World Economic Situation and Prospects
Weekly Highlights

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Why is the ECB balance sheet shrinking?

All of the major central banks have made extensive use of unconventional monetary policies since the onset of the great recession and throughout its aftermath[1].

These policies have taken the form of purchases of assets, such as sovereign bonds, bank bonds, and asset-backed securities, or in the form of credit easing policies designed to deal with liquidity problems in specific markets. If these policies have a persistent impact on the size of a central bank's balance sheet, they are also classified as quantitative easing (QE).

The European Central Bank (ECB) has relied more heavily on credit easing policies, given the banking-centric nature of the euro area economy. In addition, its bond-buying programs, including the new but not yet utilized programme of "Outright Monetary Transactions" (OMT), are not QE as they are fully sterilized. The credit easing policies have taken the form of supplying liquidity to the banking sector through increasingly enhanced repurchasing operations: changing from the original policy of offering fixed quantities of liquidity at auction-determined interest rates to offering a demand-determined quantity of liquidity at fixed interest rates; increasing the maturities of the offerings; and expanding the list of eligible collateral. This culminated in the two large-scale long-term refinancing operations (LTRO) held at the end of 2011 and in February 2012 that resulted in more than 1 trillion euro of borrowing and expanded the ECB's balance sheet to about 3 trillion euro (see figure below). However, in recent months the ECB's balance sheet has shrunk as a number of banks repaid these loans early—in the amount of euro 224.8 bn. This is in stark contrast to the Fed and the Bank of Japan which are continuing to expand their balance sheets.

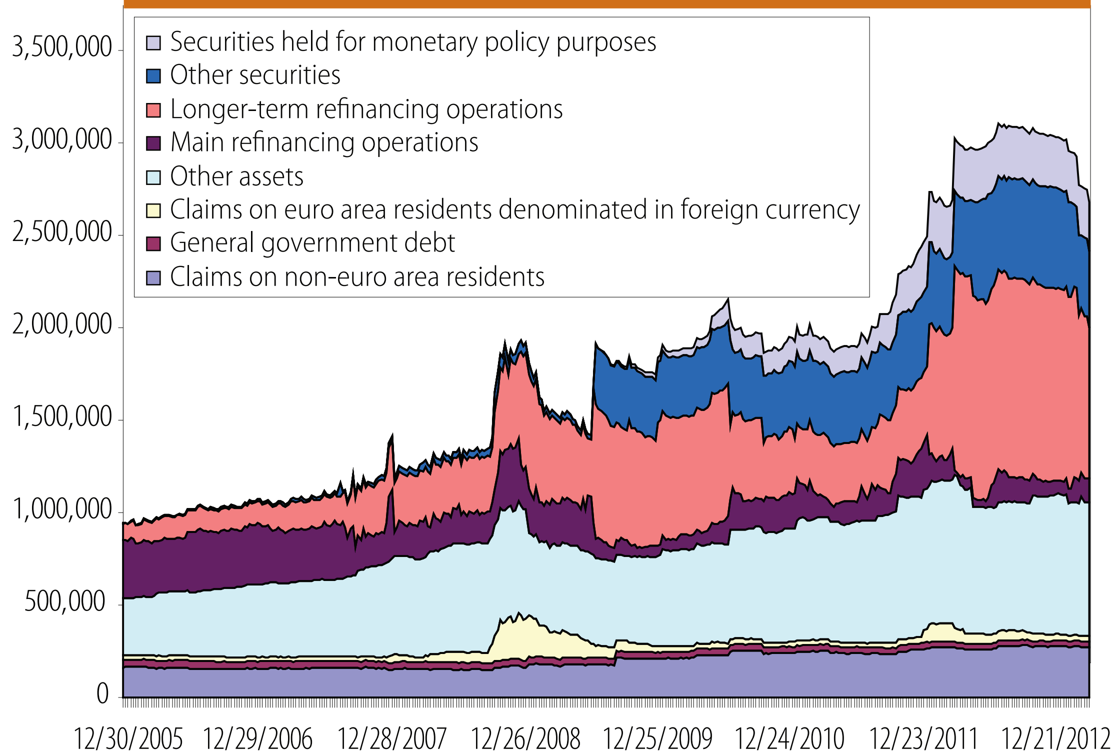
Unlike other forms of QE—where the central bank supplies liquidity through buying securities, thus controlling the amount of liquidity creation—the ECB's refinancing operations can be viewed as a form of "endogenous credit easing" as the amount of new liquidity[2] created is dependent on bank demand for liquidity. A major question is whether the ECB will allow its balance sheet to shrink further or whether it will introduce new QE policies.

1 For a comparison of QE policies across the major central banks, see Brett W. Fawley and Christopher J. Neely (2013), "Four stories of quantitative easing", Federal Reserve Bank of St. Louis Review, vol. 95, No. 1 (January/February), pp. 51-88, available from http://research.stlouisfed.org/publications/review/13/01/JanFeb2013CvrTOC.pdf.

2 See Bini Smaghi keynote speech, "Conventional and Unconventional Monetary Policy", 28 April 2009, available from http://www.bis.org/review/r090429e.pdf?frames=0.

Figure 1: Consolidated balance sheet of the Eurosystem: Assets

In millions of euro



Source: ECB.