NORGES BANK

The level of structural liquidity in the banking system and Norges Bank's liquidity management policy

Outline

- Recommendations from the working group on government transactions and the money market
- The primary objectives of Norges Bank's liquidity policy
- Will higher structural liquidity have an impact on Norges Bank's ability to meet the objecives of our liquidity policy?

Recommendations from the working group

- Transfer of funds from the government's treasury account to the Government Pension Fund (SPU)
- New correction mechanism to ensure liquidity neutrality of the petroleum fund mechanism
- The practice of issuing government debt to neutralize transfers of interest and dividends from Norges Bank is being discontinued

Objectives of Norges Bank's liquidity policy

- Ensure short term money market rates, particularly the overnight rate, are kept close to the policy rate
- Ensure an efficient payment system
- Offer liquidity insurance and be lender of last resort
- Provide a framework that ensures liquidity and credit risk to be borne by private agents in the financial system
- The policy rate is our instrument in monetary policy – we aim for high degree of pass through to market rates in a neutral way

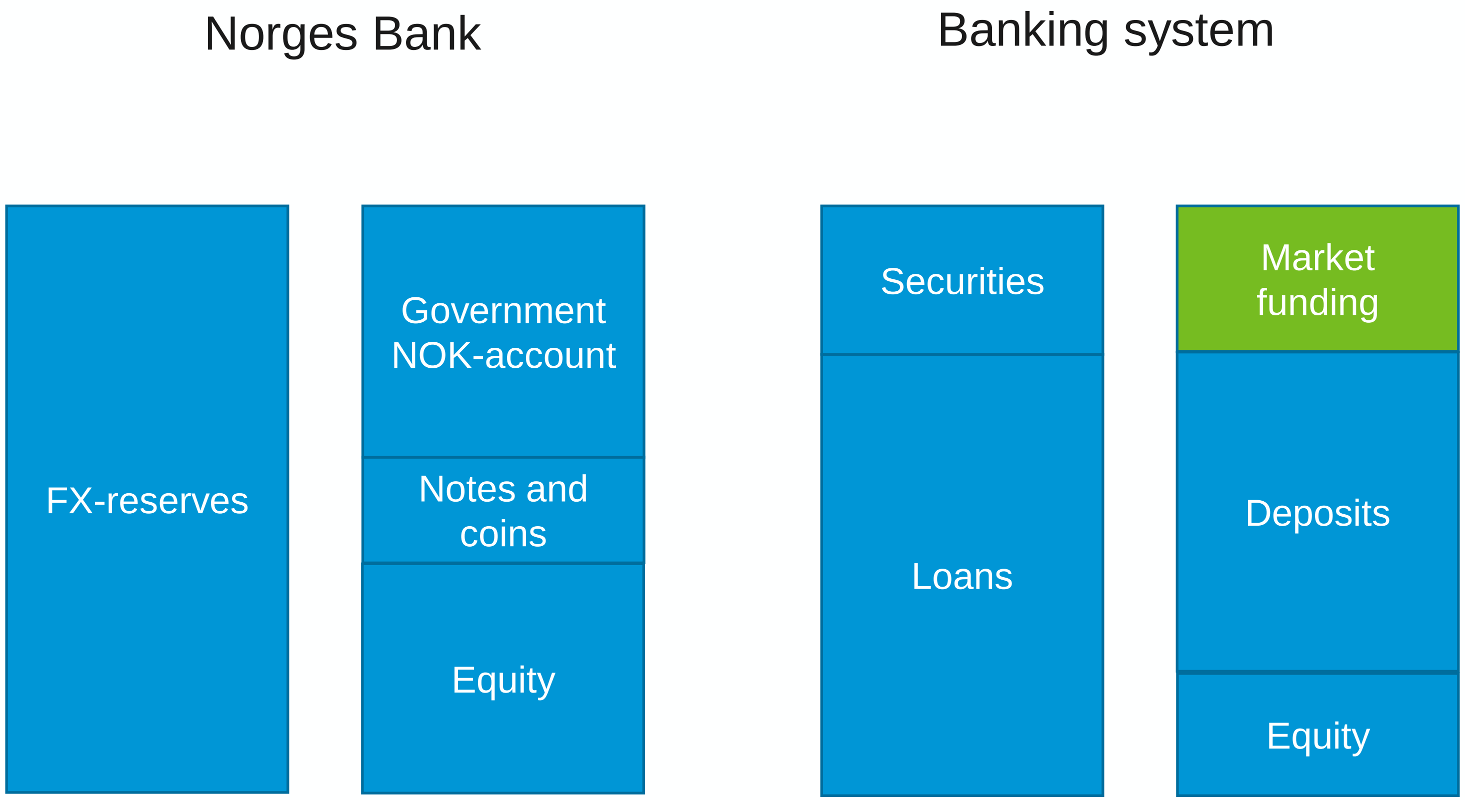
The role of central bank reserves

- Central bank reserves is the only widely accepted medium for settlement among banks
- CB’s monopoly to create central bank reserves is the basis for monetary policy
- Central bank reserves can be created in to ways: through loans (against collateral), or by financing other types of assets by issuing central bank reserves (structural liquidity)
- How reserves are created may affect bank’s balance sheets differently and thereby the objectives of Norges Bank’s liquidity policy

How are central bank reserves created?

