail" principle creates the well-known moral hazard whereby banks take excessive risks in the knowledge they will be bailed out. But a much larger moral hazard has been created by well-intentioned central banks whereby financial markets have been cossetted away from economic reality in the comfort of a cheap money bubble

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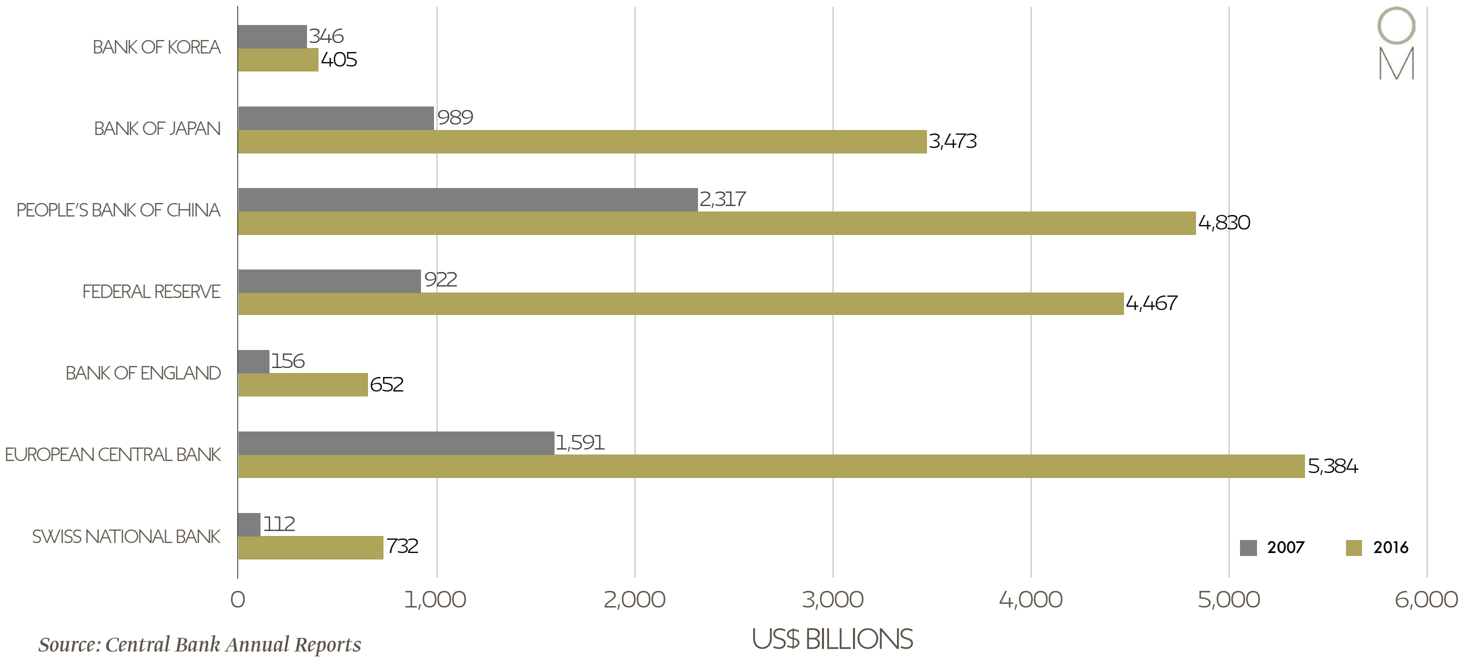
CENTRAL BANK	2007 $B	2016 $B	CHANGE	2007 % GDP	2016 %GDP
BANK OF KOREA	346	405	17%	31%	30%
BANK OF JAPAN	989	3,473	251%	21%	76%
PEOPLE'S BANK OF CHINA	2,317	4,830	108%	62%	46%
FEDERAL RESERVE	922	4,467	384%	6%	24%
BANK OF ENGLAND	156	652	319%	5%	27%
EUROPEAN CENTRAL BANK SYSTEM	1,591	5,384	238%	16%	34%
SWISS NATIONAL BANK	112	732	552%	22%	115%
TOTAL ASSETS	6,432	19,943	210%	17%	37%

Source: Central Bank Annual Reports & IMF.

TABLE 1
Assets held by Central Banks



Source: Central Bank Annual Reports

FIGURE 1
Assets held by Central Banks

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