

Implementing monetary policy

Liquidity management

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Yesterday Norges Bank's Executive Board decided to keep the key policy interest rate unchanged at 1.75 per cent

The Board decided that the key policy rate should be in the interval 1½- 2½ per cent in the period to the next publication of the Monetary Policy Report on 23 June

Monetary policy and liquidity policy

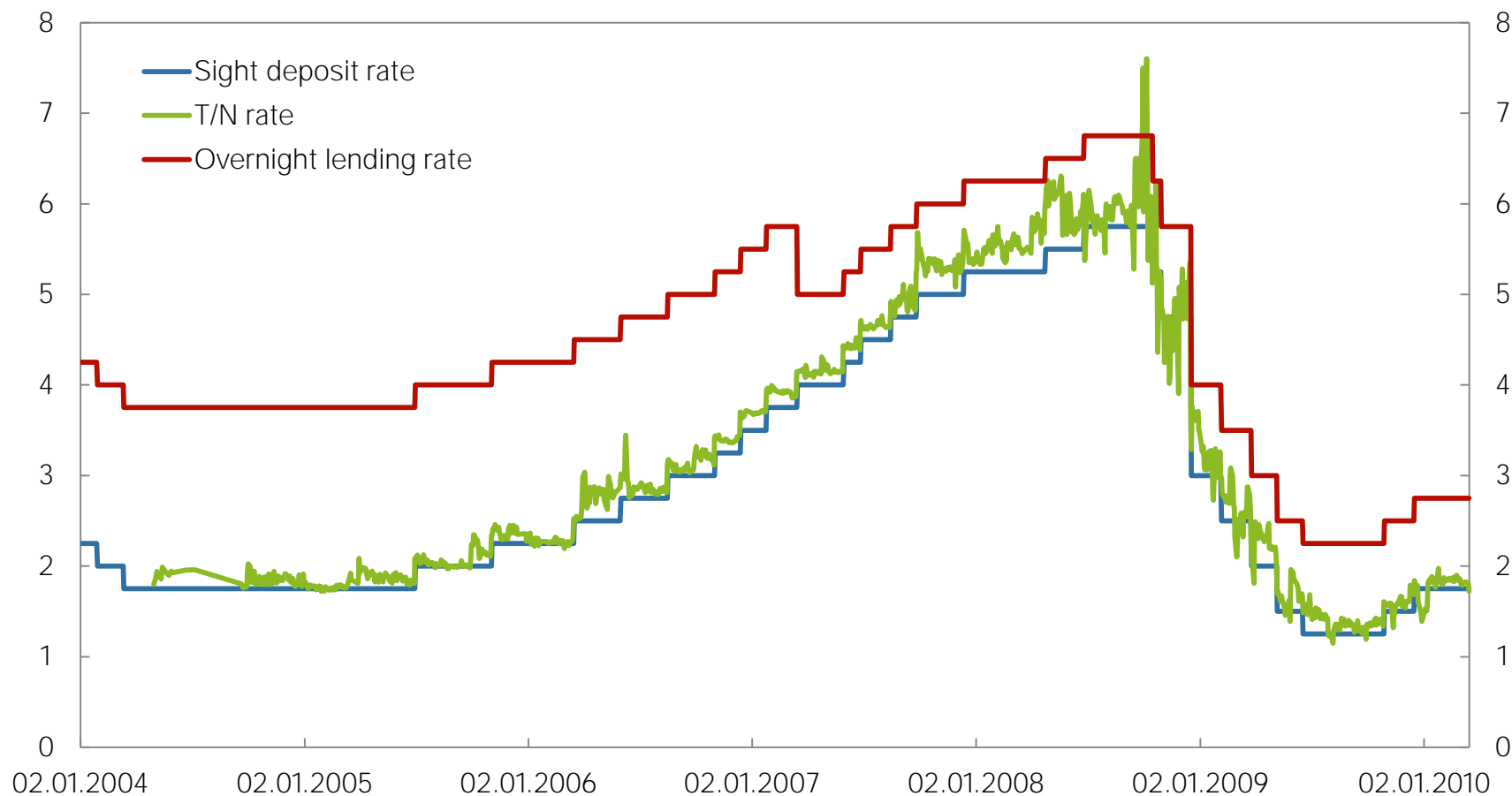
Monetary policy:

- To set the level of the key policy rate in order to fulfil the mandate for monetary policy (for example an inflation target)

Liquidity policy:

- To implement monetary policy
- Ensure that short-term money market rates (overnight, tomorrow-next) remain close to the key policy rate – by managing the liquidity in the banking system

Key interest rate and short term interest rate



What is central bank liquidity? (reserves)

Banks' deposits at their accounts in the central bank

Why do they need it?