Supply of reserves through loans

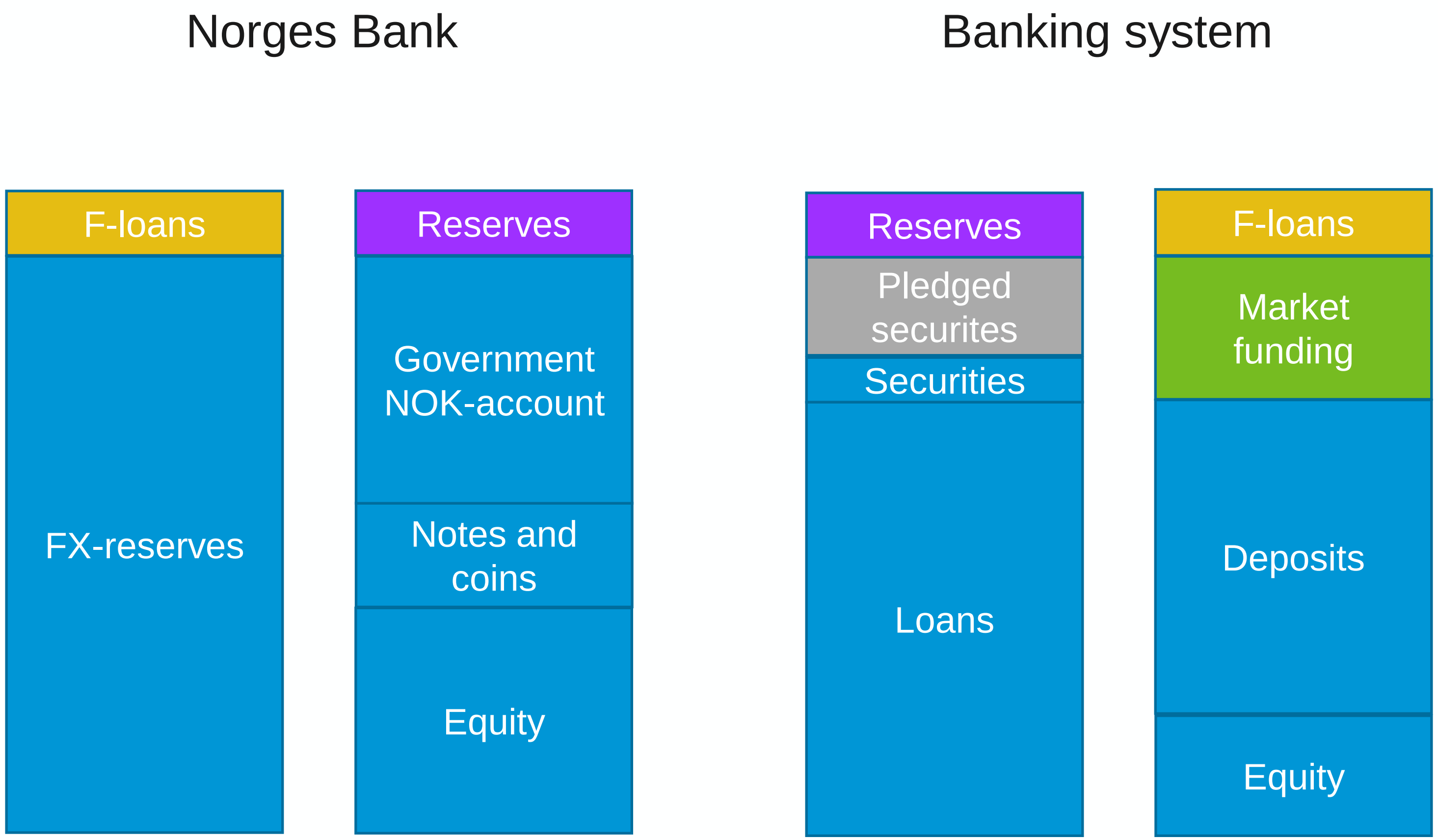
- Structural liquidity equals zero



How are central bank reserves created?

