NEWSLETTER

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How to absorb excess liquidity in the banking sector?

The Moldovan banking sector is awash with liquidity. In the past the National Bank of Moldova (NBM) used to absorb about 30% of the money base. As of today, it has to absorb ca. 45%. Thus, we estimate excess liquidity at ca. MDL 6 bn. The origin of excess liquidity lies in the bankruptcy of three banks in November 2014. In order to calm the situation, the NBM had to provide emergency loans worth MDL 13.5 bn.

The absorption of excess liquidity is necessary for conducting an effective monetary policy, but it comes at a cost. According to our estimations, the two main currently used instruments of the NBM, reserve requirement and own certificates, cost more than MDL 1 bn per year. This weakens the financial situation of the NBM and could have a negative effect on its independence.

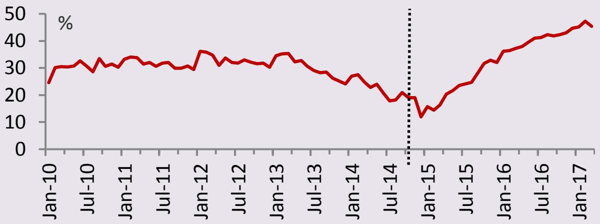
In order to improve the situation, we recommend a set of measures. Firstly, the effective interest rate on reserve requirements should be reduced. Secondly, the NBM should sell its historic government bonds worth MDL 2.3 bn, in a coordinated manner with the Ministry of Finance. Thirdly, own certificates should only be used for fine tuning. Fourthly, if necessary, the Ministry of Finance should support the NBM in improving the situation.

Although this topic is quite technical, it has wide implications for macroeconomic stability. Progress in this field would reinforce the successful recent path of macroeconomic stabilisation in the country.

Excess liquidity: Origin and quantification

After the bankruptcy of three banks in November 2014, a confidence crisis threatened the financial stability in Moldova. To avoid a collapse of the banking sector the National Bank of Moldova (NBM) provided emergency loans worth MDL 13.5 bn to the banking sector, granted over the following months and assuring people that their deposits were safe. As a result of this, excess liquidity came to the market, which called for an unusual voluminous use of instruments by the NBM to absorb liquidity.

Absorption as % of base money incl. certificates



Source: National Bank of Moldova

Based on historical data, one would expect the NBM to absorb ca. MDL 10 bn. However, the NBM is currently absorbing roughly MDL 16 bn. Thus, we estimate the amount of excess liquidity at MDL 6 bn.

Implications of excess liquidity

As a rule, commercial banks are happy with excessive liquidity, since this means they have practically no funding problems. However, excess liquidity poses serious problems for the conduction of monetary policy.

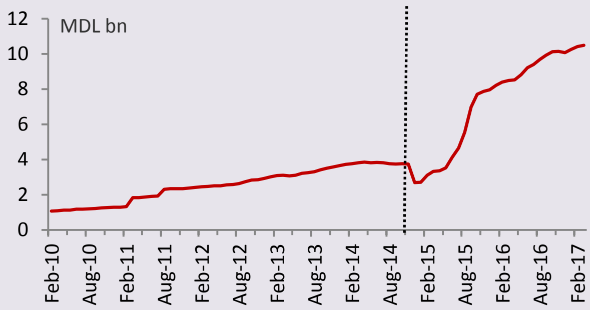
If the National Bank does not absorb excess liquidity, it cannot effectively target inflation, which is its main task as a central bank. On top, excessive liquidity poses a risk to the stability of the exchange rate, because it can be used for speculative attacks on the Moldovan Leu. Thus, not absorbing excess liquidity is not a sensible option.

On the other hand, if the NBM does absorb excess liquidity, then it incurs significant costs, thus creating financial problems.

Current absorption policy by the NBM

Reserve requirements are the main instrument for liquidity absorption at the moment. The rate of reserve requirements was increased several times. As of March 2017, the rate stood at 37% and the NBM absorbed MDL 10.5 bn of base money using this instrument. Since the effective interest rate paid on reserve requirements to commercial banks stood at effectively 5.2%, this absorption exercise costed MDL 545 m per year to the NBM.

Required reserves for Lei deposits



Source: National Bank of Moldova

In addition to reserve requirements, twice a week the central bank offers certificates with a maturity of two weeks. NBM certificates absorb currently MDL 5.8 bn of base money (March 2017). The current rate of remuneration is 9%. Assuming the NBM continues to absorb this amount over the next 12 months at the same interest rate, this would amount to payments to the banking sector of MDL 522 m. In total the NBM payments would amount to MDL 1.07 bn per year, if absorption measures were continued in the same manner as they are currently used. This poses a strong strain on the financial position of the NBM and could undermine its independence. Thus, there is need for action.

How to improve the situation?

In our view, it is necessary to revise the current monetary policy, in order to absorb excess liquidity at a lower cost.

Firstly, we recommend the NBM to decrease the remuneration on reserve requirements. Commercial banks pay only around 1.5% on sight deposits, so there is room for reducing the current effective rate of 5.2%. If the rate were to be reduced to 4.2%, as an example, the NBM would safe more than MDL 100 m per year, with a positive impact on its financial results.

Secondly, the NBM should – in a coordinated manner with the Ministry of Finance – sell the stock of MDL 2.3 bn in government bonds, which originate from 1998. In such a way, the NBM can permanently reduce excess liquidity, which is a positive feature of this instrument.

Thirdly, we think NBM certificates should mainly be used as a fine tuning instrument instead of as an instrument for massive liquidity absorption. The yield of 9% is too high and produces severe costs to the NBM. On top, the wide use of this instrument acts as a disincentive for banks to provide loans to the real economy: There are not many good alternatives for getting 9% risk-free and available on short notice. In our view, the NBM should limit the allotment of certificates and place them using a tender procedure, in order to reduce the cost of it.

Fourthly, if the instruments mentioned above are not sufficient for absorbing liquidity at a reasonable cost, the Ministry of Finance might have to support the efforts of the NBM. Thus, we propose that the Ministry of Finance issues government bonds and places the receipts in a frozen account at the NBM. Thus, the already existing liquidity buffers of the Ministry of Finance with the NBM should be extended. In order to improve the financial situation of the NBM, we propose that the interest payments are shared between the Ministry and the NBM.

Outlook

The Moldovan authorities, in tight cooperation with the IMF, have done a remarkable job of macroeconomic stabilisation after the bank fraud in late 2014. In order for this positive story to continue, the country needs an independent central bank with a solid financial position. Thus, the topic of excess liquidity, which looks like a rather technical issue at first sight, is an important issue with wide implications. It is in the interest of both the government and the NBM to improve the current situation.

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Note: Our research is based on data from March 2017. Any developments afterwards are not taken into consideration.

Editors

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A more comprehensive analysis is provided by the Policy Paper PP/01/2017 “How to absorb excess liquidity in the banking sector?”

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The German Economic Team advises the Government of Moldova on economic policy issues since 2010. It is funded by the German Federal Ministry for Economic Affairs and Energy and implemented by the consulting firm Berlin Economics.

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