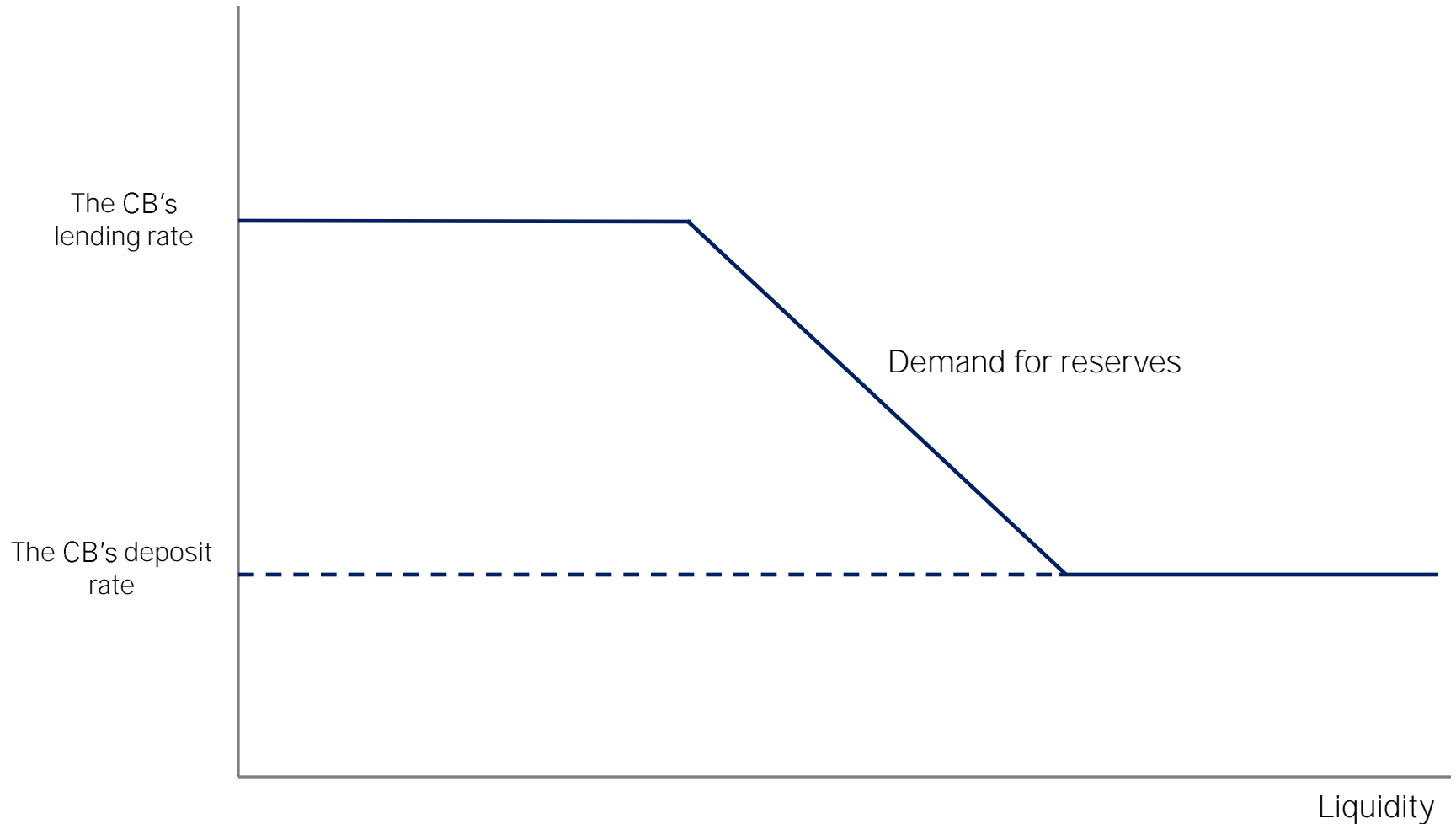
- To pay each other at the end of the day
- Net transactions are settled each day by transfers between the banks' accounts in the central bank
- A bank does not know in advance how much liquidity it will need to settle its net payments at the end of the day.
- Banks can extend credit to each other in the interbank market – redistributing liquidity
- The central bank controls the total volume of liquidity

What affects the overall level of reserves?

