Adverse Impact of Central Bank’s Liquidity Jabs on Banks and Economies

Adverse impact that surplus liquidity may have on banks and economies

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Purpose statement

This document highlights the adverse impact that surplus liquidity may have on the banks and economies if adequate demand is not created.

Disclaimer

Abstract

The Covid-19 pandemic has impacted all the economies, big or small, across the globe. Central banks everywhere have been proactively dealing with the situation and have successfully pushed a large amount of liquidity to the banks through various means. But due to widespread uncertainty caused by the pandemic, banks are reluctant to lend, and consumers are hesitant to avail credit.

Introduction

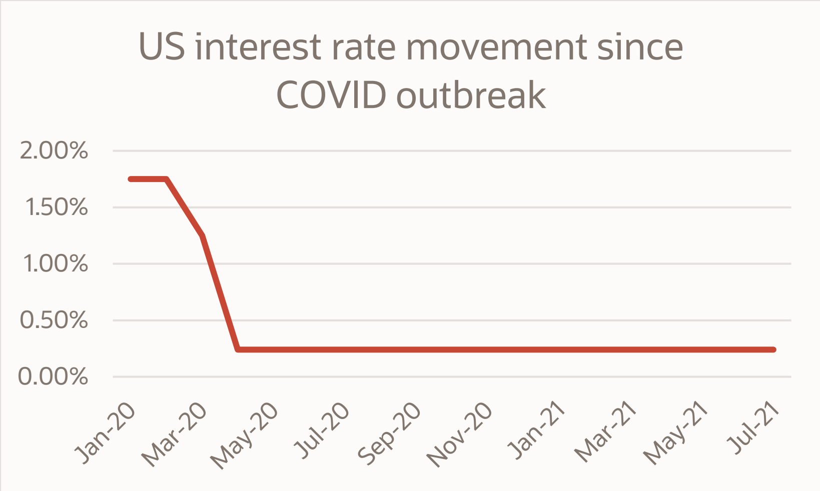
While the whole world was grappled by a strange enemy called COVID–19 and was in a quandary on what to do, central banks across the world were better prepared to fight the economic impact of the pandemic. The experience and lessons learnt from the previous crisis stayed in every central bank's memory. Hence, they pushed huge amount of liquidity to keep the banks afloat and help the overall economy in this time of magnanimous stress.

But a famous quote by Joseph Conrad is apt for the banking system today "One must not make too much of anything in life, good or bad".

Common Measures Taken by Central Banks to Push Liquidity

Let's first look at a few common measures taken by central banks to push liquidity into the banking institutions-

- **Rate cut**: Several rounds of rate cut were applied by the central banks across the globe for short- term lending to banking institutions, this resulted in a liquidity surplus across the banks. Few central banks even reduced the rates to zero and sub-zero level. Like US fed reduced its benchmark rates for short-term lending from 1% and 1.25% to 0% and 0.25%. Some European banks brought down the rate to negative.
- **Quantitative easing(QE):** Quantitative easing, a brainchild of the Bank of Japan, is a way of pushing liquidity into the markets through banks. It is now widely used by central banks across the globe. QE is a part of monetary policy and is effective when short-term rates are near zero. Under QE programms central banks purchase long-term government and other securities and increase the supply of money. For eg: in response to COVID-19 US Federal Reserve announced a quantitative easing plan of over $700 billion and subsequently enhance it by a commitment to buy at least $80 billion and $40 billion a month respectively in Government and mortgage-backed securities
- **Relaxing regulatory requirement**: Given the crisis, central banks relaxed few capital and liquidity regulatory requirements, like Reserve bank of India deferred NSFR maintenance guideline by six months, from April 01, 2020, to October 01, 2020. The maintenance of Liquidity coverage ratio was also brought down from 100% to 80% for a few months.
- **Discount window:** Discount window is used by central banks for short-term (mostly overnight) lending. Banks have cut the rate of lending through the discount window and have also increased the tenure of lending to ensure adequate liquidity with banking institutions. For eg: the US federal reserve lowered the rate that it charges banks for loans from its discount window by 2 percentage points, from 2.25% to 0.25%
- **International swap line:** US fed opened international swap lines to many central banks, which needed US dollars and it also cut the rate on the existing lines.



Liquidity Push Alone is Not Sufficient

There are many other measures taken by central banks targeted towards direct lending to the consumer or security markets - like increasing the moratorium period by 3 months, lending directly to corporates (Primary Market Corporate Credit Facility by US fed), Money Market Mutual Fund Facility (MMMFF), etc. But the scope of this article is to focus on the measures which resulted in central bank's direct lending to other banks.

The actions of central banks to keep the banks sufficiently liquidated through the stimulus packages were well in time and much needed. But the liquidity push alone is not sufficient to tackle the situation, it is important that the surplus fund with the banks goes into the hands of creditworthy borrowers, and the economic activities gradually re-instates to the pre-COVID era.

