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MACRO MORNING BRIEFING

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Securing Seigniorage

Central Banks In Europe Face Up To Losses On Asset Purchases

- Quantitative tightening is realising losses on central bank bond portfolios
- Fiscal costs are building, affecting government incomes and expenditures
- Legal frameworks differ but central banks need to exercise political vigilance

Balance-sheet unwinding and higher yields require compensation

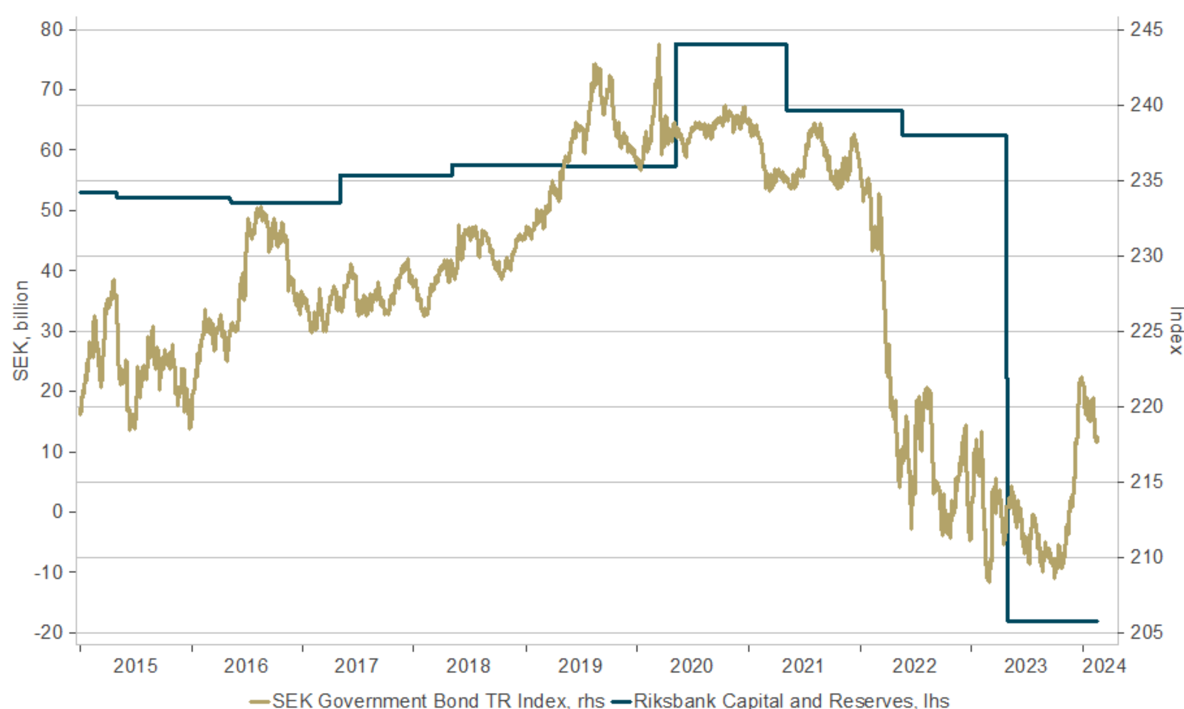
The Riksbank on Monday confirmed that while it made a profit of SEK16.2bn for 2023, "the profit is not sufficiently large to ensure that the Riksbank's equity after the allocation of profits" will reach statutory target levels. There will be no transfer of profits to the Swedish Treasury and a bylaw petition will be submitted to the Swedish Parliament to restore the Riksbank's equity – currently around negative SEK2bn – to at least the basic level of SEK40bn. While not budget-busting per se, SEK42bn is more than Sweden's entire contribution to the EU for 2024, so the fiscal impact cannot be dismissed outright.

The Riksbank is not alone in asking for equity replenishment. As rates started to rise aggressively, central banks globally have faced mounting losses from two main sources. Bond portfolios have not only suffered mark-to-market losses – some central banks that had to sell bonds outright (e.g., Riksbank and Bank of England) for quantitative tightening incurred realised losses. As exhibit 1 shows, the Riksbank's equity levels have fallen sharply in recent years due to provisions for losses which have since been realised as the Riksbank accelerated bond sales. Meanwhile at the front end, deposit rates on reserve balances have increased due to rate hikes, but without large enough coupon income to offset.