- Supply and withdrawal from the central bank
 - Open market operations (Norway: F-loans)
 - Standing facilities
- Autonomous factors
 - Demand for notes and coins
 - In Norway: payments to and from the Central Government's accounts in Norges Bank
 - Taxes, wages, pensions, changes in government debt

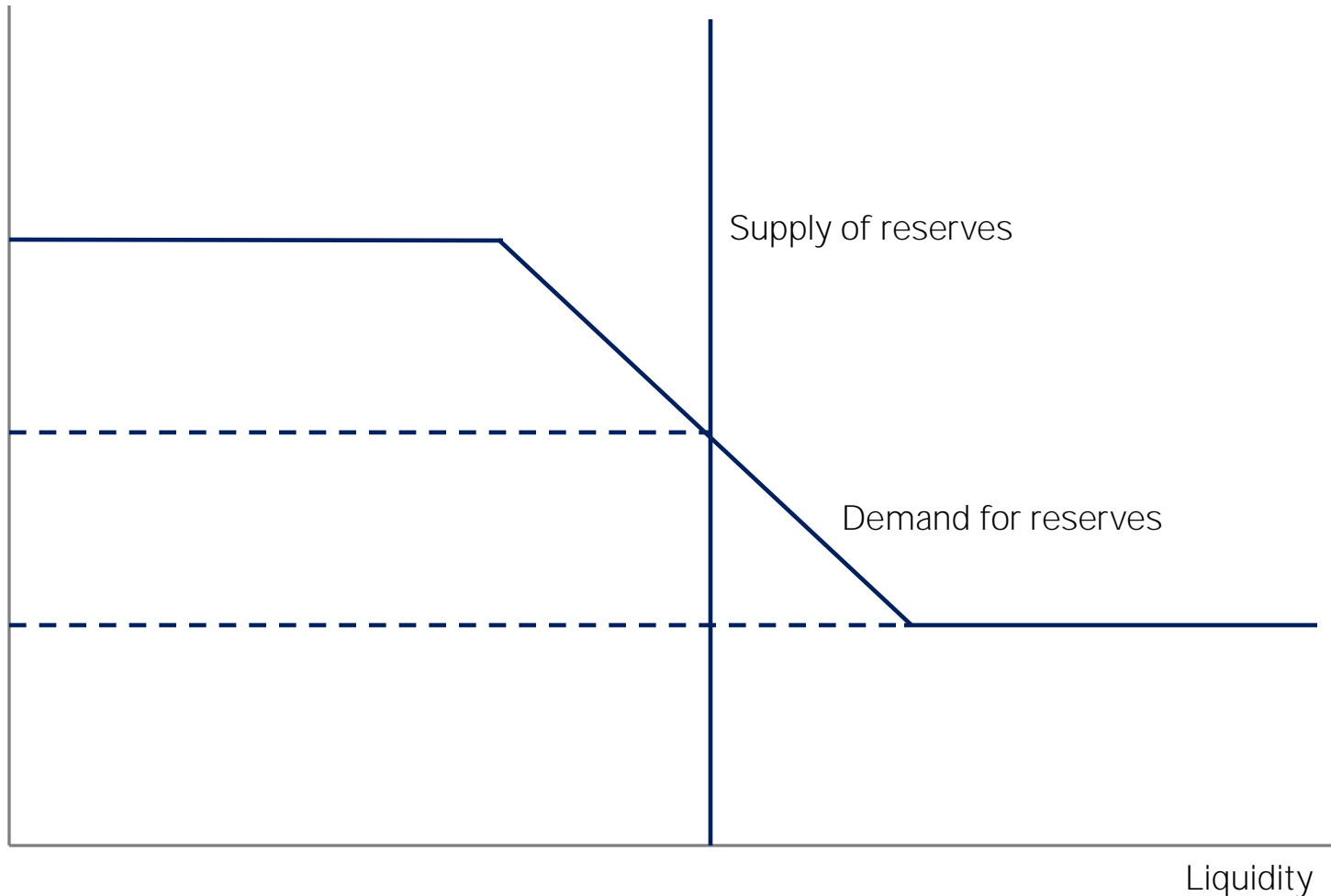
Demand for reserves

Overnight interbank rate
(The interest rate on central bank reserves that the banks distribute among themselves)

