

# Research Global

## COVID monetary policy: fast easers to tighten first

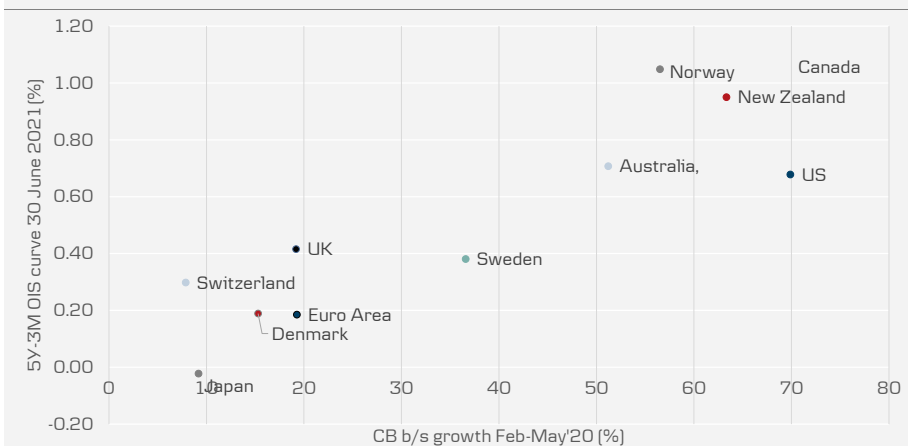
- In this first paper in a series on the cross-country monetary aspects of the COVID-19 related economic crisis, we look at how major central banks responded.
- Most central banks engaged in various balance sheet expanding operations, but the end effect on balance sheets varied greatly. Balance sheets increased the most in % terms in Canada, Australia and New Zealand.
- The response also varied in the type of operations. E.g. Canada and Scandi central banks relied more heavily on TOMOs in the first months.
- Central banks that initially eased more are expected to start tightening sooner.
- In future papers, we plan to look at the role of public liquidity management and the lasting effect on central bank balance sheets.

### Fast easers expected to tighten first

In this first paper in our series on the cross-country monetary aspects of the COVID-19 related economic crisis, we look at the responses of major central banks, which increased their balance sheets with large-scale open market operations and/or quantitative easing. Even though most central banks engaged in a combination of interest rate cuts and balance sheet increasing operations, the end effect varied greatly across countries.

We illustrate a key finding of our analysis in Chart 1: Central banks that were faster to expand their balance sheets in the first months of the crisis are expected by the market to increase interest rates first in the coming years, judging by the pricing in the OIS swap market (we use pricing this summer, since some central banks have now started to hike policy rates). This involves central banks in Australia, Canada, New Zealand and Norway. Below we analyse how major central banks conducted balance sheet increasing operations.

Chart 1. RBA, RBNZ, BoC, NB and Fed eased faster and are expected to tighten first



Source: Macrobond Financial and Danske Bank

Note: Past performance is not a reliable indicator of current or future results.

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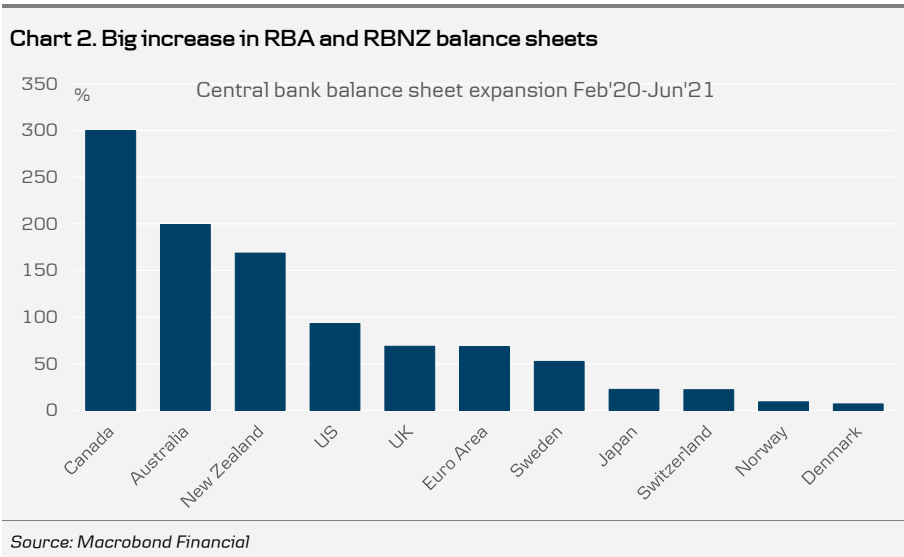
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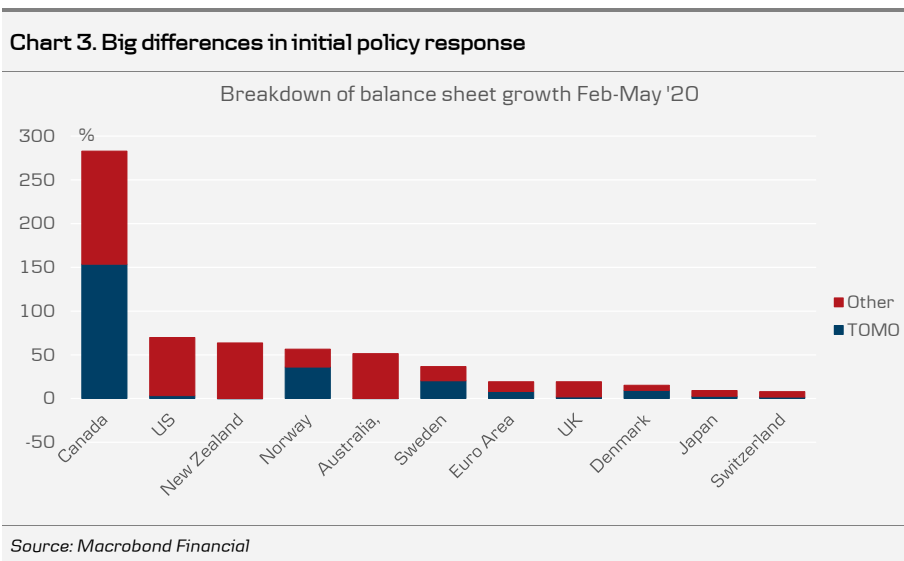
## Big differences in central bank balance sheet expansion