Seigniorage in a quantitative era is no longer straightforward, but central banks are in a unique position amongst financial institutions whereby insolvency is theoretically impossible, even if the entity itself falls into negative equity. For example, the Swiss National Bank

explicitly states that negative equity would “probably only be temporary” since a central bank generates a “structural profit” and “remains solvent in domestic currency at all times” due to seigniorage. This may be true for all central banks but philosophically, not every central bank will be comfortable with running persistent negative equity while relying on theoretical solvency. This is where governing laws of national central banks comes in. Switzerland and Sweden contrast strongly in this respect: Stockholm obliges the Riksbank to petition for equity capital, but under the SNB’s governing laws its shareholders are not “under any obligation to provide additional funding” in the case of negative equity. The National Bank Act limits the SNB’s share capital to CHF25 million, a symbolic figure compared to the Riksbank’s statutory minimum of SEK20 billion.

Exhibit #1: Riksbank Capital vs. Bonds



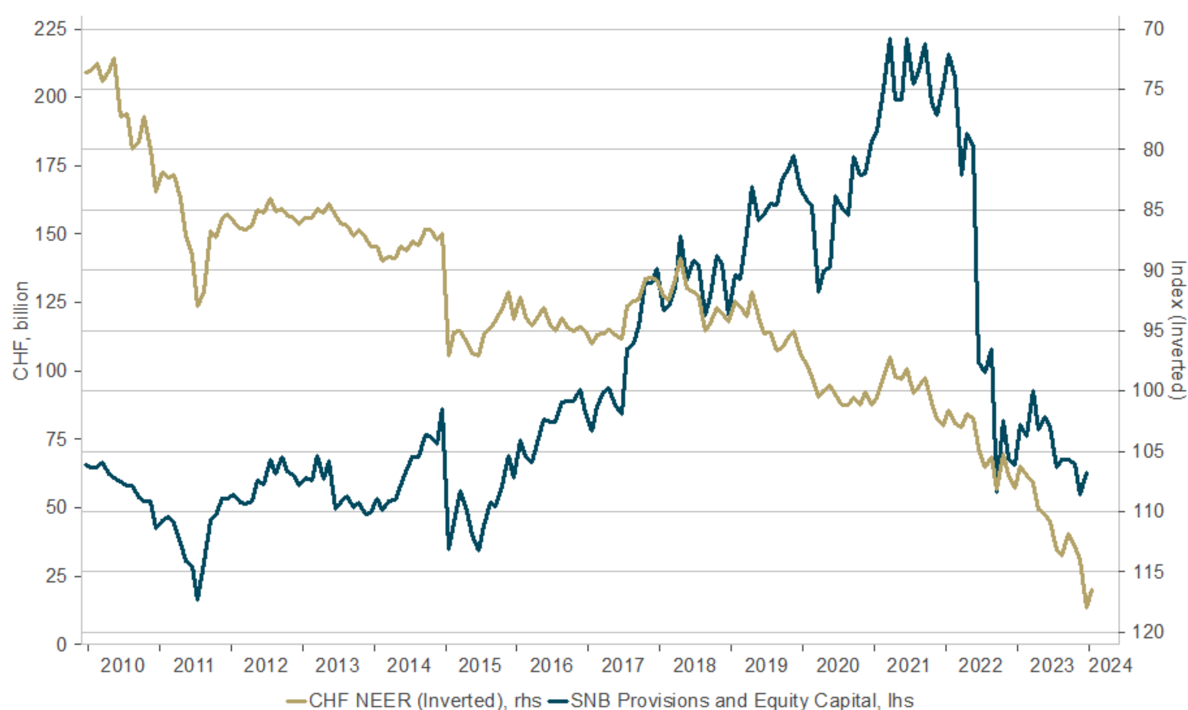
Source: Macrobond, BNY Mellon

The SNB’s equity capital has fallen sharply since 2022 but remains at very comfortable levels (exhibit 2). However, unlike all other G10 central banks, the bulk of the losses stem from foreign assets rather than losses on domestic bonds. As such, there are additional levers the SNB can pull to “regenerate” its provisions and capital through weakening the franc, though in reality this would only be done in a manner which fulfills a policy mandate.

On paper, the SNB’s framework somewhat resembles a ‘free lunch’, but there are political difficulties as well. Most central banks have transfer frameworks whereby profits above statutory or operational minimum levels are allocated to fiscal authorities. Above we mentioned that the Riksbank announced that there would be no transfer of profits this year. The SNB has not been able to generate profits for either 2022 or 2023, whereas in 2021 a

distribution of CHF6bn was provided, two-thirds of which went to cantonal governments which traditionally would have incorporated such payments into their budgets. The Bundesbank is now in a similar situation. After having reported its first loss in over 40 years in 2023, there will be a loss of revenue for the German budget, and there has been talk of recapitalisation as well. Depending on legal frameworks, the loss of fiscal revenue and potential cost of equity injections could, in extremis, prompt political changes which could heavily restrict central banks' operational freedom.