Supply of reserves through loans

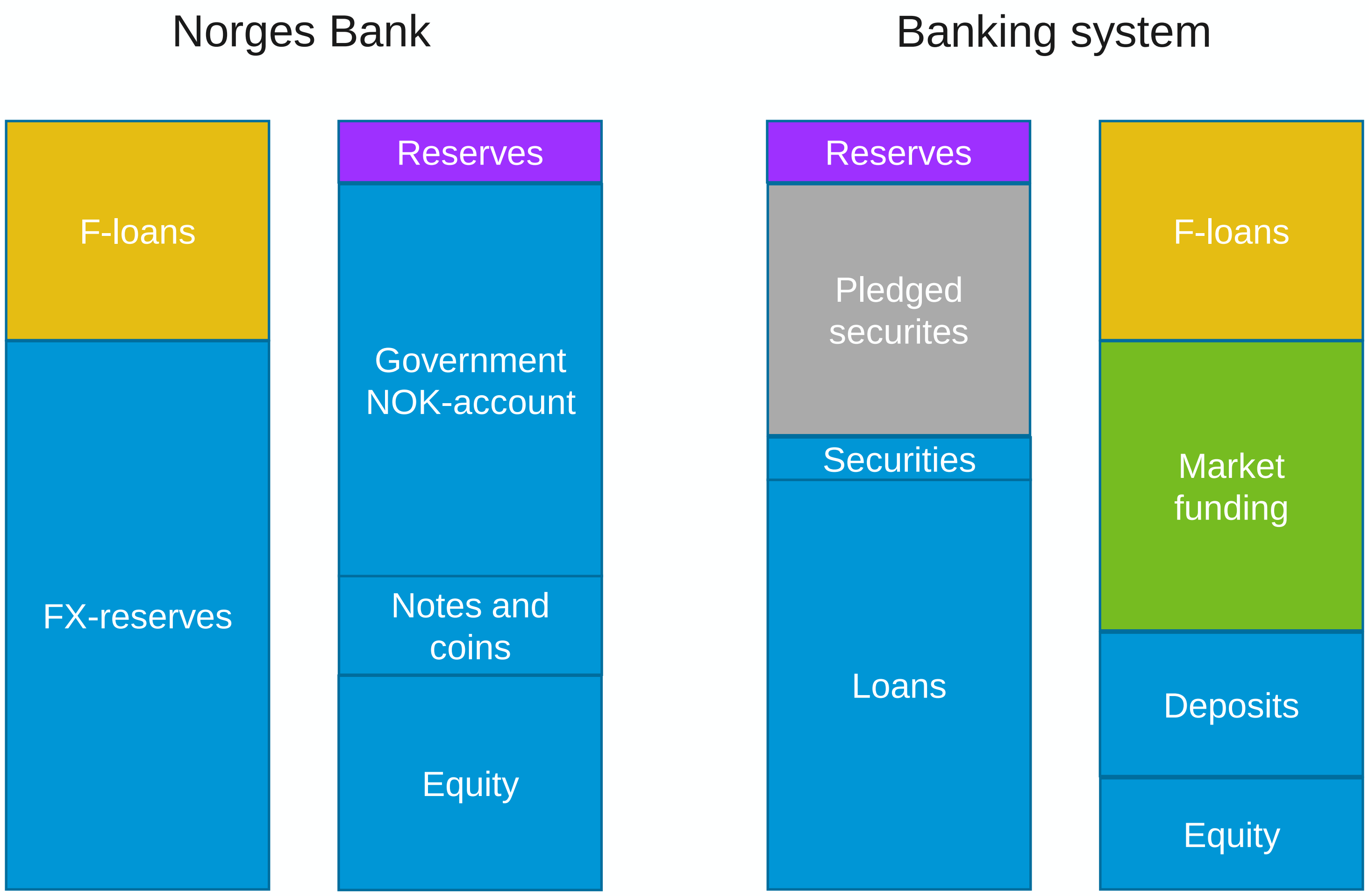
- Structural liquiduty equals zero
- Supply of reserves through F-loans to ensure total liquidity o/n of 35 billions
- Banks must pledge securites as collateral in Norges Bank while fulfilling LCR-requirement
- NB transforms securitues to reserves through bank's balance sheets
- Imposes costs to banks



How are central bank reserves created?

Supply of reserves through loans when structural liquidity is very low

- Very low structural liquidity cause loss of deposits and reserves for banks
- NB will subsitute banks loss of reserves by offering F-loans, but banks must hold securities as collateral
- Banks must hold a significant amount of securities to meet the demand for loans in NB
- Banks may limit participation in F-loan auctions and be reluctant to redistribute reserves
- Money market risk-premiums on longer tenors may increase and pass-through to short term rates may weaken



Consequences of very low structural liquidity

- Costly for banks to hold and pledge large amount of collateral – may weaken bank's incentives to participate in F-loan auctions