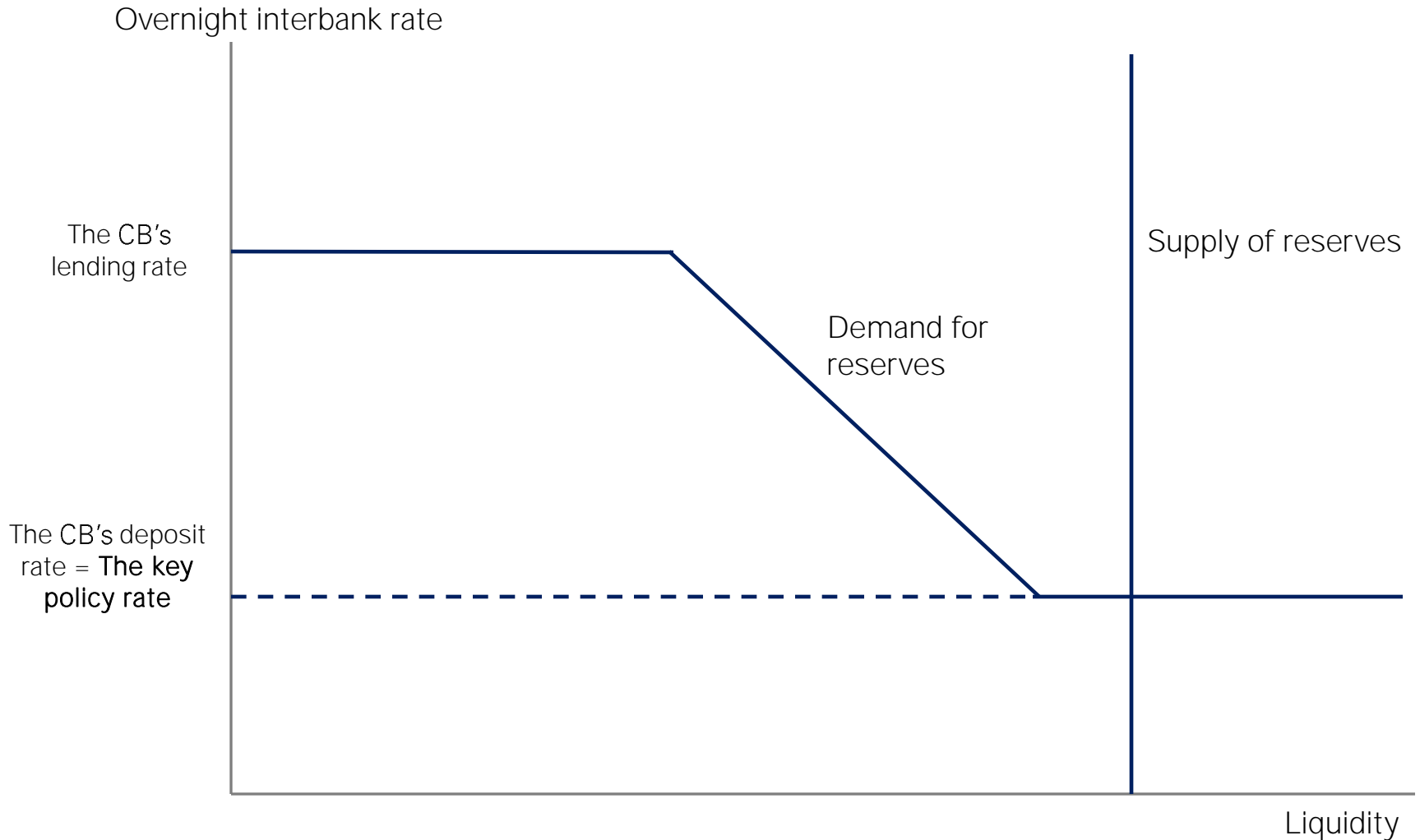


Demand for and supply of reserves "Corridor-system"

Overnight interbank rate
(The interest rate on central bank reserves that the
banks distribute among themselves)



Demand for and supply of reserves "Floor-system"



