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MACRO MORNING BRIEFING

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Liquidity Differentials More Assertive

Liquidity management challenging in high-rate environment

- Central banks' liquidity policies becoming divergent
- Bank reserves management may not align with monetary policy
- Dollar constraints on EM central banks may not last

Money divorced from monetary policy, for now

The recent round of central bank decisions yielded very limited change on the interest rate front globally. Rate adjustments in key economies were scarce and markets may have been relieved that the direction of travel remains towards easing. However, central banks throughout the past few weeks have spent a comparatively disproportionate amount of time and policy space highlighting changes in liquidity arrangements. For example, the Federal Reserve (expectedly) announced a slower pace of quantitative tightening to begin in June. The European Central Bank is still expected to begin rolloffs from its Pandemic Emergency Purchase Programme in H2; its policy rates are expected to start coming down beforehand.

Since emergency measures were adopted during global financial crises, central banks have sought to ‘divorce money from monetary policy’. Even pre-pandemic, central banks were comfortable in allowing large amounts of excess reserves (legally defined or otherwise) to maintain easy financial conditions amid fears of secular stagnation. Emergency measures during the pandemic turbocharged such balances, but the supply-triggered inflation spiral thereafter showed that processes are hardly symmetrical. The impact of transmission during liquidity tightening differs from economy to economy based on the composition of central bank liabilities, and central banks can be highly restricted by the assets acquired during the quantitative easing phase. Meanwhile, the legal tools at central banks’ disposal to manage liquidity also differ greatly and affect transmission in money markets.

The bottom line: among the world's major economies, liquidity and interest-rate policies can be divergent. Assessing overall financial conditions requires a more holistic approach that combines the marginal change in the quantity of money (reserve balances) and the price of money (interest rates). The Bank of Japan's announcement this week is one such example – reducing the level of purchases to push up yields while maintaining an explicit easing context. The marginal increase in the quantity of money will slow but is still rising, and any increases in the price of money across the curve remain tightly controlled.

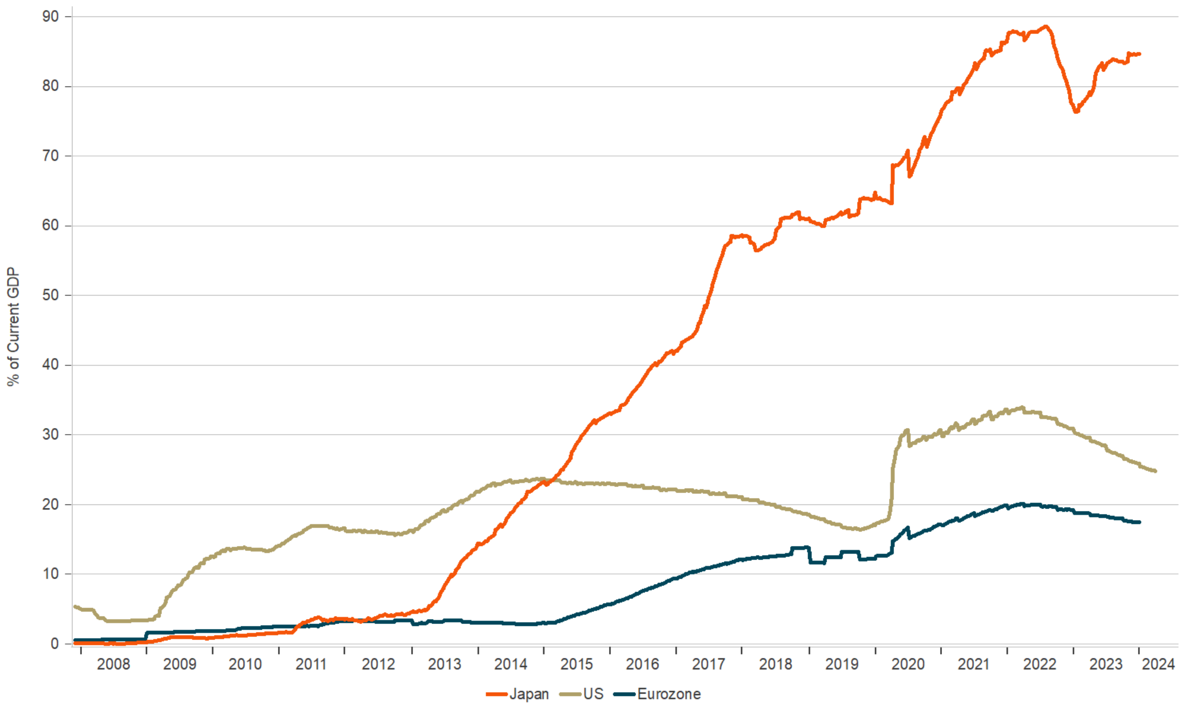
The conventional measure of system liquidity is normally calculated by bank reserves in excess of reserve requirements as a share of GDP. Regulatory approaches differ (e.g., the US no longer has required reserves), but conventional wisdom in the present policy context is that as reserve balances fall towards a critical mass, the marginal cost of reserve balances will rise more sharply, manifested through greater sensitivity to further reduction in reserve balances. Central banks subsequently engage in money-market operations to manage system liquidity. The BoJ remains an outlier in G5 as other central banks in the group are generally attempting to unwind their balance sheets on an absolute and relative basis. Sometimes these operations can seemingly run counter to the general policy direction, which at present is QT as global inflation levels remain above target.