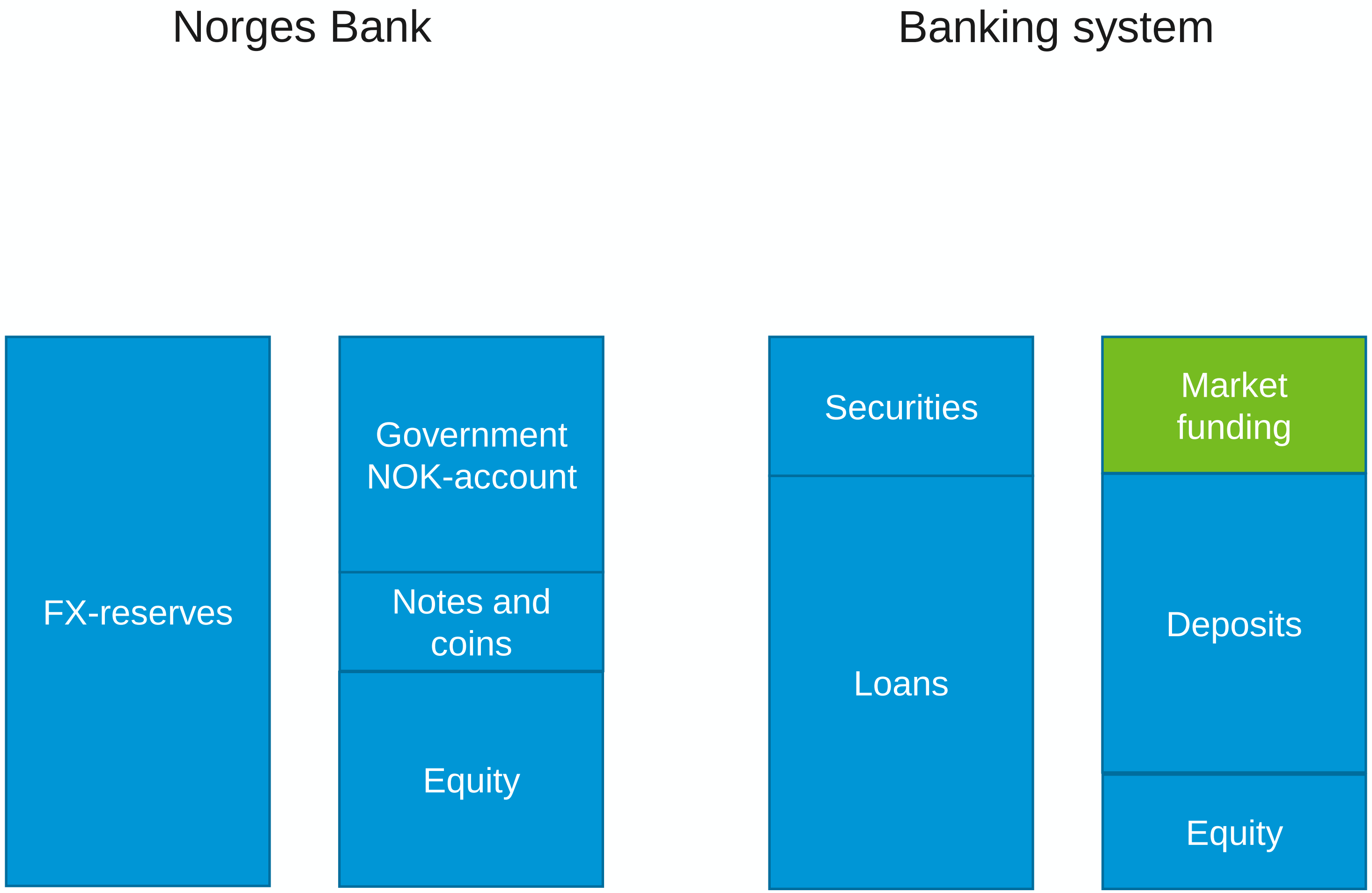
- Risk of less efficient pass through from policy rate to short term money market rates

- Increased volatility in longer term money market risk premiums

- Norges Bank's footprint increases – operational framework – collateral rules, maturity of markets operations and access policy – becomes more important

How are central bank reserves created?