Corridor vs. Floor - pros and cons

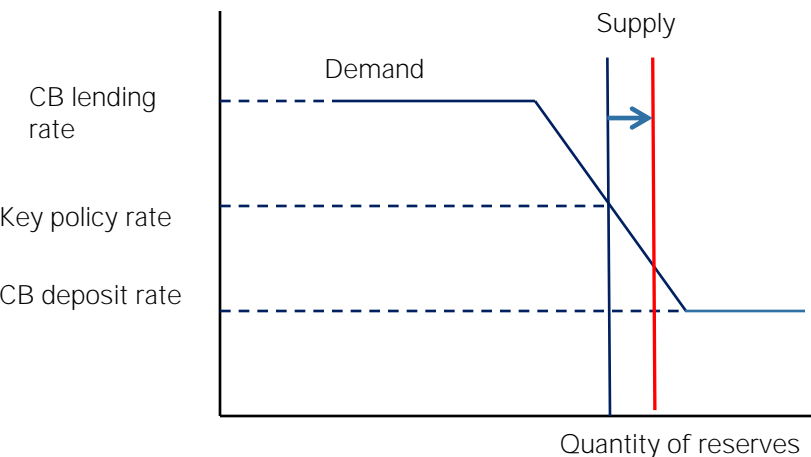
Three differences:

- The ability to supply more liquidity to the banking system for reasons related to financial stability
- The need to fine-tune the supply of liquidity
- Activity in the interbank-market

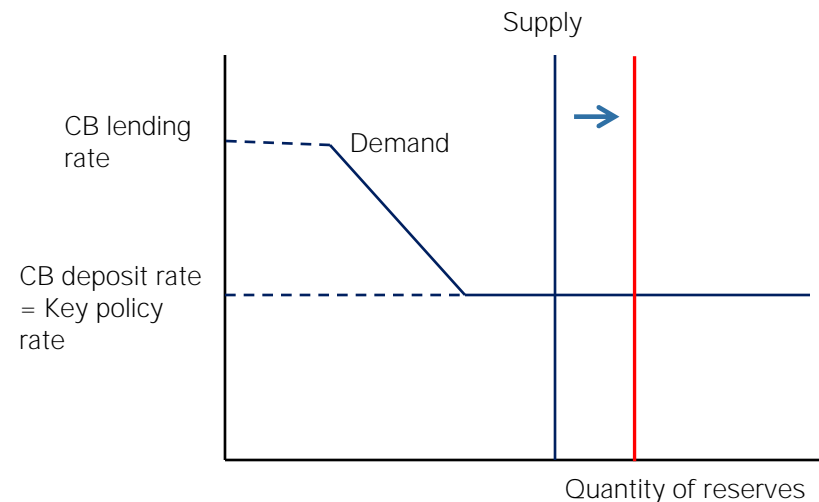
The ability to supply more liquidity

- Can be useful in times of financial unrest. Either because increased demand for reserves or as a side-effect of other measures
- **Corridor:** Potential trade-off between large supply of liquidity and maintaining the o/n rate equal to the key policy rate
- **Floor:** The CB can supply large amounts without pushing the overnight market rate below the key policy rate. The CB has two measures: the key policy rate and supply of liquidity