Exhibit #2: SNB Provisions And Equity vs. CHF NEER



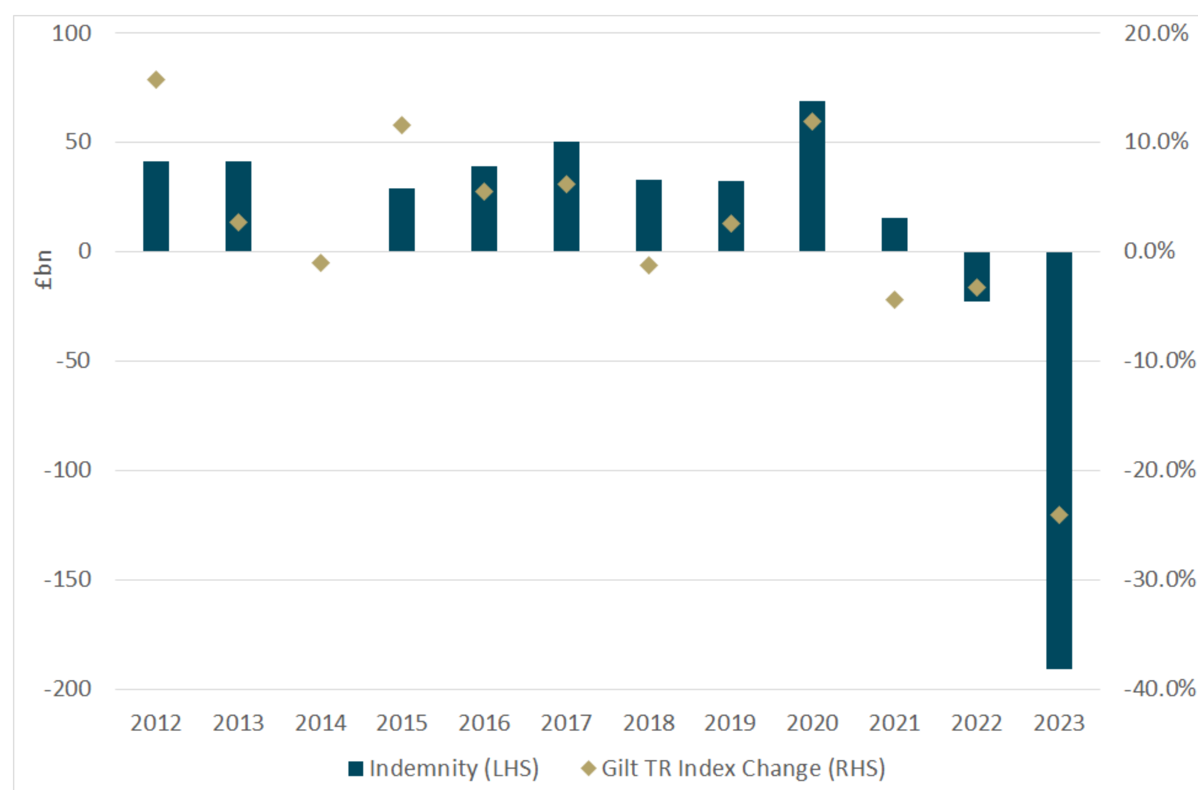
Source: Macrobond, BNY Mellon

We expect this issue to be extremely pronounced in the UK, where under an indemnification agreement between the BoE and HM Treasury, losses on the BoE's asset purchase facility are fully covered by the state. As Gilt yields have risen strongly, these potential losses have ballooned. Exhibit 3 shows that the indemnity now stands at close to £200 bn and wipes out previous gains when quantitative easing was a profitable enterprise for all central banks. According to the latest reports, the government has already transferred £38bn to the BoE since October 2022, not far off the entire UK long-term care budget during the same period.

The issue has become so contentious that the Treasury has refused to publish arrangements surrounding the indemnity, with the chancellor claiming that "the disclosure of operationally sensitive information…could have an adverse impact on Debt Management Office operations". The UK's public finances remain very precarious and appear set to become a key point of contention in the upcoming election. The BoE understandably will desire to steer well clear of such debates, but the potential figures are too large to ignore. Members of Parliament on the Treasury Committee have already asked the Treasury to look at potential

changes in the indemnity, such as excluding them from current fiscal rules. The Committee also warned that “there is no reason to think that the arrangements devised more than a decade ago are the most suitable available”.

