# Central Bank Profit Distribution As A Monetary Policy Tool

Hiermeyer, Martin

25 April 2020

# Central Bank Profit Distribution
# As A Monetary Policy Tool

*By* MARTIN HIERMEYER*

Next to conventional and unconventional monetary policy, there may be another form of monetary policy: Central bank profit distribution to the government. By distributing a higher profit than normal if inflation is below target, and a lower profit than normal if inflation is above target, central bankers may achieve their inflation target better. To guard against excessive inflation, lawmakers might stipulate that central bankers can only distribute higher profits than normal if conventional monetary policy is exhausted (0% policy rate).

* e-mail: m.hiermeyer@gmx.de

## I. Introduction

Conventional monetary policy can be defined as central bankers influencing inflation through open market operations, the discount rate and/or reserve requirements.

Unconventional monetary policy can be defined as central bankers influencing inflation through credit easing, quantitative easing, forward guidance, and/or signaling. Central banks generally only resort to unconventional monetary policy if conventional monetary policy has run out of steam, i.e. if the central bank's policy rate is already at 0% and inflation is still below target.

Next to conventional and unconventional monetary policy, there may be another form of monetary policy: Central bank profit distribution to the government.

As Bunea et al. (2016) have pointed out, central banks today distribute profits to their governments in line with a specific formula dictated by their legal framework. The formulas differ between central banks. For the period

2007-2013, Bunea et al. (2016) report that some central banks distributed a profit to their government even when the central bank experienced a net loss in the relevant year. Others, in contrast, distributed only a part of an annual net profit or even nothing at all.

Bunea et al. (2016) suggest principles for a proper "central bank profit distribution policy". One principle is that the policy should have a neutral impact on monetary policy.

This paper questions this tenet and asks: Might central bank profit distribution be a useful tool for monetary policy?

## II. Possible Disadvantages

There are three possible disadvantages to using central bank profit distribution as a tool for monetary policy: (1) A central bank that distributes higher profits than normal because inflation is below target engages in direct government financing – an explosive endeavor that has caused hyperinflations in the past; (2.) A central bank that distributes higher than normal profits because inflation is below target may use up its capital quickly; (3.) A central bank that distributes higher (lower) profits than normal because inflation is below (above) target complicates the government's budget process.

All three concerns deserve a closer look.

### *A. Risk Of Hyperinflation*

Currently, central banks distribute profit according to a legal framework that does not include any reference to monetary policy or the inflation rate. Rather, the relevant legal framework reflects accounting standards and other conventions.

It is generally assumed that a profit calculated in this way is a "fair" one, one which can be distributed to the government without constituting direct government financing – an endeavor explicitly outlawed in many countries.

If the normal profit is the "fair" profit, any add-on profit (distributed additionally because inflation is below target) reflects direct government financing.

Direct government financing is a dangerous tool, one which has triggered many hyperinflations in the past. There are good arguments to not open this "Pandora's box".

On the other hand, direct government financing is not unheard of, anyway. For example, the Bank of England engages in direct government financing right now.

More importantly, with clear legal rules, the risk of excessive inflation may be containable. For example, lawmakers could legislate that the central bank is only allowed to distribute higher-than-normal profits if inflation is below target and if conventional monetary policy is exhausted (policy rate of 0%). Furthermore, lawmakers could set a limit for the maximum profit that a central bank can distribute.

### *B. Effect On Capital*

If a central bank distributes higher profits than normal, its capital becomes lower than normal. Capital might even turn negative.

While central banks can operate with negative capital, negative capital may be a concern to the public (Stella 1997, 2002, 2003, Bindseil et al. 2004). Such concern may be more pronounced if it takes long for capital to recover (for example because it is only after many years that an above-target inflation rate forces the central bank to distribute lower-than-normal profits, rebuilding capital).

While such concerns should not be taken lightly, it must be seen that the distribution of higher profits than normal may happen in a situation where inflation is below target and conventional monetary policy is exhausted (0% policy rate). In such a situation, the policy may replace quantitative easing, a policy which also concerns the public given the associated exploding size of central bank balance sheets.

Also, it must be seen that the central bank could choose to build up a capital buffer during times of above-target-inflation by combining a relatively loose conventional monetary policy with a zero-profit-distribution policy.