Reasons why surplus liquidity did not result in proportionate lending

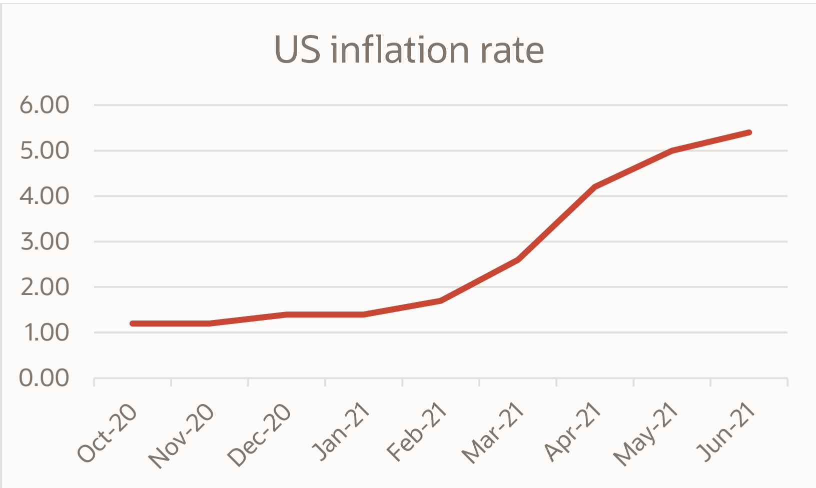
But due to the reasons mentioned below the liquidity pushed into the banking system didn't result in proportionate lending:

- **Banks unwillingness to lend:** Due to the potential negative impact of the pandemic on employment and people's business, there are chances that the credit rating of borrowers and the value of collaterals against which the bank lends, may go down. This makes banks skeptic of lending.
- **Provision for potential losses:** Banks are setting aside a larger amount of funds for potential losses in existing loans due to the possibility that the credit quality of borrowers will decline as a result of lesser economic activities. A study published in BIS quarterly review (March -2021) shows that the provision for the first half of the year 2020 was three times as compared to the second half of the year 2019.
- **Less demand for credit:** Many businesses, especially small businesses suffered immensely due to lockdown restrictions. The unemployment rate has also increased. This has given rise to uncertain income streams for individuals and corporates and hence the demand for credit has declined.
- **Operational issues:** Banks in many European countries and countries like India, which are facing the second, or third wave of the pandemic are not adequately staffed due to restrictions imposed by local authorities or absenteeism due to fear of pandemic. Also, the focus of banks is on the safety of their staff and perform the most essential duties rather than growing the business.

Adverse Impact of Surplus Liquidity on Banking Institutions and the Economies

It is apparent that banks are sitting on high amount of liquidity. Although this status-quo may not be maintained for long and at some point, in near future banks will start pushing this money into the economy. But if it happens without creating adequate demand, it may prove to be counterproductive to the banking institutions and the economies in the following ways:

- **Inflation:** The spurt of the money supply to the banks and the general economy will increase inflation and if the same is not followed by an increase in credit supply and demand growth the situation may get worse and the economy may fall into stagflation. Stagflation is a condition where inflation increases, but economic growth is stagnant.
- **Irrational lending:** With piling up of liquidity and low interest rates, banks may get enticed towards irrational lending. This can result in overfunding to existing customers or funding to new customers with low credit quality. This will have long-term impact on the bank's overall credit quality.
- **NPA pile-up:** This is connected to the point mentioned above. Apart from new lending, the existing accounts may also slip into NPA due to high unemployment rates and losses to businesses caused by low economic activity.
- **Currency devaluation:** Measure like quantitative easing to push liquidity may result in devaluation of currency. As the bond yields decrease due to quantitative easing the currency devaluation occurs. The devaluation of currency can help the country's exporters as the export would be cheaper in the global market, but this will make import expensive. This has happened during the 2008 crisis with USD index, which fell more than 5% after the first round of quantitative easing.
- **Liquidity trap:** A liquidity trap is a situation where the interest rates are very low but still the consumer continues to hoard cash in saving and current accounts and does not want to invest in any other instrument. This happens as the customer foresees a negative event in the economy and does not want to put money in low yields bonds, which will result in a loss to him when the interest rates in the market increase. The similar situation applies to the banks where banks prefer to keep liquidity rather than lending to customers. As the bank's return from its credit is low to cover the cost and keeping reserves with the central bank gives a higher return.
- **Overheating of stock markets:** During the pandemic markets across the globe crashed for the initial few weeks, but then they reached their all-time highs in 4-6 months from the start of the pandemic. Many experts say that this unprecedented run in the stock markets is due to the enormous liquidity stimulus by central banks across the bank. Though this can't be verified but this is the main reason quoted by several experts for the northward run of security markets.
- **Lower net interest margins:** The excess liquidity for many banks is placed in low-yielding accounts. This will impact the NIM of the banks



Conclusion

There is no doubt that central banks across the globe learnt their lessons from past crises and provided enough stimulus packages this time to keep the liquidity of all the banks in a sound position. But they will have to be cognizant of the fact that excess liquidity may cause several damages to the overall economy. They will have to either start absorption of liquidity (through ways like rate hike, Open Market Operations, etc.) at an appropriate time or keep nudging the banks to lend using their swelling coffers, as the increase in demand is of utmost importance along with the increase in liquidity. Recently the situation in a few countries like the US/UK has improved and economic activities are coming back to normal owing to a reduced number of COVID cases and vaccination activities. This might indicate that the central banks of such countries will take necessary actions to suck liquidity from the markets, though not likely before first quarter of 2022, as the damage done is immense. But still, the battle could be longer as uncertainty grapples the humankind due to many factors like - vaccine hesitancy, deadlier variants, and resurgence of cases in some countries.

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