Corridor



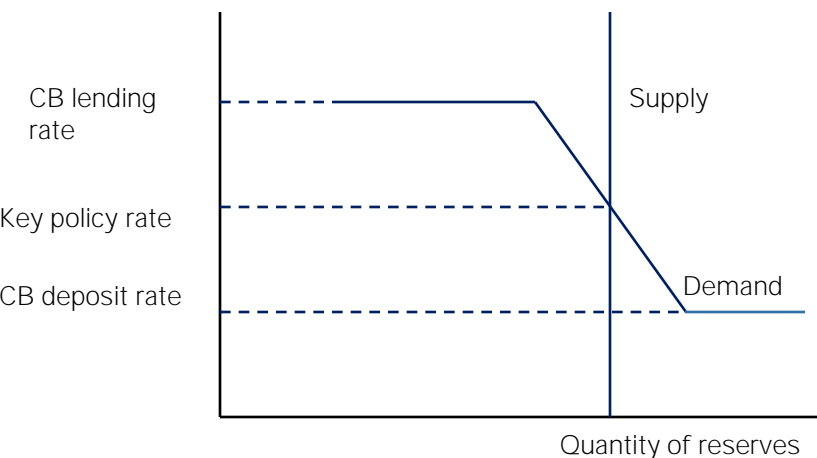
Floor



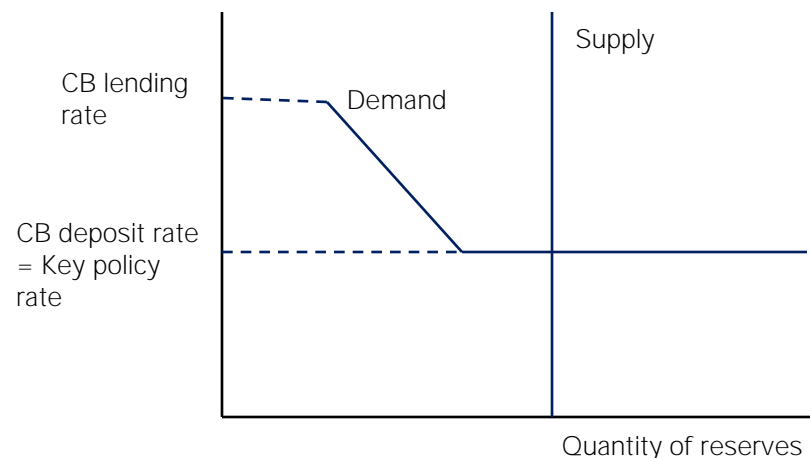
Fine-tuning of liquidity

- **Corridor:** Small changes in supply and demand will change the overnight interest rate. CB must fine-tune the supply
 - Fine-tuning: Daily repo-transactions through auctions
- **Floor:** Beyond a threshold, smaller changes in supply and demand has little or no effect on the overnight interest rate

Corridor



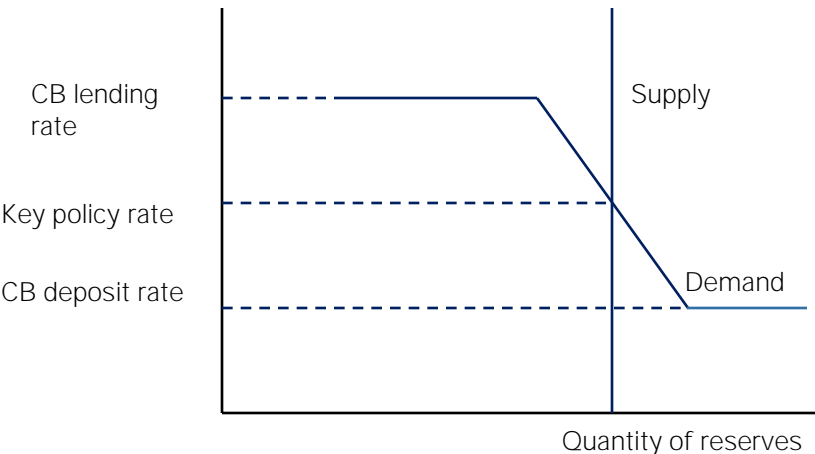
Floor



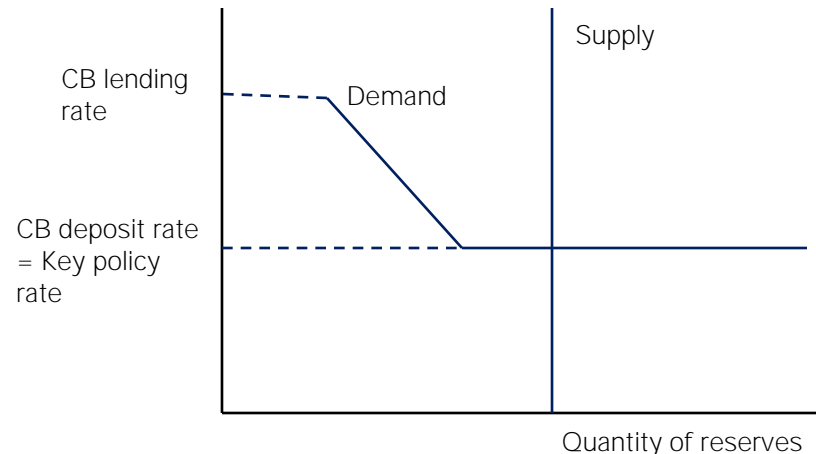
Activity in the interbank market

- **Corridor:** Gives incentives for high activity in the interbank market. Costly for banks to use CB's standing facilities (stigma?)
- Can give a more active and liquid market also for longer-term money market rates
- Banks are encouraged to monitor each other
- **Floor:** Less important for banks to lend excess liquidity in the interbank market

