Australia's Central Bank Says It Is Bust

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The central bank of Australia on Wednesday made the astonishing admission that it is, basically, bust. Its entire equity has been wiped out by pandemic-related bond buying.

Of course, the Reserve Bank of Australia is a central bank, and can print money. So it can work its way out of a situation that would bankrupt a conventional bank or company.

Still, as the U.S. Federal Reserve meets today on interest rates, it's an interesting insight into the challenges other central bankers face as they attempt to reconcile Covid stimulus with post-Covid inflation and economic emergence.

The RBA began its bond-purchase program in November 2020 as a second stimulus package in response to the pandemic. The first round of measures saw it slash rates to record lows, and set up a term funding facility offering cheap three-year funding to banks. For the bond buying, the central bank bought Australian government bonds and semi-government securities in the secondary market to lower interest rates on bonds maturing between five and 10 years out.

The program was extended, and extended, and extended yet again. Ultimately, the RBA bought A$281 billion (US$188 billion) in national, state and territory government bonds.

Now the bill has come due.

The RBA will announce its full-year results for the Australian fiscal year through June 30 in a month or so. But they won't be pretty.

The central bank has had to mark the value of its holdings to market, resulting in a A$44.9 billion (US$30.0 billion) valuation loss. Offset by A$8.2 billion (US$5.5 billion) in underlying earnings from the central bank's holdings, and it is posting a net loss of A$36.7 billion (US$24.5 billion).

That has exhausted the bank's A$15.4 billion reserve fund and A$8.4 billion in other reserves, and then some. So the RBA is in negative equity to the tune of A$12.4 billion (US$8.3 billion).

"If any commercial entity had negative equity, assets would be insufficient to meet liabilities, and therefore the company would not be a going concern," RBA Deputy Governor Michele Bullock explains in outlining the central bank's situation. "But central banks are not like commercial entities."

The RBA has a government guarantee against its liabilities, meaning "there are no going concern issues with a central bank in a country like Australia," she says by way of reassurance. And of course the central bank can simply print more money, so "the Bank can continue to meet its obligations as they become due and so is not insolvent. The negative equity position will, therefore, not affect the ability of the Reserve Bank to do its job."

A license to print money to get out of that kind of problem is never, however, going to be good news for your currency. And indeed, the Aussie dollar has lost 13.6% of its value against the U.S. dollar since early April. Look back 18 months, and the decline in what some Aussies joking call the "Pacific peso" is 19.5%.

It's a far cry, with US$1 now buying you A$1.50, from 2013, when the Aussie dollar briefly rose above parity to become stronger than its U.S. counterpart. However, the Australian government was forced to inject cash into the central bank in 2013 because it had suffered losses on its foreign-currency reserves. The RBA notes it's not requesting any cash injection now.

With interest rates rising in Australia, the RBA is in the unenviable position of having to pay out higher interest on its liabilities than it is able to earn on the bonds and other assets it has been buying. "In other words, underlying earnings are negative," Bullock says. "It is difficult to be precise about how long this situation will last or how big these negative earnings will be."

On the plus side, having marked to market at June 30, the central bank finds that its bond holdings are now valued below their face value at maturity. As a result, it should be making capital gains as the bonds come due. The RBA is now going to run its bond portfolio back down.

The RBA slashed rates to a record low of 0.1% in November 2020. The Aussie central bank has now hiked three times, bringing the current interest rate to 2.35% as of its September 6 meeting. It is next due to meet on rates on October 4.

As of the end of the June quarter, the RBA held A$356 billion (US$238 billion) in Australian government bonds, and also has another A$188 billion (US$125 billion) in assets connected to the term funding facility. Across the entire government, the entity that issues the Aussie government's debt - the Australian Office of Financial Management - will be reporting a significant gain on the liabilities it has issued, equivalent to the losses that the RBA has had to write down.

The RBA notes that other central banks would be in a similar position but use different accounting methods. The Bank of England and the Reserve Bank of New Zealand both have an indemnity from the government on any losses. So their governments would essentially bail them out, something the RBA stresses it is not asking the Australian government to do.

However, the RBA typically contributes its profits to the government coffers as a dividend. The government likely should expect a hole in its budget where that dividend contribution used to be, for "the next few years," Bullock says. The last bonds mature in 2033.

Similarly, the Swiss National Bank reported a first-half loss of 95.2 billion Swiss francs (US$98.7 billion), its largest since the central bank was set up in 1907. Falling bond prices and the appreciation in the Swiss franc ate into its huge foreign-currency holdings, but like the RBA the loss is on paper until the bonds mature.

The bottom line, Bullock says, is that central banks had to spend their way out of the pandemic crisis if their economies were going to stay afloat. In that sense, the RBA's bond buying "broadly achieved its aims," she concludes.

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