DEUTSCHE BUNDESBANK
EUROSYSTEM

MANAGING SURPLUS LIQUIDITY

INTERNATIONAL CENTRAL BANKING COURSES
EXPERT PANEL
1–3 APRIL 2009

Centre for Technical Central Bank Cooperation

Managing surplus liquidity

Report on the expert panel, 1-3 April 2009, held at the Bundesbank in Frankfurt/Main.
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Overview

From 1-3 April 2009, the Bundesbank conducted an expert panel on managing surplus liquidity as part of its international central banking courses. Participants included nine visiting experts from partner central banks (Albania, Armenia, Jordan, Macedonia, Moldova, the Philippines, Russia, Serbia and Sri Lanka), two external experts from the University of Leipzig and experts from the Bundesbank. They exchanged their views, experiences and knowledge about (a) the main sources of surplus liquidity, (b) instruments and procedures to manage surplus liquidity and, finally, (c) ways to prevent and eliminate the surplus. While the Eurosystem is a typical example of a central bank facing a liquidity shortage in the domestic banking system, many central banks worldwide face a structural liquidity surplus. The most important source of surplus liquidity is the accumulation of foreign reserves under fixed or managed floating exchange rate regimes. Absorbing excess liquidity from the domestic banking system on a structural basis poses different challenges. If the central bank does not succeed in draining sufficient surplus liquidity, it will become more difficult to steer interest rates and risks to price stability or financial stability will increase. If the central bank pursues market-oriented monetary policy operations in order to absorb liquidity, it has to compete with other investment opportunities of domestic banks in its monetary policy operations. The resulting increased interest rates may trigger even more foreign exchange inflows and interventions of the central bank and drive up sterilisation costs. Faced with this dilemma, many central banks try to reduce part of the surplus liquidity with reserve requirements and thereby accept that low or no remuneration of reserve requirements can have distortionary effects on the domestic financial system.

Since the third quarter of 2008, however, emerging market economies have been increasingly affected by the global financial turmoil. Surplus liquidity in some central banks diminished drastically due to strong foreign exchange interventions in order to avoid a depreciation of the domestic currency.

(a) Defining the structural liquidity position and identifying sources of surplus liquidity

The definition of surplus liquidity crucially depends on distinguishing autonomous factors from monetary policy operations in the central bank's balance sheet. If autonomous (liquidity-providing) factors on the asset side exceed autonomous (liquidity-absorbing) factors on the liability side, the central bank will absorb liquidity in its monetary policy operations on a net basis. The central bank may provide liquidity to some banks and absorb liquidity from others; however, since liquidity is, on aggregate, not distributed efficiently among banks, liquidity-absorbing monetary policy operations exceed liquidity-providing monetary policy operations.

The definition of autonomous factors may be difficult in practice. The Eurosystem defines autonomous factors as items on its balance sheet which have an impact on credit institutions' current account holdings but are not under the direct control of the Eurosystem's liquidity management. Therefore, in the Eurosystem, net foreign assets and government deposits are regarded as autonomous factors.

Experts mentioned that their central banks have exchange rate objectives and therefore use interventions in the foreign exchange market (reflected in changes of net foreign assets) as a regular instrument for exchange rate management. Liquidity management that aims at a minimum level of excess reserves in order to steer domestic short-term interest rates and eventually price stability as the ultimate goal is therefore challenged by an exchange rate objective. In principle, dual objectives will confront the central bank with the well-known "impossible trinity" given a sufficiently high degree of capital mobility. The increase of net foreign assets due to the exchange rate regime was identified as the main source of surplus liquidity for the central banks of the visiting experts. Domestic assets reflecting (past) monetary financing or financial restructuring can also be sources of surplus liquidity; however, they played no role in the balance sheets of the respective central banks. Experts mentioned that government deposits are sometimes used as an instrument to support liquidity management. If the central bank can "freeze" the government deposits, government deposits effectively become a monetary policy instrument. In other cases, however, the Ministry of Finance may withdraw its funds at its discretion and thereby reduce the supporting function of government deposits for the central bank's liquidity management. Thus, depending on the circumstances, government deposits can be regarded as an autonomous factor or a ("quasi") monetary policy instrument.

(b) Instruments and procedures to manage surplus liquidity

Experiences with reserve requirements

Reserve requirements are an actively used instrument for absorbing surplus liquidity at the visiting experts' central banks. This is in contrast to the Eurosystem's minimum reserve system, which primarily pursues the aims of stabilising money market interest rates and enlarging a structural liquidity shortage. Since minimum reserve holdings in the Eurosystem are fully remunerated, they are no longer regarded as a burden on the financial system.

In contrast most visiting experts reported that minimum reserve holdings were not remunerated or were remunerated at rates well below market rates. In some cases, minimum reserve holdings were fully remunerated when they originated from the part of the reserve base denominated in domestic currency. Only one expert reported that minimum reserves on the foreign currency-denominated reserve base were also fully remunerated.

Most central banks use averaging provisions; in one case, the averaging provision was not applied to minimum reserves on the foreign currency-denominated reserve base.

The experts from Serbia[1] and Russia reported that their central banks require that minimum reserves on the foreign currency-denominated reserve base be held in domestic currency. The expert from Macedonia mentioned that domestic banks opposed this proposal, because it would have increased the currency mismatch of their balance sheet.