### *C. Effect On The Government's Budget Process*

The more complex the formula for the central bank's profit distribution, the less predictable the central bank's profit distribution and the harder the budget process for the government.

However: Budget processes are designed to handle some uncertainty. For example, tax revenue – a much bigger item in the budget process – is also highly uncertain.

## III. Possible Advantages

There are three possible advantages to using central bank profit distribution as a tool for monetary policy: (1) Distributing higher central bank profits than normal may stimulate inflation when conventional and unconventional monetary policy fail to do so; (2) Distributing higher profits than normal may make quantitative easing redundant – the central bank does not have to load up its balance sheets with bonds, a considerable advantage not only for monetary unions; (3) The central bank's profit acts as an automatic fiscal stabilizer if the central bank distributes a higher (lower) profit if inflation is below (above) target.

### *A. Powerful When Everything Else Fails*

The last decade has shown that inflation can be persistently low for long, and that conventional monetary policy may run out of steam soon.

The cure of choice – quantitative easing – seems to have done well so far, although it is unclear whether even more unfavorable circumstances could have brought quantitative easing to its limits, too. In particular, the Japanese experience shows how tedious quantitative easing can be at times.

There can be little doubt that central bank profit distribution would be infinitely more powerful than quantitative easing as a monetary policy tool. As discussed above, it reflects direct government financing, which can trigger hyperinflations if one is not careful as there is little limit to how much money central banks can print, and to how much money governments are willing to spend if unconstrained.

However, given the right dosage, central bank profit distribution might just be what is needed to reflate a economy sometimes.

### *B. Less Bonds On Central Bank Balance Sheets*

If central bank profit distribution replaces quantitative easing as a policy tool, central banks are spared the need to buy large quantities of government and/or of commercial bonds. This is advantageous as such purchases distort markets and endanger financial stability. Also, government bonds are generally part of the mix in quantitative easing, which can be a problem for monetary unions. After all, if the central bank, for a lack of union-level bonds, buys bonds of member states, an unwanted joint liability may arise.

### *C. Automatic Fiscal Stabilizer*

With central bank profit distribution as a tool for monetary policy, the central bank's profit acts as an automatic stabilizer: The central bank distributes a higher profit than normal to the government when inflation is below target (and the economy could do with some fiscal stimulus), and a lower profit than normal when inflation is above target (and fiscal austerity is the order of the day).

## IV. Conclusion

Using a central bank's profit distribution to the government as a monetary policy tool is not something which should be done lightly. After all, it opens the door for direct government financing – a dangerous tool, historically responsibly for many costly hyperinflations. With those hyperinflations in mind, lawmakers in many countries have since outlawed direct government financing.

When those laws were made, inflation, not deflation, was the main issue. Thus, little thought then had to be spent on how to reflate a notorious low-inflation economy.

The last decade has shown that notoriously low inflation or deflation can be a tricky issue, too, and even quantitative easing might not suffice as a policy response.

This paper therefore carefully weighed the pros and cons of one specific form of direct government financing – central bank profit distribution to the government as a tool of monetary policy.

It is the opinion of the author that with the right safeguards, central bank profit distribution is an option to reflate notorious low-inflation economies if conventional monetary policy has failed to do so.

## REFERENCES


Bindseil, Ulrich and Manzanares, Andres and Weller, Benedict (2004): The Role of Central Bank Capital Revisited. ECB Working Paper No. 392. Available at SSRN: https://ssrn.com/abstract=586763.

Bunea, Daniela; Karakitsos, Polychronis; Merriman, Niall; Studener, Werner (2016) : Profit distribution and loss coverage rules for central banks, ECB Occasional Paper, No. 169, ISBN 978-92-899-2002-5, European Central Bank (ECB), Frankfurt a. M., http://dx.doi.org/10.2866/983615

Stella, P. (1997) Do Central Banks Need Capital?î, IMF Working Paper, no 83, International Monetary Fund, Washington D.C.

Stella, P. (2002) Central Bank Financial Strength, Transparency, and Policy Credibility IMF Working Paper, no. 137, International Monetary Fund, Washington D.C.

Stella, P. (2003) Why Central Banks Need Financial Strength, Central Banking, XIV, no. 2, p.27.