Liquidity and Monetary Policy

CFS Symposium

Banking, Liquidity, and Monetary Policy

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Contribution by

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1. <u>Liquidity – an elusive concept</u>

"Liquidity" is a highly relevant quality in any economy, and, yet, at the same time it is one of the most elusive concepts. The term is used to characterize the situation of economic agents (or sectors) and the quality of an asset (or group of assets). The Radcliffe Report of 1959 – an influential publication at that time – put overall liquidity in the center for the assessment of the economic situation.

However, it turned out that this concept was not operational. There existed neither a feasible approach for measurement nor could the central bank control this complex variable.

For an extended period of time a number of central banks used proxies of liquidity in the banking sector as the foremost analytical tool as well as the intermediate target for the conduct of monetary policy. The Fed used "free reserves" for this purpose.

Before adopting monetary targeting (in 1975) free liquidity reserves ("freie Liquiditätsreserven") dominated the strategy of the Bundesbank. Free liquid reserves were basically defined as the sum of excess reserves (reserves at the central bank minus minimum reserves) plus the available refinancing potential (at the central bank). This concept became more and more dubious because on the one hand it was almost impossible to measure free liquid reserves appropriately and on the other hand free liquid reserves lacked the prerequisites as an intermediate target.

So, it is no surprise that central banks followed other approaches, from monetary targeting to inflation targeting. The ECB adopted a two pillar strategy.

"Liquidity" is not any more used as a properly defined concept. However, bankers worldwide use the term liquidity probably almost daily. In its last Annual Report the BIS sees the need for central banks "to balance various considerations, including the availability of high-quality collateral, regulatory reforms and views concerning the appropriate role of central banks liquidity in normal and turbulent times" (p. 73). During the Press Conference on 1 August 2013 President Draghi said, "and I will re-state, that liquidity will remain ample as long as it is needed…"

Nobody would doubt that liquidity is ample. But, how ample is liquidity? The rich statistical part of the ECB's Monthly Bulletin e.g. has no table on liquidity. And this does not come as a surprise. The liquidity position of the banking sector is influenced not only by its reserves at the central bank. Potential access to refinancing at the central bank is a close substitute to central bank money. In case of a policy of full allotment at a fixed rate the stock of eligible collateral (corrected for haircuts) has the characteristic of a “near-central-bank-money asset”. Any change in the collateral policy has an influence on the liquidity of the banking sector as a whole and of individual banks. The liquidity situation of individual banks depends also crucially on the functioning or mal-function of the money market.

Finally, changes in the overall economic situation will also have an influence on the liquidity of banks and the banking system as a whole. A collapse e.g. of the housing market is a case when the market for mortgages becomes illiquid. The interaction of agents in markets can also create liquidity e.g. via financial innovations.

2. Monetary policy and liquidity

The contrast of a world-wide expansion of central banks’ balance sheets and the corresponding increase in central bank money on the one hand and a slow pace of growth of broad money on the other hand demonstrates that higher liquidity does not necessarily translate into stronger demand. As Keynes famously once has remarked “we cannot….make the horses drink…But we can provide them with water”.(The Means to Prosperity, 1933) Impulses from monetary policy work through the banking system. This is especially true for a financial system like that of the euro area which is dominated by bank lending. The ECB can reduce its interest rates and improve the liquidity situation of the banking system. But, the central bank cannot force banks to expand lending to business. Any attempt to make central bank refinancing conditional on lending has its limits as the Bank of England’s “Funding for Lending Scheme” has demonstrated. And, as Rajan in his famous Jackson Hole contribution stressed – liquidity infusion is not costless. “It does impose lower policy rates, sometimes for a considerable duration, and entails a tax on savers and a transfer to those who need the liquidity.” [1]

This cost becomes especially visible in an extended period of time of very low interest rates via the so-called risk-taking channel. [2] Theory would predict that ample liquidity and low

[1] Rajan, Raghuram G. (2005), Has Financial Development Made the World riskier?, in: Federal Reserve Bank of Kansas City, ed., The Greenspan Era: Lessons for the Future, p. 347.
[2] Rajan (2005) and Borio, C. and H. Zhu. 2008. “Capital Regulation, Risk-Taking and Monetary

interest rates come together. It is therefore hard to understand why quantitative easing and interest rate policy could be treated as different tools of monetary policy. Ample liquidity provided at very low interest rates causes a combination which creates strong incentives for risky investments. Central banks dispose of no measures to prevent that ample liquidity is not used for business investment, but for investing in nominal assets. The risk of bubbles, probably also in the construction sector is the other side of the cost of "liquidity infusion."

Another aspect of such a situation is the impact on individual banks. Intended or not, ample liquidity at very low interest rates will help banks to survive which under "normal conditions" would become insolvent. Those banks have strong incentives to undertake risky investments and/or continuing their lending to companies which might otherwise not be able to deliver on the debt service. In short, this is a situation in which "zombie" banks keep "zombie" companies alive.

This is the opposite of what Bagehot's rule would imply, namely providing unlimited credit to illiquid, but solvent banks at a penalty rate. A central bank which conducts a policy of ample liquidity at extremely low interest rates in order to stimulate the economy has the corresponding risk of undermining a needed restructuring of the banking sector. Liquidity is no viable substitute for equity.

3. Conclusion

Although "liquidity" is a vague concept it has become the focus of monetary policy. One might also be tempted to say – vagueness is the very reason for its "popularity". Quite often the term is just used as a substitute for "money". For the conduct of monetary policy an adequate measurement of liquidity and an assessment how liquidity can be influenced and what the consequences will be are some of the greatest challenges for central banks.

For a proper assessment the central banks cannot ignore the interdependence of its own actions and global developments. Domestic and global liquidity ultimately will have an influence on domestic price stability, financial stability, and the real sector. "Given the multi-dimensional nature of global liquidity and the lack of a catch-all indicator to capture its

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development, it is important that a broad range of measures are monitored, with a view to maximizing the information available to policy-makers."[3]

[3] ECB, Global Liquidity: Concepts, Measurements and Implications from a Monetary Policy Perspective, Monthly Bulletin, October 2012, p. 68.
See also: Domanski, Dietrich, Fender, Ingo, McGuire, Patrick, Assessing global liquidity, BIS Quarterly Review, December 2011.