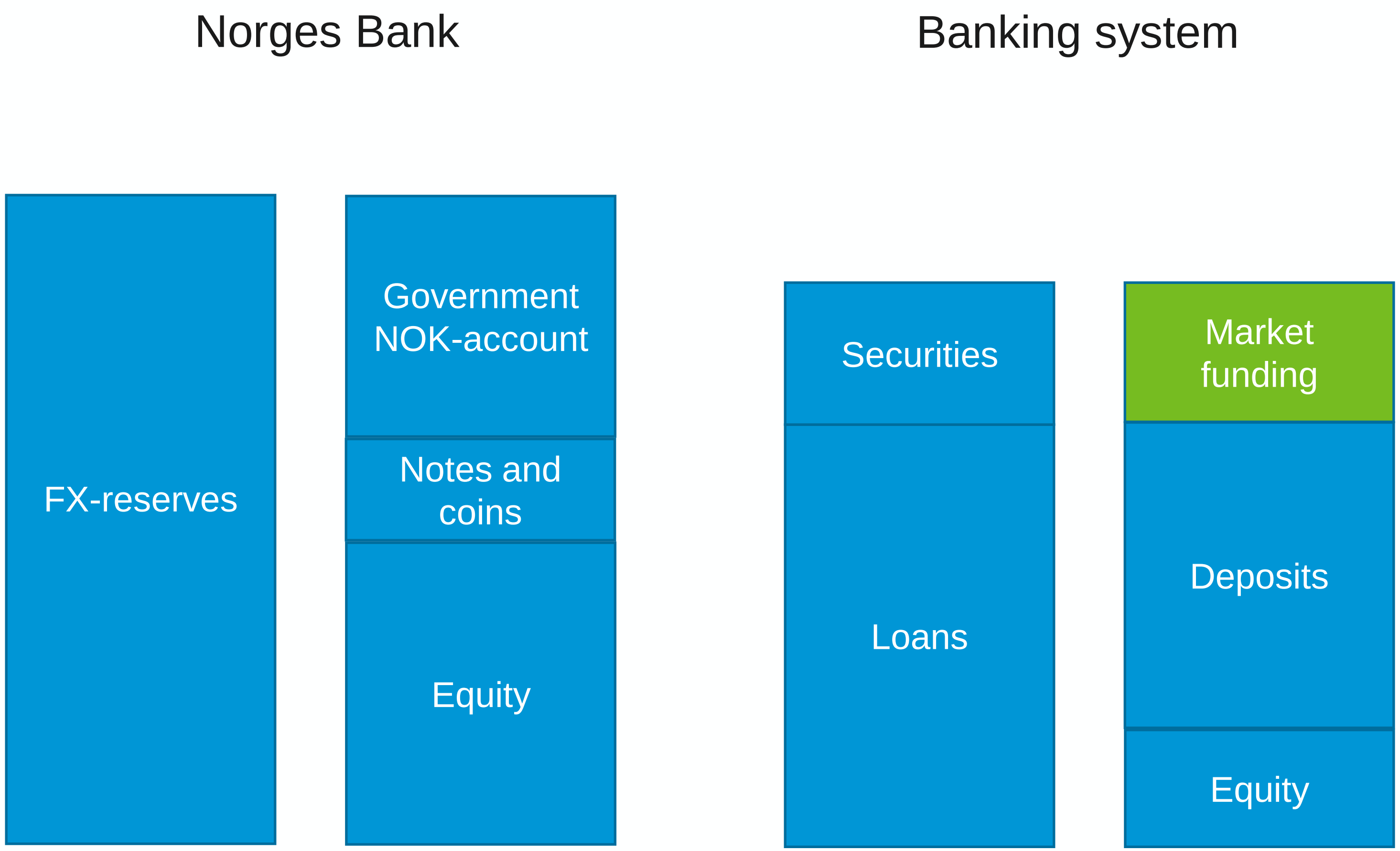
Supply of reserves through financing of assets



How are central bank reserves created?

Supply of reserves through financing of assets

- Growth of fx-reserves is matched by higher equity for Norges Bank



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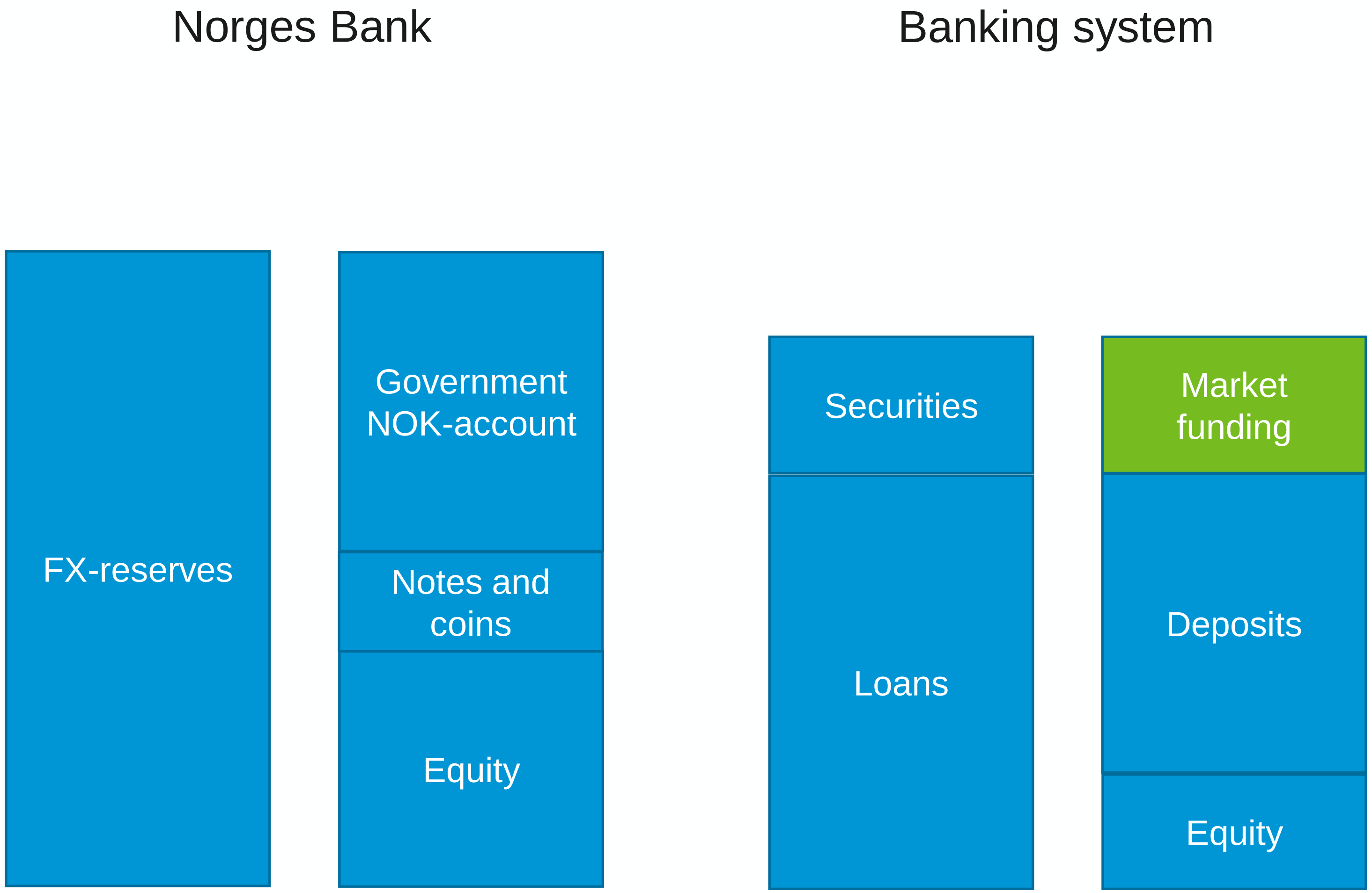
Supply of reserves through financing of assets