Experiences with open market operations and standing facilities

Open market operations and the use of standing facilities are (still) mainly liquidity-absorbing on a net basis, even though the malfunctioning of interbank markets, which was further aggravated due to the impact of the global financial turmoil, often forces central banks to provide and support liquidity at the same time. In Russia and Moldova, however, the liquidity-absorbing open market operations have decreased sharply over the last months and the central bank already provides more liquidity than it absorbs in its open market operations. In both cases, strong foreign exchange interventions have increased liquidity needs in the domestic banking system, while a substantial decrease of the currency in circulation partly counterbalanced this effect.

At most central banks, open market operations take place in the form of reverse transactions rather than in the form of outright transactions. One reason for shifting from outright transactions to reverse transactions may be that the central bank and the government do not want to compete in the same segment of the financial market (central bank securities, for example, are shorter-term, whereas the issuance of government securities cover the longer maturities). Another reason mentioned is that banks want to hold securities until maturity, so outright transactions fail to enhance interbank trading and the development of the domestic money market.

Most experts mentioned that their central banks offer standing facilities for providing and absorbing liquidity. In the case of Macedonia, a liquidity-absorbing standing facility does not exist in order to encourage interbank trading in the face of strong surplus liquidity.

Coordinating liquidity-absorbing measures with the government

Liquidity management can be coordinated with the government in different ways. In Russia, for example, growth of government deposits has been the main liquidity-absorbing factor until the financial turmoil changed the situation. Shifting government deposits from commercial banks to the central bank is – for example – also sometimes used as a liquidity-absorbing measure that was mentioned by one expert. As long as the government deposit is not "frozen" by the central bank, it cannot be regarded as a "quasi-monetary policy operation".

Sometimes, coordination with the government fails to succeed. In the case of Macedonia, treasury bills were introduced for monetary policy purposes in 2006. While the 28-day central bank bills had so far sterilised surplus liquidity, the treasury bills were envisaged to cover the three-month segment and thereby support the sterilisation of surplus liquidity and the development of a homogenous market for

1 In Serbia, part of the minimum reserves on the foreign currency-denominated reserve base, currently 40%, has to be held in domestic currency. Specifically, the calculated dinar required reserves are the sum of required reserves calculated in dinar by applying appropriate ratios on the dinar reserve base plus 40% of the dinar equivalent of required reserves calculated in euros.

public debt. Accordingly, the share of this new three-month sterilisation instrument should have increased and the share of the 28-day sterilisation instrument should have decreased. However, due to strong interventions in the foreign exchange market and the increasing budgetary needs of the Ministry of Finance, the increasing surplus liquidity prevented decreases in the share of central bank bills and increases in the share of treasury bills for monetary purposes. The issuance of treasury bills for monetary policy purposes was eventually discontinued in the second half of 2008.

Experts mentioned that coordination with the government sometimes fails to succeed because the government mistakenly thinks it can avoid the higher interest costs for borrowing in the domestic market. Market-oriented sterilisation ceteris paribus will have an impact on the domestic interest rate level, irrespective of whether the government issues securities for monetary purposes or whether it leaves the task of sterilising the surplus to the central bank.

Financial costs for the central bank and implications for financial sector development

Market-oriented sterilisation can cause substantial costs for the central bank and may have an impact on its reputation and eventually on its financial independence. Similarly, valuation losses on the foreign reserve portfolio can add to the financial costs. Experts agreed that central bank communication is very important in explaining the reasons and consequences of central bank operations.

Experts reported that rapid domestic credit growth is often fuelled by banks' borrowing from abroad. Sterilising surplus liquidity alone is insufficient in dealing with this challenge. Therefore, some central banks have taken additional regulatory steps. In Macedonia, for example, the proposal of a liquidity ladder, which aims at closing the maturity and currency mismatches in banks' balance sheets, was well perceived by the domestic banking community.

(c) Eliminating and preventing surplus liquidity

Remedies for surplus liquidity depend on its sources. If surplus liquidity is due to the accumulation of foreign reserves, the central bank should reconsider (1) the exchange rate objective and (2) the measures to decrease net foreign exchange inflows. Dismantling restrictions on capital outflows or encouraging government borrowing in the domestic financial system rather than abroad are measures that can decrease net foreign exchange inflows and the associated upward pressures on the exchange rate.

Surplus liquidity due to the accumulation of domestic autonomous factors is either due to some form of government financing of the central bank or due to financial restructuring via the central bank. The former has been successfully tackled by the strengthening of institutional frameworks of central banks. However, if the domestic financial system needs restructuring after monetary disruptions or financial crises, the central banks will usually be called upon for support as a lender of last resort. Besides the well-known risk of moral hazard, the central bank also runs the risk of being burdened with government debt for

which the Ministry of Finance afterwards lacks responsibility. Many central banks struggle with this burden for years and sometimes decades, because the government debt is not remunerated at market rates and therefore puts pressure on the financial soundness and eventually the independence of the central bank. Securitising government debt and remunerating it close to market rates enables the central bank to sell the government debt in the domestic banking system and thereby absorb part of the surplus liquidity that it created. Avoiding the government debt on the central bank balance sheet in the first place could prevent the creation of surplus liquidity. The use of equalisation claims in Germany after the Second World War is a successful example of this option that nevertheless mobilises seigniorage to finance the restructuring process.

Finally, the increase of currency in circulation is the ultimate liquidity-absorbing factor that brings central banks out of their debtor position. This, however, depends on the demand for domestic currency. Several reasons may prevent an increasing demand for domestic currency. An important reason for many emerging market economies is currency substitution that may not reverse even though the original driving forces such as macroeconomic instability and/or political uncertainty have long disappeared.

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