In Canada, the central bank increased its balance sheet 300% the past year; in Australia and New Zealand over 150%; in the US, UK, euro area and Sweden it rose more than 50%, while the balance sheet expansions were smaller in Japan, Switzerland, Norway and Denmark (see Chart 2). Hence, even though it was a global shock to all countries, the response varied, and as we will show below, it matters for the outlook for monetary policy after the crisis.



## Some central banks were faster out of the gates than others

Next, we zoom in on the monetary policy responses in the first months of the crisis, where the differences already started to show. All central banks took policy rates to the effective lower bound (if not already there), except for Denmark, where the central bank had to hike its policy rate to curb a weakening currency in accordance with its EUR peg. Expansion of balance sheets and type of market operations varied greatly though.



Central banks in the US, New Zealand, Norway and Australia increased their balance sheets more than 50% during the first three months of the crisis. In Sweden, the central bank expanded the balance sheet close to 40%, while in the euro area, UK, Denmark, Japan and

Switzerland it was about 20% or lower. Canada is a story of its own. The central bank expanded the balance sheet more than 250% in the first three months (see Chart 3).

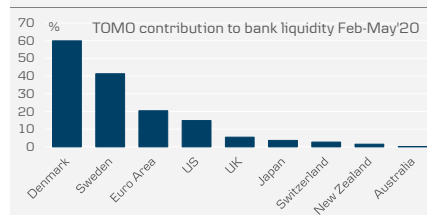
Scandinavian central banks predominantly used temporary open market operations (TOMO), e.g. repos, in the early months of the crisis. Other central banks also engaged in TOMOs, and since we use monthly data and look at the period from February to May in our comparison, numbers understate the importance of TOMO, e.g. in the US, where the use of repo operations peaked in the middle of March.

### TOMOs big support to bank liquidity in Scandies and Canada

While quantitative easing, e.g. through bond purchases, often is used to support the bond market and keep bond yields low, TOMOs target bank liquidity directly, with the central bank serving as lender of last resort. TOMOs provided big support to bank liquidity in Denmark and Sweden in the early months of the crisis, where it added 40-60% to liquidity in the first three months. It also played an important role in the euro area and US, where it added between 15 and 20%. We note again the caveat of using monthly data mentioned above. See Chart 4 for details.

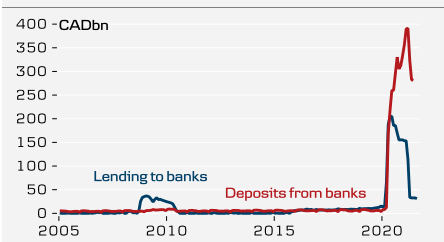
We have reserved Canada and Norway for individual charts. In both countries, central banks operated with tight liquidity regimes before the crisis. When the crisis hit, lending to banks blew the scales in the first months and were multiple times higher than in other countries in our analysis. The use of TOMOs has since normalised in both countries (see Charts 5 and 6).

Chart 4. Most support from TOMOs in Denmark and Sweden



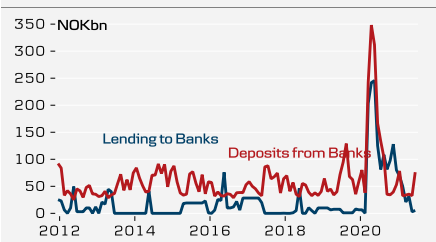
Source: Macrobond Financial

Chart 5. Large scale TOMOs in Canada...



Source: Macrobond Financial

Chart 6. ...and Norway



Source: Macrobond Financial

### Key findings and future implications

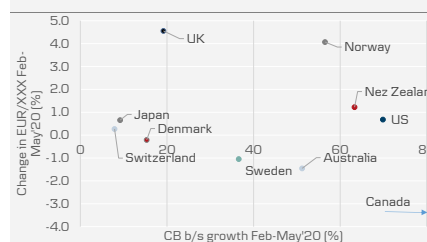
We end our analysis by revisiting our key finding on the first page: fast-easing central banks look set to tighten monetary policy first, a point that will be important to remember if/when the global business cycle turns again. In Chart 7, we checked for a relationship between balance sheet expansion and currency depreciation, but did not find any convincing results.

Most major central banks employed the same tools during the crisis, ranging from lowering interest rates and TOMOs to quantitative easing, but used in varying size and pace.

- Central bank balance sheets increased the most in % terms in Canada, Australia and New Zealand.
- Canada and Scandi central banks relied more heavily on TOMOs in the first months of the crisis to support bank liquidity.
- Central banks that initially eased more are expected to start tightening sooner.

We do not have a strong view on why it has varied between central banks. It is probably due to prior experience, how hard the domestic economy is, and coincidence. Overall, most central banks now have experience with different types of 'unconventional' monetary

Chart 7. No apparent relationship between b/s growth and ccy changes



Source: Macrobond Financial

Note: Past performance is not a reliable indicator of current or future results.

policy and may use these again in the future. Policies that were deemed ‘unconventional’ after the financial crisis have now become ‘conventional’.

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Jens Nærvig Pedersen, Chief Analyst, and Kirstine Grønborg Kundby-Nielsen, Student.

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