

Why are there no intraday money markets? (why is there an overnight one??)

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Discussion

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A summary

- Intraday mkt can in principle be organized like an ON mkt
- Desirability depends on several factors/mechanisms
- Paper carefully discusses such factors, but does not attempt to draw a normative conclusion
- Analysis distinguishes between two cases concerning supply of ON reserves by cb:
 - i. Supply at positive marginal cost
 - ii. Supply at zero marginal cost
- Under (ii) paper argues that distinction between intraday and overnight becomes blurred; usefulness of overnight market is questioned

Overall comments

- Thought-provoking paper, full of insights
- Paper raises interesting issues concerning monetary policy operational framework and overnight market that may need further analysis (not necessarily in this paper); key question is: *Do the benefits generated by the overnight market exceed its costs?*
- Revealed preference approach (confirmed by recent New Zealand experience) suggests that answer so far is "Yes"

Interesting insight

“In both [the overnight and the intraday market] the ‘price’ is a policy variable and the supply is under the control of the central bank” (p. 11)

Therefore,

“The price of funds in the overnight market does not aggregate information in the way other markets usually do” (p. 11)

Same would hold true in an intraday mkt

So what is the purpose of an intraday market, or of the ON market?

Section 3.a: M&M convincingly argue that an intraday market could be organized like an overnight mkt

- Thus, they review arguments for and against overnight mkt, checking whether they also apply to intraday mkt
- Distinguish between systems in which overnight funds are provided at a positive marginal costs by cbs, and systems in which this cost is zero

Section 3.b: Arguments in favor of an overnight/intraday mkt when marginal cost of ON funds is positive

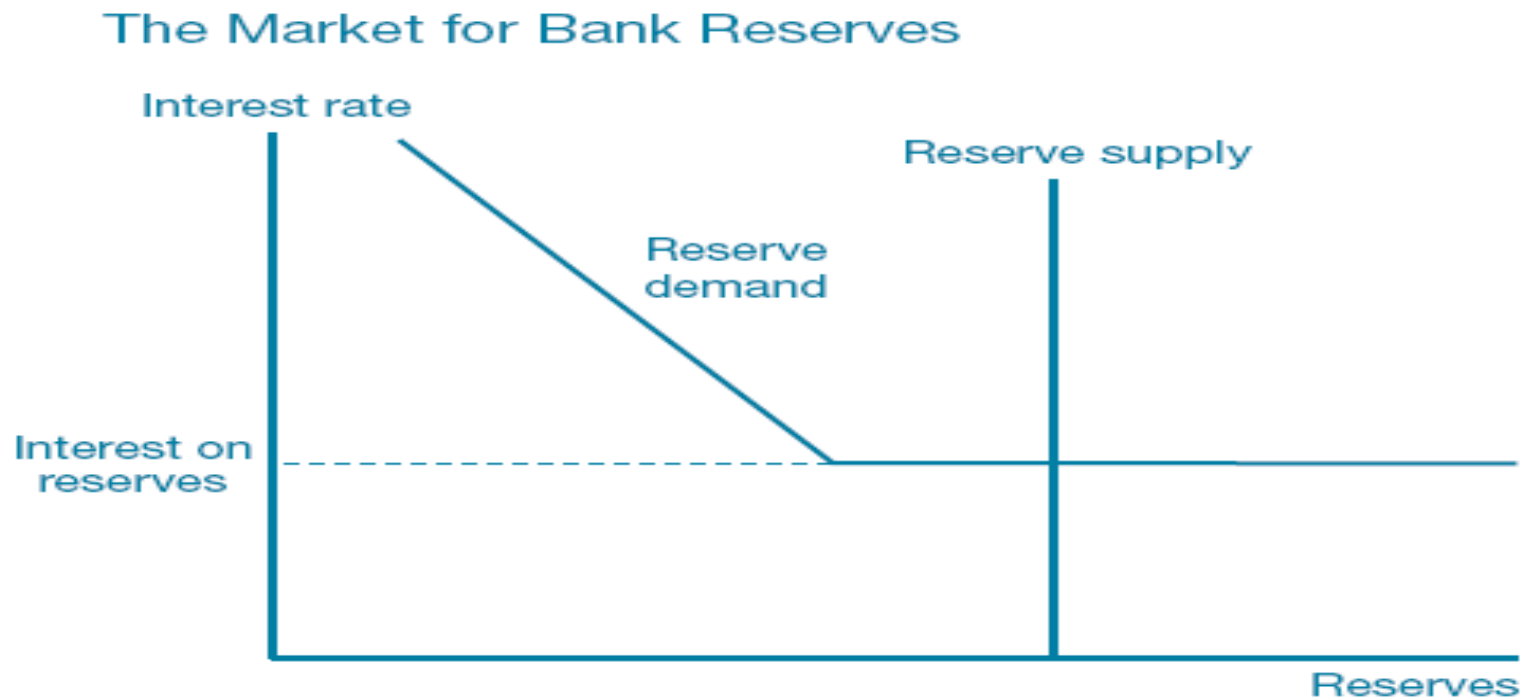
- Little literature on issue. Chapman and Martin (2007): optimal liquidity management system is via market (OMO to a restricted no. of agents)
- Basic intuition: market induces better incentives to monitor/allocate risk
- Basic assumption: banks have better info than central bank
 - Recent episodes of freeze in interbank markets may cast doubts on this assumption
 - Issue worth investigating: do we have evidence of overnight rates moving in line with bank proxies of credit standing?

