

Eurozone central banks face test of credibility on losses

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Markets Insight



Losses on the balance sheets of the world's leading central banks have become an increasing preoccupation for governments, central bankers and the financial markets.

This is an unfortunate legacy of the massive amounts of government bonds acquired under quantitative easing in the past decade to try to boost inflation.

Some of these purchases were misguided and they should have anyway been ended much earlier in the light of signs that inflation was picking up again well before the Ukraine invasion.

Central banks need to show that they understand the full implications of the complex issues surrounding their balance sheets, especially in Europe. Otherwise this could undermine public confidence in the euro, especially in Germany, the eurozone's largest member.

The debate on central banks' balance sheets might appear technical. Central banks cannot go out of business – they print money, after all. However, for central banks in the eurozone, the question of how the losses arose, and who will pay for them, is politically sensitive.

Lacking any centralised political counterpart to the European Central Bank, these national central banks will cope with the losses in individual ways.

These include stopping dividend payments to governments and, in some cases, asking government for funding to restore their capital backing.

The cumulative losses – which could add up to several hundred billions of euros – stem from two main factors.

Central banks face an increasing disparity between income from their government bond portfolios and expenses paid on deposits from commercial banks, now rising rapidly because of

sharp rises in official interest rates to quell much higher inflation.

They must cope with valuation deficits caused by redemption in coming years of government bonds often acquired at expensive prices. In the euro area, the biggest losses will be borne by the central banks of countries with the highest credit ratings – Germany, the Netherlands, Austria and Finland.

While the ECB was building up roughly €5tn of government bond holdings, these countries' bonds were the highest priced, frequently bearing negative coupons, and so will give rise to the largest losses when financing costs

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are taken into account. The Dutch central bank has estimated €9bn of losses for coming years. Since the ECB belatedly started to raise rates, other central banks have made similar calculations.

With a portfolio of about €1tn of German government bonds at acquisition value, the Bundesbank is expected to clarify this issue in its annual report for 2022, due out on March 1. It will have to quantify the depreciation of acquired assets or justify the continued book value of historic acquisition costs.

QE has not been the only source of losses. The ECB's "targeted longer-term refinancing operations" have allowed banks to borrow at negative interest rates, boosting interest income by depositing excess liquidity with the ECB and profiting from higher rates.

The ECB also needs to explain the economic impact of its acceptance of downgraded assets as collateral in the pandemic emergency purchase programme.

The euro area's risk exposure raises wider issues regarding the ECB's role. The Bundesbank's potential or declared losses might add impetus to a lawsuit against PEPP at the German constitutional court launched in March 2021 by a group including Europolis, a Berlin think-tank of which I am the founder.

The action refers to a constitutional court ruling on the ECB's 2012 "outright monetary transactions" programme, which prohibits Bundesbank participation in asset-purchase programmes that expose it to the risk of losses endangering its credibility.

Some might argue that the constitutional court did not sufficiently consider the economic literature on central banks, since they can never become insolvent. But the Bundesbank's soon-to-be quantified capital losses may have a political impact.

Isabel Schnabel, the German executive board member, said in November 2021 that raising rates before the end of net asset purchases would mean "central banks would be willingly accepting losses on their balance sheets that would ultimately lead to losses for the average taxpayer".

In Germany, there is considerable public scepticism over the ECB's policies in recent years. We may be approaching a necessary moment of truth for the central bank. Giving the full facts on losses is by far the best way of limiting any erosion of public confidence.

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