Exhibit #3: BoE indemnity From HM Treasury

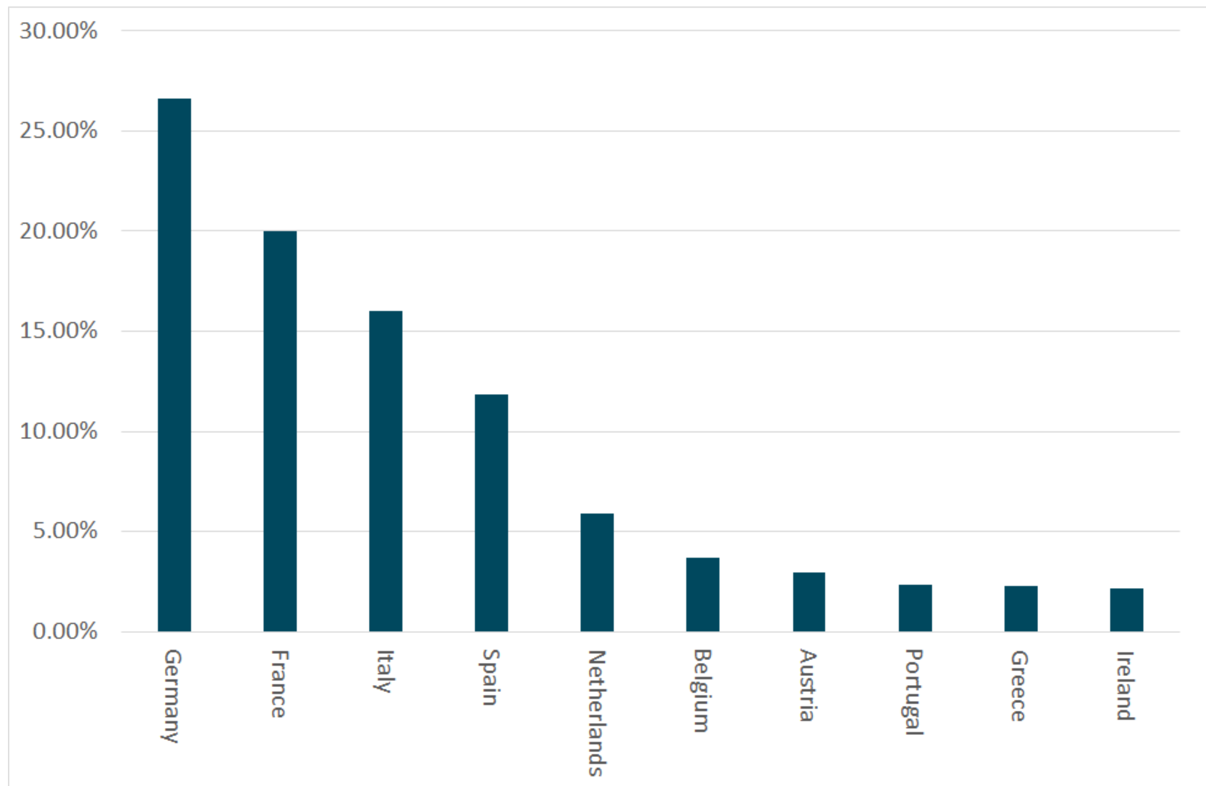


Source: Bank of England, Bloomberg, BNY Mellon

For the Riksbank and Bank of England, financial support is necessary largely because their quantitative tightening operations have realised some losses. Given the scale of balance-sheet expansion over the past 15 years, it is understandable that the Federal Reserve, European Central Bank and Bank of Japan are far less likely to ever contemplate selling assets outright, especially with fiscal burdens in each of their economies continuing to rise. The US can always fall back on the dollar’s exorbitant privilege, and Japan’s financial system is largely internalised. The ECB, however, faces multiple constraints already, and the spectre of governments recapitalising it, in addition to national central bank requirements, will likely also be a political headache. In additional to Eurozone members, non-Eurozone members also contribute to the ECB’s capital. The total levels are adjusted every five years to reflect changes in growth and population, and whenever a country joins the EU.

The Bundesbank – which fiercely guards its own independence – stresses that the ECB’s capital “safeguards its independence from political influence”. By extension, this means that any erosion of the capital would jeopardise such independence, and the Governing Council is unlikely to adopt any measures which risk pushing the ECB in that direction. At present, large asset sales will likely be at the top of that list of risks.

Exhibit #4: ECB Capital Key Largest Contributors



Source: ECB, BNY Mellon

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