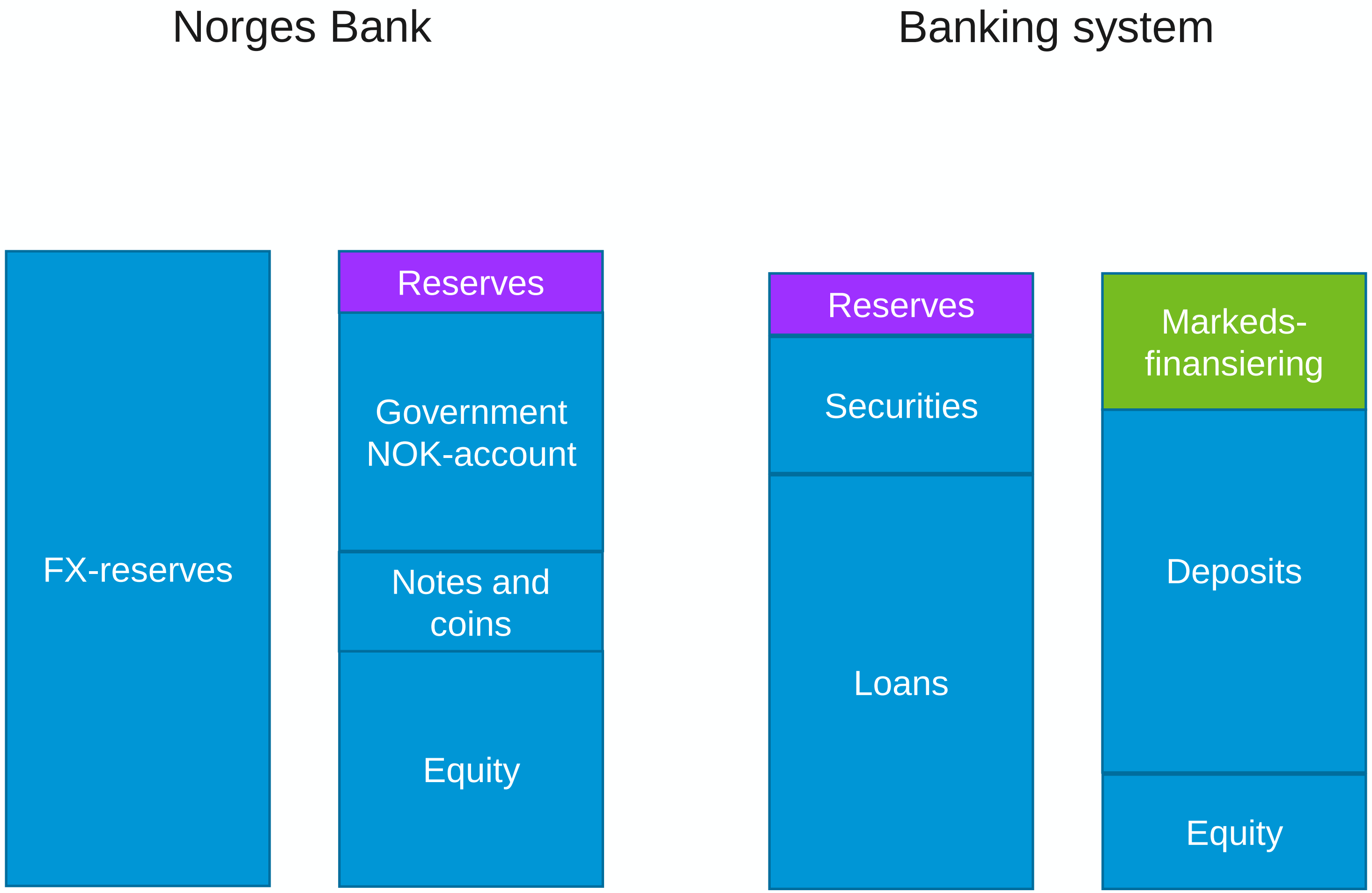
- Growth of fx-reserves is matched by higher equity for Norges Bank
- Increased equity triggers transfer to government, account – reserves are created



How is central bank reserves created?

