Explaining

Financial system liquidity

What is financial system liquidity?

The financial system is said to be liquid when financial institutions can easily raise cash, either by selling 'liquid assets' or by borrowing in the wholesale money market. The most liquid assets held by banks are their 'settlement cash' deposits at the Reserve Bank and assets that can be discounted on demand at the Reserve Bank (i.e. quickly converted to cash). These assets are important to the trading banks in particular, because they require cash during each trading day, and especially at the end of it, in order to settle their accounts with each other. However, liquidity is also used for other purposes.

Having the right level of liquidity is important to the banks and finance companies, because their business involves borrowing and lending money. Liquid assets or cash are not normally available to be lent because they are needed in order to allow the company to settle its immediate debts quickly. Having the right amount of liquidity is of primary importance to any financial institution.

The role of the Reserve Bank

The Reserve Bank has a particular interest in managing liquidity in the financial system for three reasons:

- The Reserve Bank has to keep short term wholesale interest rates around the level of the Official Cash Rate (OCR). This can be influenced with the right amount of liquidity in the system. If liquidity is short, interest rates will increase and vice versa.
- The stability of the financial system rests in part on the ability of the trading banks to settle with each other. There must be sufficient liquidity for them to do so. If a bank cannot settle, payments cannot be made and the system may freeze up.
- The Reserve Bank helps balance the flows of money between private and public sectors, aiming to keep an adequate but not excessive amount of liquidity in the financial system.

Where liquidity comes from

The Reserve Bank can add or withdraw liquidity in the form of total settlement cash, from the financial system through a variety of mechanisms. These include a range of passive borrowing facilities as well as active 'open market operations'. The latter include the swapping of foreign exchange currency for New Zealand dollars at current market rates and temporary purchases of eligible securities – what are known as 'repurchase transactions'.

Liquidity in the credit crunch

The 'credit crunch', as it developed during 2007-08, meant that some of the sources used by New Zealand trading banks to obtain liquidity – notably short-term borrowing on the international markets – either became difficult to obtain, expensive, or dried up. The Reserve Bank had already been making significant changes to the liquidity management system, even before the 'credit crunch', and quickly moved to introduce a further range of facilities and services to ensure that liquidity was maintained and could be managed. These included the use of such instruments as 'Residential Mortgage-Backed Securities' (RMBS), by which the Reserve Bank permitted a trading bank to borrow money for liquidity purposes, using the RMBS as security.

A glossary of liquidity terms

Liquidity management comes with its own jargon – much of which is plain English, but which carries a different meaning when used in the sense of liquidity and the instruments used to manage it. There are many terms, some of the key ones being:

Repo: A transaction in which securities are exchanged for cash, for a specific period, then reversed.

Fx swap: A foreign exchange swap. The two parties agree to exchange one currency for another at a particular moment, and then reverse that transaction later at a specific future date (the 'forward date').

Eligible security: Securities that can be used at a central bank as security to obtain cash.

Haircut: This is typically associated with repo arrangements. The haircut is the value of the assets that are taken, over and above the amount of cash that has been provided, so as to provide a buffer against adverse market movements in the price of the asset.

Further information

Ian Nield, 'Evolution of the Reserve Bank's liquidity facilities', Reserve Bank of New Zealand *Bulletin*, Vol. 71, No. 4, December 2008.

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