

— DNB Research Conference 2017 —
Discussion ‘Non-Neutrality of Open-Market Operations’
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¹The views expressed herein are solely those of the discussant and in no way reflect the views of the Bundesbank or the Eurosystem.

What the Paper Does

Motivation

- Unconventional monetary policy (MP) \Rightarrow income losses on central bank's (CB) balance sheet \Rightarrow effects on inflation and output

Question

- Under what conditions is - broadly defined - MP neutral?

Approach

- Closed economy model
- 3 actors: treasury, central bank, households
- Treasury and CB have separate budget constraints
- Importance of transfer schemes between actors

What the Paper Finds

Main result: General Neutrality Property

- With unconventional monetary policy, CB bears some risk which before was in hands of private sector
- If private sector ultimately bears this risk, equilibrium prices and quantities do not change
- Treasury must tax households and transfer taxes to CB to cover losses

⇒ Neutrality breaks down if some risk remains with CB or treasury

Praise

- I learned a lot from reading this paper. Thank you!

Two Comments

- Authors coin the term 'Impossible Trinity in Central Banking' - is this term well-chosen?
- Paper is rather theoretical - would benefit from some real-world examples and calibration exercises

A New Term: 'Impossible Trinity in Central Banking'

Central bank can't have simultaneously:

- 1 Independent interest rate policy
- 2 Independent unconventional monetary policy
- 3 Control over its profit/loss: 'financial independence'

⇒ Basically says that central bank's budget constraint has to hold

Do we ever need both policies (1) and (2) at the same time?

- Unconventional MP relevant only at zero lower bound (ZLB)
- But at ZLB, independent interest rate policy impossible anyway

⇒ Under this view, term 'Impossible Trinity' is a misnomer

Can Apply *Original* 'Impossible Trinity' to Central Banking

Open economy central bank can't have simultaneously:

- 1 Independent interest rate policy
- 2 Independent *exchange rate* policy
- 3 Control over its profit/loss: 'financial independence'

⇒ Central bank has to accept loss arising from int'l capital mobility

This 'Impossible Trinity in Central Banking' has always existed

- ...even with old-style central banking
- Exchange rate policy is optional; CB chooses two out of (1),(2),(3)

⇒ In closed economy, term 'Impossible Trinity' is misleading

What Happens when Central Bank makes a Loss?

Bundesbank Act, § 27 *Distribution of profit:*

- ① *20% of the profit, but at least €250m, shall be transferred to the statutory reserves until they equal €2.5bn; [...]*
 - ② *the balance shall be paid over to the Federal Republic of Germany*
- No automatic transfer from Treasury to cover income losses
 - Instead, provisions for 'general risks' amounting to €15.4bn

ECB Convergence Report, May 2012

- *The event of an NCB's net equity becoming [...] negative would require that the respective Member State provides the NCB with an appropriate amount of capital [...] within a reasonable period of time so as to comply with [...] financial independence*
- *Meaning of appropriate and reasonable? Enforcement?*

Bundesbank Balance Sheet Profit/Loss (-), million €



"It is not our job to deliver a profit, but to safeguard price stability." J. Weidmann, February 2017, FAZ-interview

Financial Independence Then and Now

Bundesbank made losses in 1970s

- Financial independence was thus undermined
- Losses kept on books until sufficient profits accumulated in later years

(Why) does financial independence matter now?

- With exchange rate risk, losses limited in size and duration
- With interest rate risk, potential losses (presumably) much larger

⇒ Quantify and compare two types of risk to financial independence

Wrapping Up: Two Main Comments

Term 'Impossible Trinity in Central Banking'

- Arguably, unconventional MP only ever relevant at ZLB
- For open economies, concept existed all along

Actual policymaking

- Which transfer schemes exist in practice?
- Quantify risks to financial independence coming from different sources