11 November 2021

Research Global

COVID monetary policy: Lender of last resort to the public

- **In the second paper in our series on different cross-country monetary aspects of the COVID crisis, we look at the role of government liquidity management.**
- **When the crisis hit last year, debt management offices build large liquidity buffers on deposit accounts amounting to around 6-13% of GDP.**
- **Quantitative easing no longer is just about supporting bank liquidity. Now it is also about supporting public liquidity.**
- ***This is the second paper in a series, which looks at different cross-country monetary aspects of the crisis. In the first paper Research Global: COVID monetary policy: fast easers to tighten first, we look at the central bank response.***

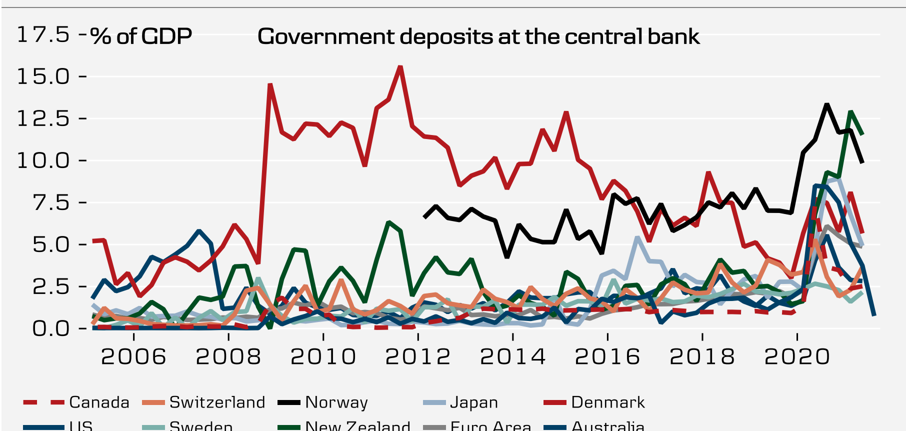
Surge in government's liquidity buffers

In the second paper our series, which looks at different cross-country monetary aspects of the COVID crisis, we turn to the role of government liquidity management. When the crisis hit last year, debt management offices build large liquidity buffers on deposit accounts (see chart 1).

Most governments in G10 hold a deposit account with the central bank – Sweden is an exception. Government deposits are ready available liquidity to spend on the budget. In most cases liquidity buffers amounted to around 6-13% of GDP, which meant governments had raised enough funds to cover all or most of the deficit resulting from the crisis.

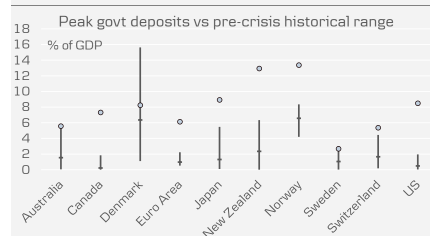
The level of liquidity buffers before the crisis varied between countries. Denmark operated with a large buffer during the financial crisis and the European debt crisis, while the Euro Area, Japan and the US historically have held small buffers. In all countries, except for Denmark, liquidity buffers grew to record high levels during the crisis (see chart 2).

Chart 1. Big increase in liquidity buffers



Source: Macrobond Financial

Chart 2. Record high liquidity buffers in many countries



Source: Macrobond Financial

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Most governments funded higher buffers through issuance of short-term debt, e.g. Treasury bills and Commercial Paper, which enabled them to easier adjust size of buffers and eventually bring them down again.

There are good arguments for the change in government debt management during the crisis, e.g. operating with substantially larger buffers. These include the uncertainty about public expenses in relation to lockdown related compensations etc. and stress in financial markets and the risk of sudden loss of access to markets, e.g. due to the uncertainty of the lock down, market participants working from home etc.

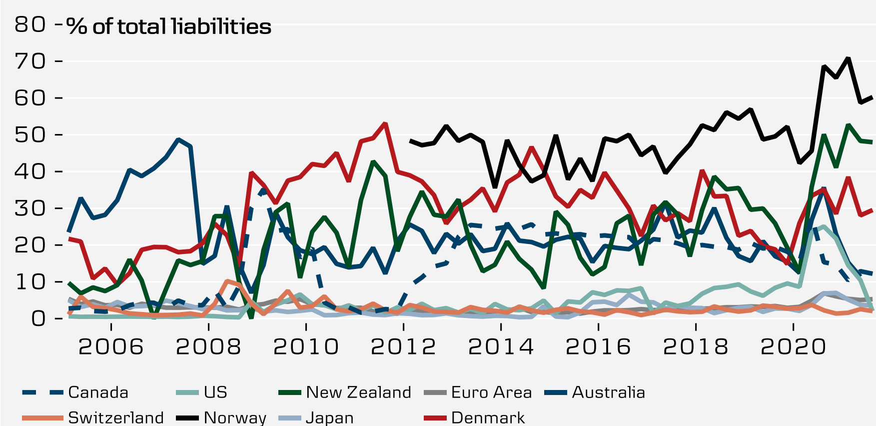
Governments fund larger part of central bank balance sheets

Since most governments hold their deposits with the central bank, the increase in liquidity buffers also had implications for central bank balance sheets. Government deposits are a liability on the balance sheet along with bank reserves and currency in circulation.