We have already documented how the Fed is slowing QT, but during the same periods of policy communication, the anticipated pace of easing has been slowed sharply. In holistic terms, the Fed is trying to lower the impact of the marginal change in the quantity of money but keeping the marginal cost of money high. Due to strong disintermediation in the US banking system, there is enough separation between the two facets of policy operations to minimise conflict and market interpretation of Fed policy.

Both the Fed and ECB are still shrinking their balance sheets and reducing excess reserve balances as a result (exhibit #1). However, the ECB faces greater constraints in policy transmission: not only in money markets but also in ensuring that QT is not disruptive to the Eurozone sovereign bond market and the knock-on effect to Eurozone financial conditions through credit spreads. This means the Eurozone lacks the 'separation' in policy impact from QT and rates. For this reason, we continue to find it perplexing that the ECB is comfortable with its plan to reduce the PEPP by EUR7.5bn per month starting in H2 and discontinuing PEPP reinvestments altogether by the end of the year, on option ongoing in its Asset Purchase Programme maturities. The ECB has also signalled rate cuts to begin in June, and we also believe the market continues to underprice the degree of easing needed this year.

This all points to upside risk in the marginal change of the quantity of money but downside risk in its price; the latter may mitigate the impact of the former. While the ECB has pledged full flexibility in the process, we believe Eurozone money-market volatility is a risk in H2.

