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Why a central bank cannot go bankrupt

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The dramatic increase in risks taken by major central banks since the 2008 financial crisis and exacerbated by the Covid-19 crisis may have led some to express the fear that central banks could suffer losses, that their capital may, therefore, become negative and that this may undermine their effectiveness and even drive them to bankruptcy. These fears, however, are largely unfounded because a central bank has the unique ability to effectively serve its purpose regardless of its financial status. Even if its capital becomes negative, a central bank is not subject to any legal requirements to undergo reorganisation or bankruptcy proceedings.

As the days unfold, the monetary taboos crack and break. The ECB has temporarily suspended its limits on sovereign debt buyouts[1]. The Bank of England is directly financing the British government's expenses related to the Covid-19 pandemic “as a temporary measure” which “will provide a short-term source of additional liquidity”. And the Fed has agreed for the first time in its history to purchase high-yield (“junk”) bonds from speculative-grade companies notably via exchange-traded funds (ETFs).

Could the dramatic increase in risks taken by major central banks as part of the unprecedented policies currently in force **drive them to bankruptcy? No** – central banks normally possess the resources required to manage their responsibilities on their own.

Central banks can create money to pay their debts

Financing for central banks is completely different to that of commercial banks and private corporations because **their commitments** – banknotes and commercial banks’ overnight deposits held at central banks[2] – **are the only authorised forms of payment in their jurisdiction.** Central banks have a monopoly on creating money,

As such, central banks can always honour their financial commitments[3]: all they would have to do to settle their debts is create money, which they can do at will, instantly and at virtually no cost (they don't pay interest on sight deposits and the cost of printing banknotes is negligible).

[1] As part of its 750-billion euro Pandemic Emergency Purchase Programme (PEPP), the ECB can now purchase unlimited debt from any Member State of the eurozone facing hardship, freeing itself from two of its key rules: 1) buying no more than one-third of a sovereign issuer's eligible debt and 2) buying sovereign bonds in an amount commensurate with each county's shareholding in the EU’s capital.

[2] The total amount of banknotes and coins and the commercial banks’ reserves held at the central bank is referred to as the “monetary base” or "narrow money”.

[3] Nevertheless, it should be noted that when a central bank has major debts in a foreign currency – such as is the case with some emerging countries – the central bank's ability to acquire the relevant foreign currency (on the forex market or via foreign assistance) determines its ability to honour its payment obligations in foreign currencies.

This has **three fundamental consequences** for central banks:

- They can lose money to the point of having negative capital without this being a problem for clients from whom they borrow money[4].
- Sheltered from bank runs, they normally retain their ability to deliver in the event of negative capital.
- Thus, they are not subject to any reorganisation or liquidation requirements.

Central banks generate structural revenue

There is another reason why lack of capital is generally not an issue for a central bank: **thanks to their monopoly on issuing banknotes, they generate structural revenue** – referred to as **"seigniorage"** – which usually guarantees their profitability in the long term.

Their monopoly on the narrow money supply enables central banks to issue all the desired money by acquiring income-generating assets in return. Since their financial commitments are not associated with any debt servicing costs, the **income** that their assets generate (interest on loans they grant or returns on assets acquired) is a **structural surplus, which enables them to increase or, in the event they have incurred losses, replenish their capital over time.**

Given the periodic revenue they derive from their exclusive right to issue banknotes, **central banks are not held to any capital reserve requirements.**

The persistence of a negative level of capital may nevertheless raise questions

One could, however, imagine that a permanently negative level of capital could theoretically become problematic. **Some crisis situations can limit the long-term profitability of a central bank.** In the extreme, one could arrive at a situation – highly improbable empirically but theoretically conceivable – where all discounted future earnings could be insufficient to offset current expenses. This would force a central bank to create money to cover its current expenses, causing it to lose control over monetary policy.

To maintain their credibility and independence, central banks remain ever-vigilant when managing their balance sheets and are committed to establishing adequate capital reserves by any means necessary to make sure their balance sheets do not incur structural damage.

[4] Remember, for an ordinary company, capital is for protecting creditors. When its capital is negative, a company can no longer honour its commitments because it has insufficient funds. The company then has to undergo reorganisation or, worst case scenario, bankruptcy proceedings.

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