A Central Bank's optimal balance sheet size?

By C.A.E. Goodhart

Prior to 2009, no one could, or did, ask this question.

The size of the CB's balance sheet was determined by:

1) The demand for bank notes,
2) The required reserves of commercial banks,
3) Foreign exchange operations,

so there was no question of choice of size.

But all that changed with QE.

QE forced a change from a corridor system to a floor system for the Monetary Policy Operational Framework. So, one question influencing the future size of a CB's balance sheet is what should be the operational framework going forward, corridor or floor, or some hybrid?

Here I can strongly recommend a recent IMF WP/24/56, (March 2024), 'The ECB's Future Monetary Policy Operational Framework: Corridor or Floor?', by Brandao-Marques and Ratnovski.

In this they concluded that,

> 'The analysis of tradeoffs suggests that, on balance, in steady state, a hybrid system that combines the features of the "parsimonious floor" (with a minimal volume of reserves) with a lending facility or frequent short-term full-allotment lending operations priced at or very close to the deposit rate, making it a "zero (or near-zero) corridor", would be most conducive for achieving the ECB's monetary policy objective.'

There is no doubt in my mind that QE was a correct and effective response to a panic-driven surge in cash demand, but should it have been not only continued, but also much extended, when the dash for cash had calmed down?

Since QE involved a massive effective shortening of the outstanding duration of public sector debt, at a time, post GFC, that interest rates were at an all-time low, did this not imply either enormous confidence that such low rates would remain for a long time into the future, and/or that short-run policy concerns took priority over longer-term considerations?

A second question is whether actions to influence the duration of the outstanding debt are fiscal or monetary? My own answer would be that such measures were primarily fiscal, since resultant changes in the monetary base had by then little, or no, implications for the broad money stock. Although CBs always, I believe, coordinated with their own government's fiscal authorities, should future decisions on QE, or QT, be primarily the responsibility of the fiscal or the monetary authority? Either way does this limit the separation, and supposed independence, of the two authorities? Does that matter?