Corridor



Floor

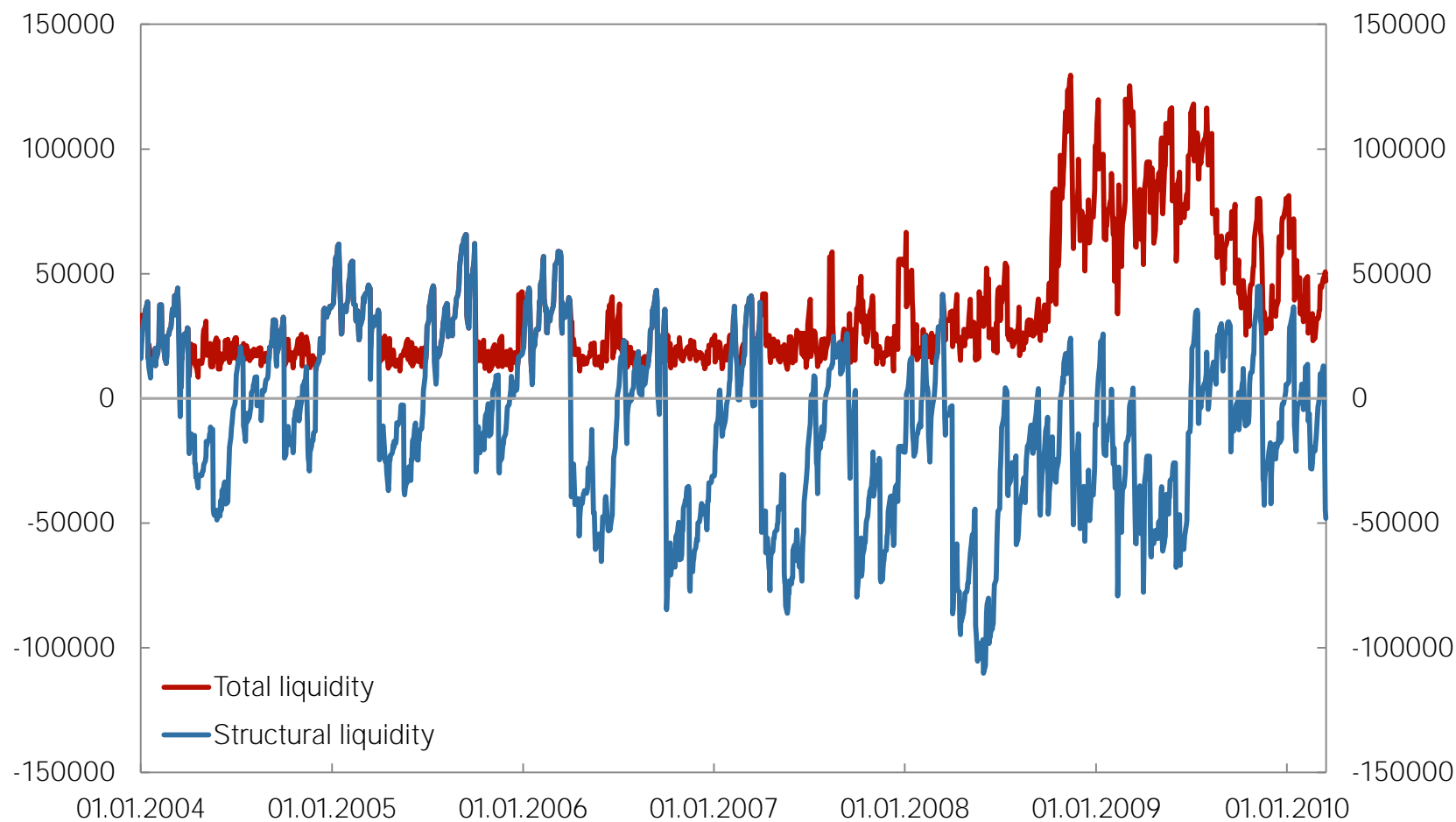


Liquidity management in Norway: Floor system

- Norges Bank ensures that there is sufficient liquidity in the banking system
 - Structural liquidity: Level of liquidity before NB operations
 - Total liquidity: Structural liquidity plus supply from NB
- Liquidity is normally supplied through auctions of F-loans to banks
- The tomorrow-next-rate remains close to the key policy rate (the floor)

Fidjestøl (2007): The central bank's liquidity policy in an oil economy

Structural and total liquidity. Mill kroner



Liquidity supplied by F-loan auctions

- Fixed rate for the life of the loan
- Require collateral in the form of securities
- Maturity varies in the line with variations in the need for liquidity
- Multi-price auctions
- Up to 15 banks normally take part
- Liquidity may also be supplied by foreign currency swaps