Supply of reserves through financing of assets

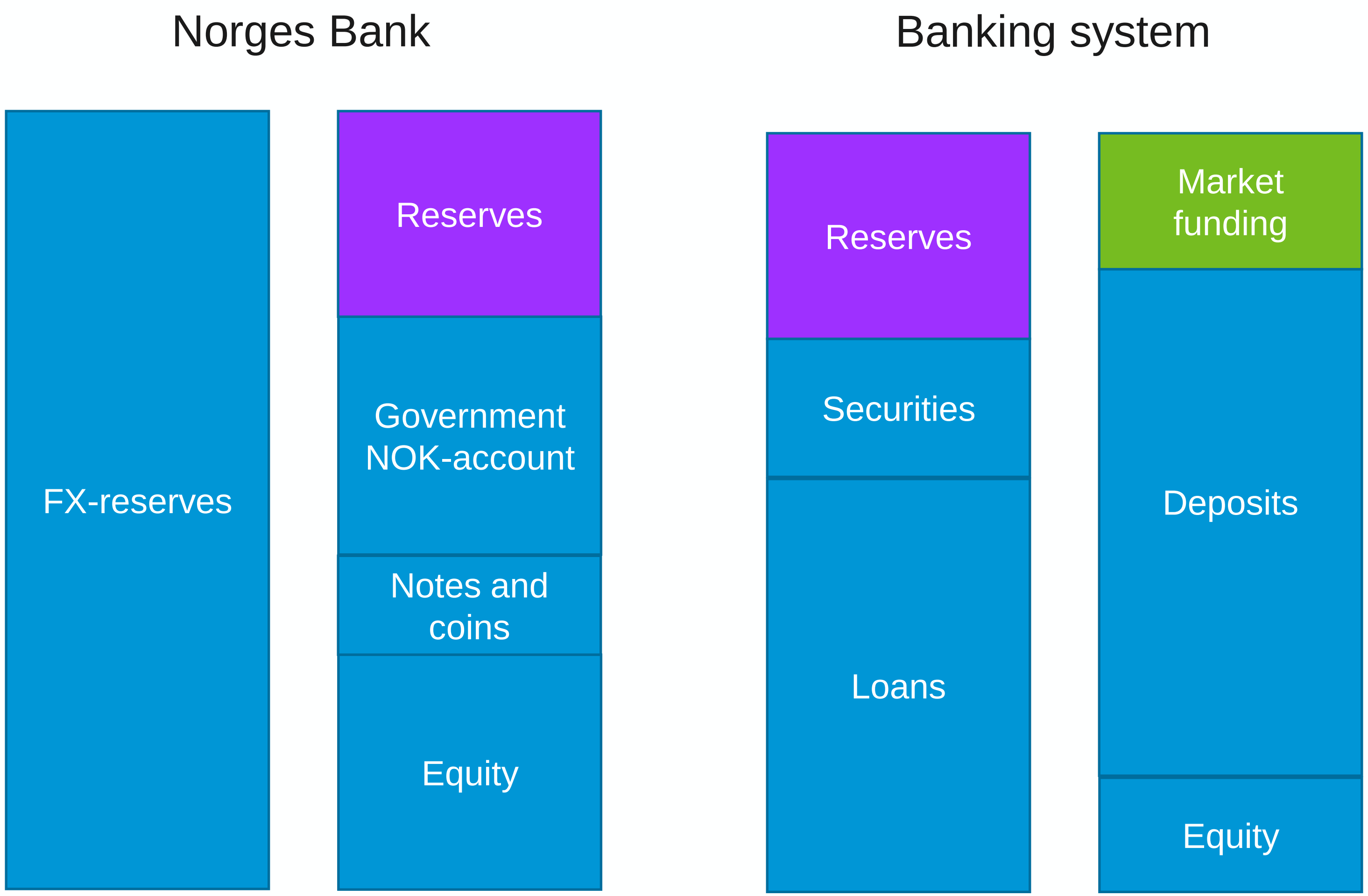
- Growth of fx-reserves is matched by higher equity for Norges Bank
- Increased equity triggers transfer to government, account – reserves are created
- Government's use of proceeds will increase amount of reserves in the banking system and bank's deposits
- The government will no longer neutralize increase of reserves by issuing government debt
- Dette gir en mer likvid banksektor, sammenlignet med tilførsel av reserver gjennom lån



How are central bank reserves created?