Section 3.c: Arguments against intraday/overnight market when marginal cost of ON funds is positive

- i. Fixed costs, delays
(delay is not an argument against intraday market as such)
- ii. Lack of commitment by central bank. M&M suggest problem would be larger intraday (in practice distinction may be academic – see August 9th episode)
- iii. Intraday market would generate relatively little information

Section 4: Optimal reserves supply when marginal cost of ON funds is zero

- Marginal cost of reserves can be set to zero by paying interest on reserves & fully satiating demand (Goodfriend 2002)



Source: Goodfriend (2002)

Benefits: *“If the supply of overnight reserves is no longer tied to the setting of the central bank’s target rate, it can be used to satisfy other objectives”* (M&M, p. 22)

- i. *“One possible objective is to reduce or eliminate the supply of intraday reserves”* (M&M, p.22)
- ii. Other objectives: *“ ... a central bank could increase bank reserves in response to a negative shock ... that elevated spreads in credit markets”* (Goodfriend (2002))

Side effect: overnight money market may disappear, but should we care?

“...the study of the case where the central bank supplies reserves at a zero marginal cost leads us to the maybe surprising conclusion that the overnight market could be relatively unimportant ...” (M&M, pp. 25-26)

Remark 1: operational frameworks in which reserves are supplied at a positive marginal cost already allow pursuit of above mentioned objectives:

- i. *“When the opportunity cost of overnight reserves is zero, the distinction between overnight and intraday reserves becomes blurred [...] Banks can hold enough reserves overnight to satisfy both their intraday and their overnight needs.” (M&M, p.3)*

But this is also the case in the ECB operational framework: High level of compulsory reserves reduces intraday liquidity needs. Reserves are remunerated, yet marginal cost is positive (*quasi zero?*)

ii. Policy rates are already (to large extent) independent of reserve management:

1. open mouth operation mechanisms
2. target rates as signaling devices

This allows flexible, timely adjustment of overnight reserve supply, “independent” of policy interest rate (see reaction of the ECB to the sub-prime turmoil)

→ distinction between systems with zero vs. positive cost of overnight funds could be less clearcut/useful than it seems at first sight

Remark 2: could the approach be turned on its head?

Do the benefits generated by the overnight market (info production, risk allocation, ...) exceed the costs (management of interbank systems, personnel, ...)?