Exhibit #1: G3 Excess Liquidity Ratios

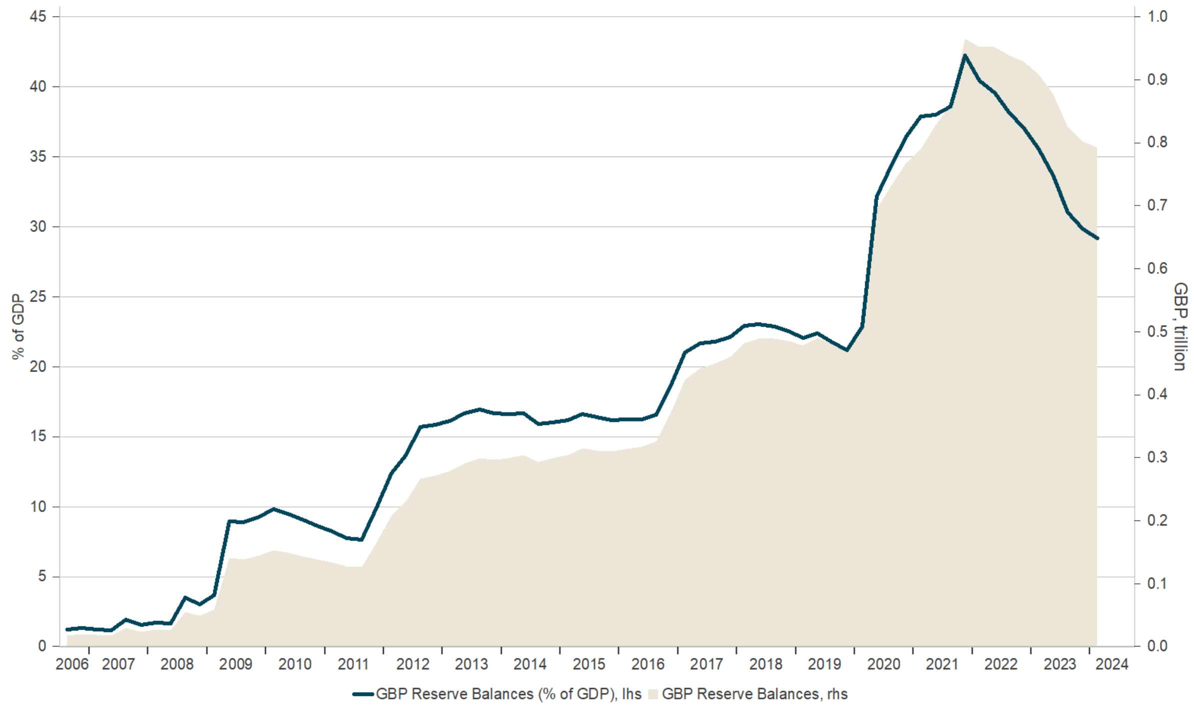


Source: Macrobond, BNY Mellon

Bank of England Governor Bailey had to address liquidity issues extensively at the last policy decision as usage of the BoE's short-term repo (STR) operation continues to rise. To the BoE's credit, increased deviations in money-market rates from the Bank Rate have been well-telegraphed. In August 2022, even before liquidity interventions were needed during the ‘Mini-Budget’ crisis, the BoE released an explanatory note, warning of the implications for money-market rates as asset sales pushed the limits of reserve scarcity. As such, the BoE’s STR is currently only being deployed for liquidity management to maintain rate alignment.

However, Governor Bailey did not give an indication for neutral reserve levels, and we think it not reasonable to assume that this would decline naturally to pre-pandemic levels, even if the balance-sheet expansion since then were considered emergency measures. Due to inflation, nominal GDP has increased at a faster-than-expected pace and, consequently, brought down the bank reserves-to-GDP ratio aggressively (exhibit #2). Using simple extrapolation, we expect the BoE to be comfortable with reserves settling above £600bn.

Exhibit #2: Bank of England Bank Reserves

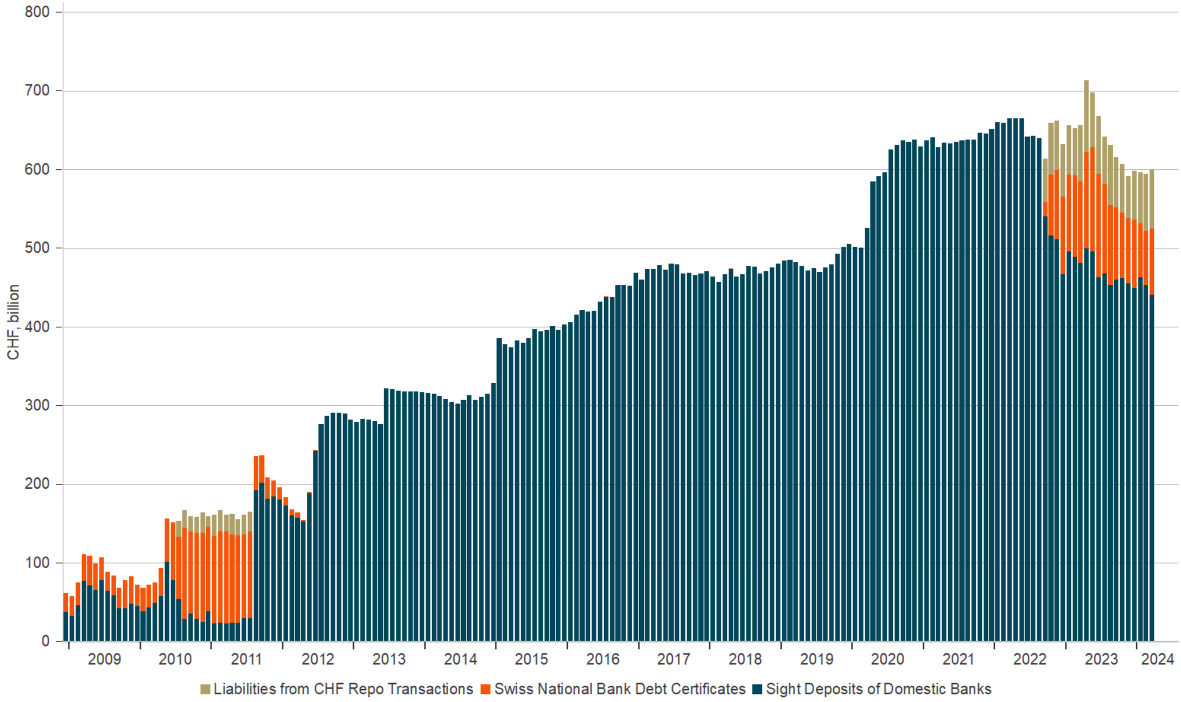


Source: Macrobond, BNY Mellon

Another recent liquidity-relevant decision to raise eyebrows came via the Swiss National Bank. In April, the SNB decided to increase the minimum reserve requirements for domestic banks and widened the base of calculation for reserves by removing previous exemptions. Reserve requirement hikes tend to be seen in a tightening context, as they would constrain lending, but the SNB had surprisingly cut benchmark rates the previous month. The SNB framed the move as ensuring "continued effective and efficient implementation of monetary policy"; in practice, it was another exercise in aligning money-market rates with benchmark rates: as sight deposits (bank reserves) do not attract interest payments, money-market rates can better converge to policy rates by avoiding marginal increases in liquidity. The level of rates (i.e., the price of money) was less relevant in the context of this decision.