The rise in government deposits meant that a greater share of central banks' liabilities are now government deposits. It varies a lot between countries from as much as up to 70% in Norway to below 10% in Japan, Euro Area and Switzerland (see chart 3) and in most countries, it rose to historic high levels.

For central banks engaging in government bond purchases, it effectively means that governments use the funds from bond issuance to fund the central bank's purchase of bonds with the result being higher government gross debt, larger central bank balance sheets and a higher government liquidity buffer. It serves an important purpose of providing liquidity to governments in a time of crisis, but if it remains a buffer, it exaggerates gross debt figures and central bank balance sheets.

Chart 3. Governments fund a larger share of central bank balance sheets



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Mitigating a negative monetary shock

A rise in government deposits at the central bank – all other things equal – is a negative money supply shock, since bank reserves will experience a 1:1 decline. I.e. if governments' precautionary liquidity demand rises during a crisis, the central bank will have to mitigate this through a further expansion of its balance sheet in order not to negatively affect bank liquidity.

In chart 4 below, we illustrate how much the increase in government deposits during the crisis last year constitute relative to the pre-crisis level of the monetary base. Hence, how big of a percentage increase in the monetary base did it take to fully offset the impact of the shock to governments' liquidity demand? The shock was substantial most places. It was more than 200% in New Zealand and Norway, over 100% in Canada, around 40% in the US and close to 20% in Euro Area.

There is one important caveat to this part of the analysis. In terms of the monetary impact, it matters how governments' fund their liquidity buffers. Only if a domestic source of revenue, i.e. issuance of domestic debt or taxes, funds the rise in deposits will it constitute a negative monetary shock. E.g. in Denmark, the government issued foreign Commercial Paper, which led to a rise in the central bank's FX reserve, but had no bearing on bank liquidity.

From the change in the monetary base between February 2020 and June 2021, we see that central banks about at least expanded their balance sheets to offset the impact of the surge in government deposits and in most places further to effectively ease monetary policy. Hence, on a net basis rise in public liquidity demand did not trigger a monetary contraction.

Chart 4. Potential big monetary effects

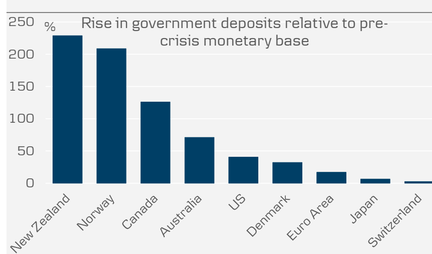

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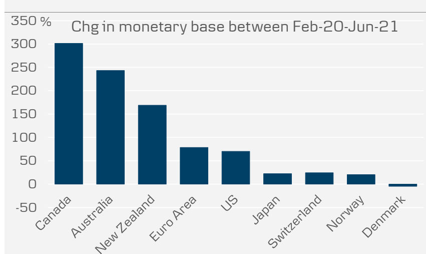
Chart 5. Big rise in money base most places



Source: Macrobond Financial

Future implications for issuance, monetary policy and money markets

Our analysis above on the experience of government's use of liquidity buffers during the crisis last year has several market and policy implications including:

- Overfunding of public deficits, which leads to, exaggerated gross debt levels and higher issuance of short-term debt.
- Even higher central bank balance sheets as bond purchases have to mitigate effect from higher level of government deposits.
- Hence, quantitative easing is no longer just about supporting bank liquidity. Now it is also about supporting public liquidity.
- Central banks can taper and unwind balance sheets with no bearing on monetary policy when governments draw down liquidity buffers.
- Higher volatility and higher uncertainty with respect to the outlook for bank liquidity if development in government deposits is unpredictable.

Since almost all major countries and central banks were engaged in this type of policy during the crisis it will likely stay in the toolbox for use in future crises. Finance ministries, debt offices and central banks will likely also become more active in guiding on the use of liquidity buffers thereby increasing transparency of its impact on the money market.

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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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