Liquidity supplied by foreign exchange swaps

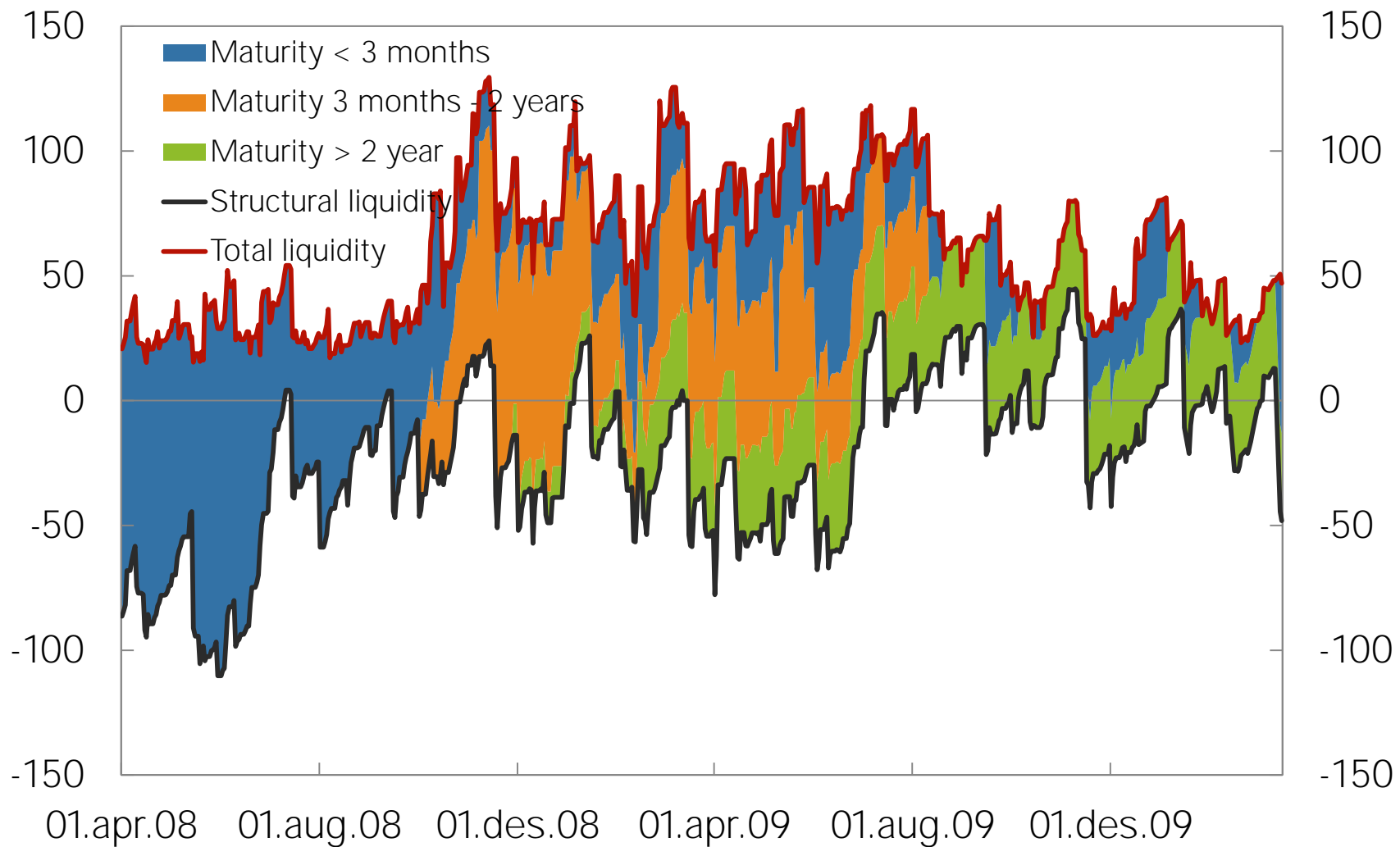
- Provide NOK against USD/EUR
- Advantages
 - The banks do not need to tie up collateral
 - Norges Bank is able to directly influence money market premiums
- Disadvantages
 - Limited number of banks
 - Difficult to price

Crisis related operations

- Large additional supply of NOK liquidity
- Loans from Norges Bank with longer maturity, 3, 6, 24 and 36 months
- Provisions of kroner and USD through swap agreements
- Eligible collateral for loans in Norges Bank expanded

Total and structural liquidity and loans at different maturities

Bn NOK



Source: Norges Bank