Supply of reserves through financing of assets

- Effects will be more prominent in the years to come
- Growth of fx-reserves will lead to growth in structural liquidity
- As a result the banking sector will be more liquid



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Supply of reserves through financing of assets

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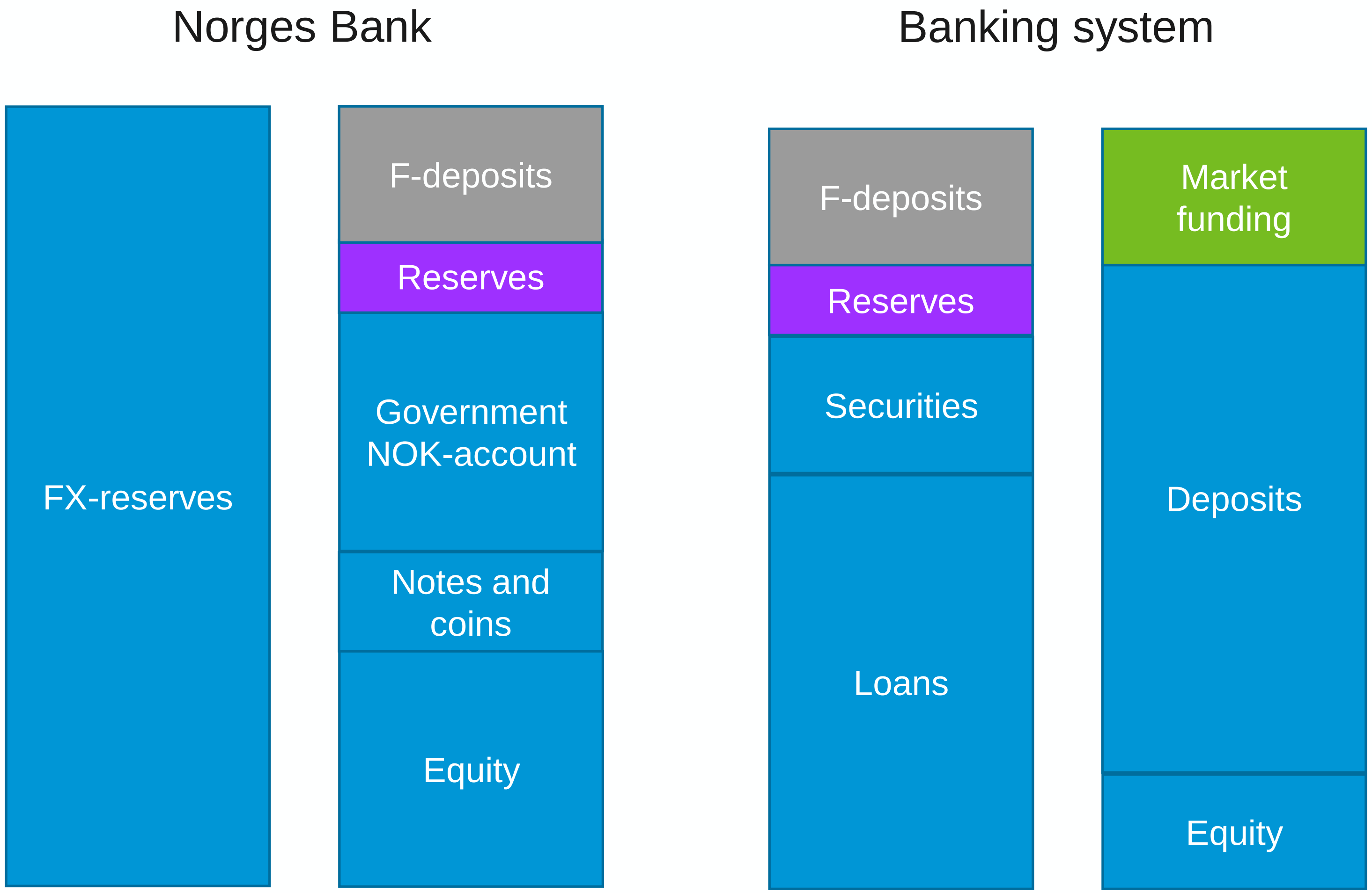
- Growth of fx-reserves will lead to growth in structural liquidity
- As a result the banking sector will be more liquid
- Withdrawal of reserves through F-deposits will will have limited effect:
  - Increased F-deposits imply higher LCR
  - Fluctuations of surplus structural liquidity will not generate need for F-loans
- A more liquid banking sector may result in lower risk premias and changes in bank's balance sheets to utilize surplus liquidity



Consequences of very high structural liquidity

- Higher structural liquidity may result in a more liquid banking sector

- May cause lower money market risk premias and weakened incentives for banks to manage liquidity risk
  - Undermines the objective that risk premiums are to be determined in the market

- Unlikely that banks over time will adapt to higher LCR than today
  - Indicates that banks will make adjustments to take advantage of high structural liquidity

- Still need for Norges Bank as lender of last resort
  - Higher structural liquidity will not necessary provide a less risky banking sector

Summary

- Terms and conditions for bank’s access to reserves is set by Norges Bank
- The way reserves are supplied – through loans or by financing assets – have different impact on bank’s balance sheets
- In the years to come, structural liquiduty will increase as the government discontinue to neutralize transfers of interest and dividends from Norges Bank
- Higher structural liquidity may have consequenses for Norges Bans footprint and how we meet our liquidity policy objectives
- Norges Bank will assess whether there is a need to make adjustments to liquidity policy or to Norges Bank's balance sheet