The SNB remains highly capable of managing sight deposits through a multitude of instruments (exhibit #3). If additional easing is needed, there is plenty of scope to increase sight deposits through the repurchase of SNB bills and/or not rolling repo contracts.

Exhibit #3: SNB Liabilities



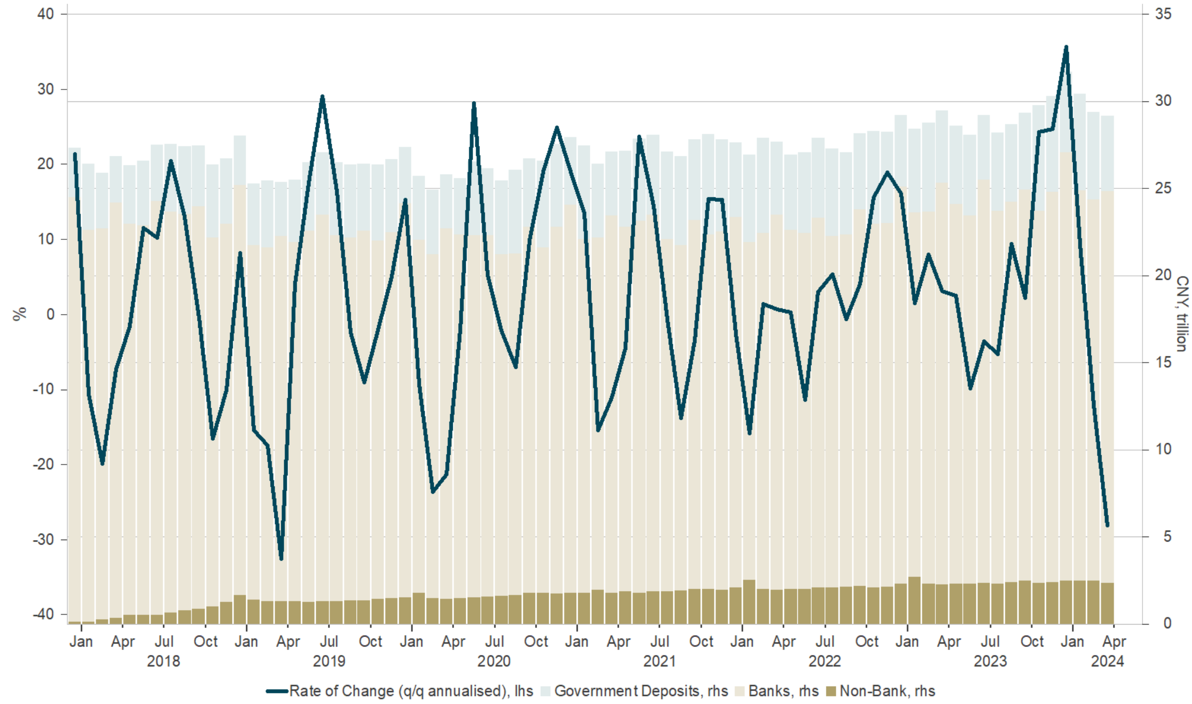
Source: Macrobond, BNY Mellon

Liquidity frameworks in emerging markets are generally different, as their assets are mostly foreign-denominated. During reserve accumulation phases, sterilisation of FX reserves is also used to manage system liquidity. Over the past few years, however, EM central banks have been able to acquire domestic assets for policy purposes without jeopardising exchange rate stability. There remains a strong aversion to quantitative easing through large-scale asset purchases, but targeted injections are no longer seen as controversial.

We are particularly attentive to the People's Bank of China's potential forays in the secondary bond market as long-dated special Chinese Government Bond (CGB) issues launch. Despite growth pressures, the key components of the PBoC’s liabilities, bank reserves and fiscal deposits, have contracted sharply this year (exhibit #4). There is clear scope to increase reserves and even engage in ‘soft’ yield curve control as a form of stimulus. As China’s financial conditions framework has always been quantity-driven, interest-rate developments will mostly feature in an FX context.

Either way, we think a PBoC more actively engaged in liquidity management would likely have consequences for short-rate dynamics across Asia, perhaps even beyond.

Exhibit #4: Key PBoC Liability Components



Source: Macorbond, BNY Mellon

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