Yes → central bank should supply liquidity at a positive marginal cost

No → central bank should supply liquidity at a zero marginal cost

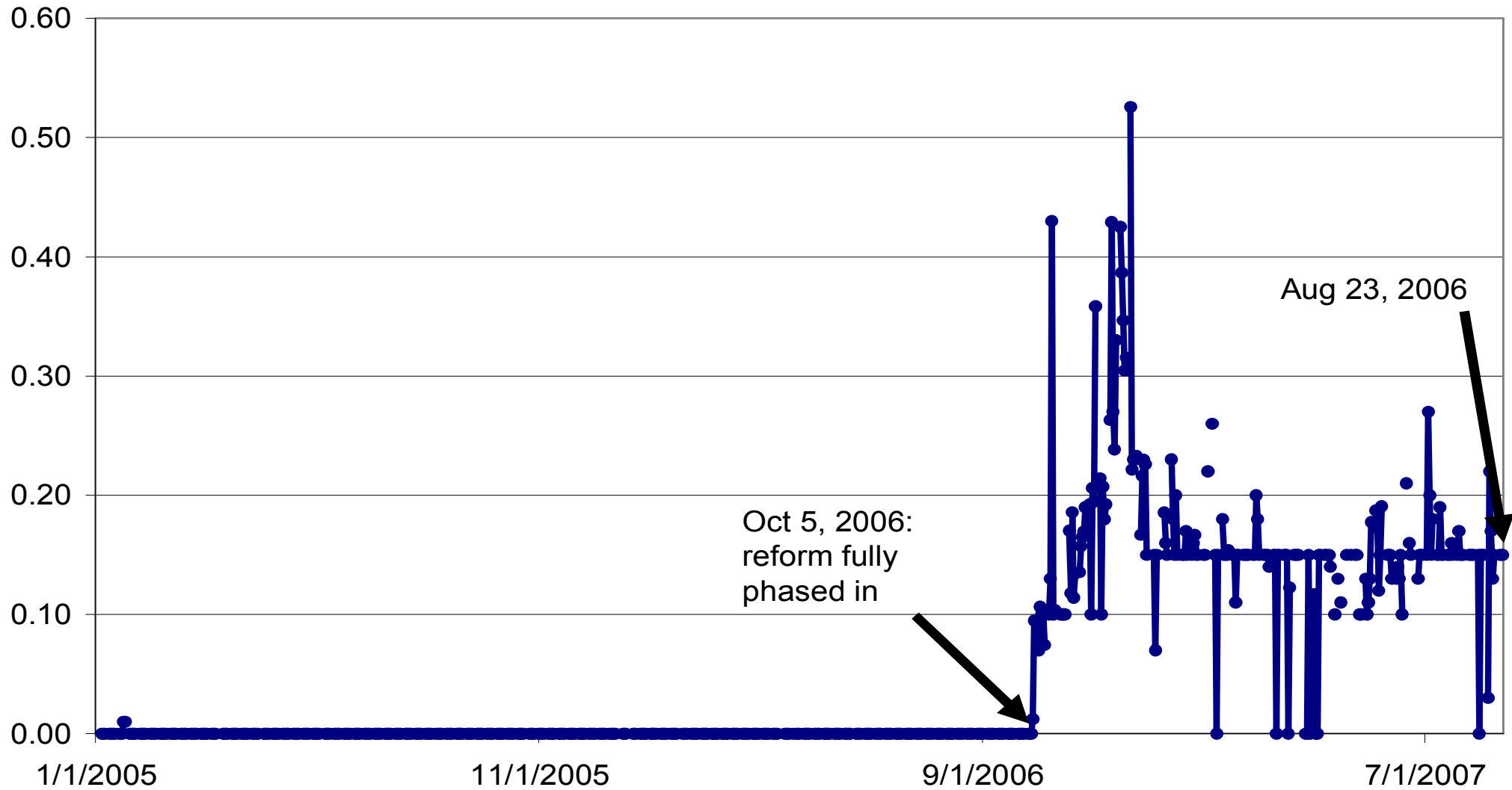
The empirical experience: RBNZ case study (Nield (2006))

- Floor on policy rate (reserves earn OCR since October 2006)
- Supply of reserves increased from NZ\$20 mn to about NZ\$8 bn
- In principle, it looks like Goodfriend (2002) implemented literally



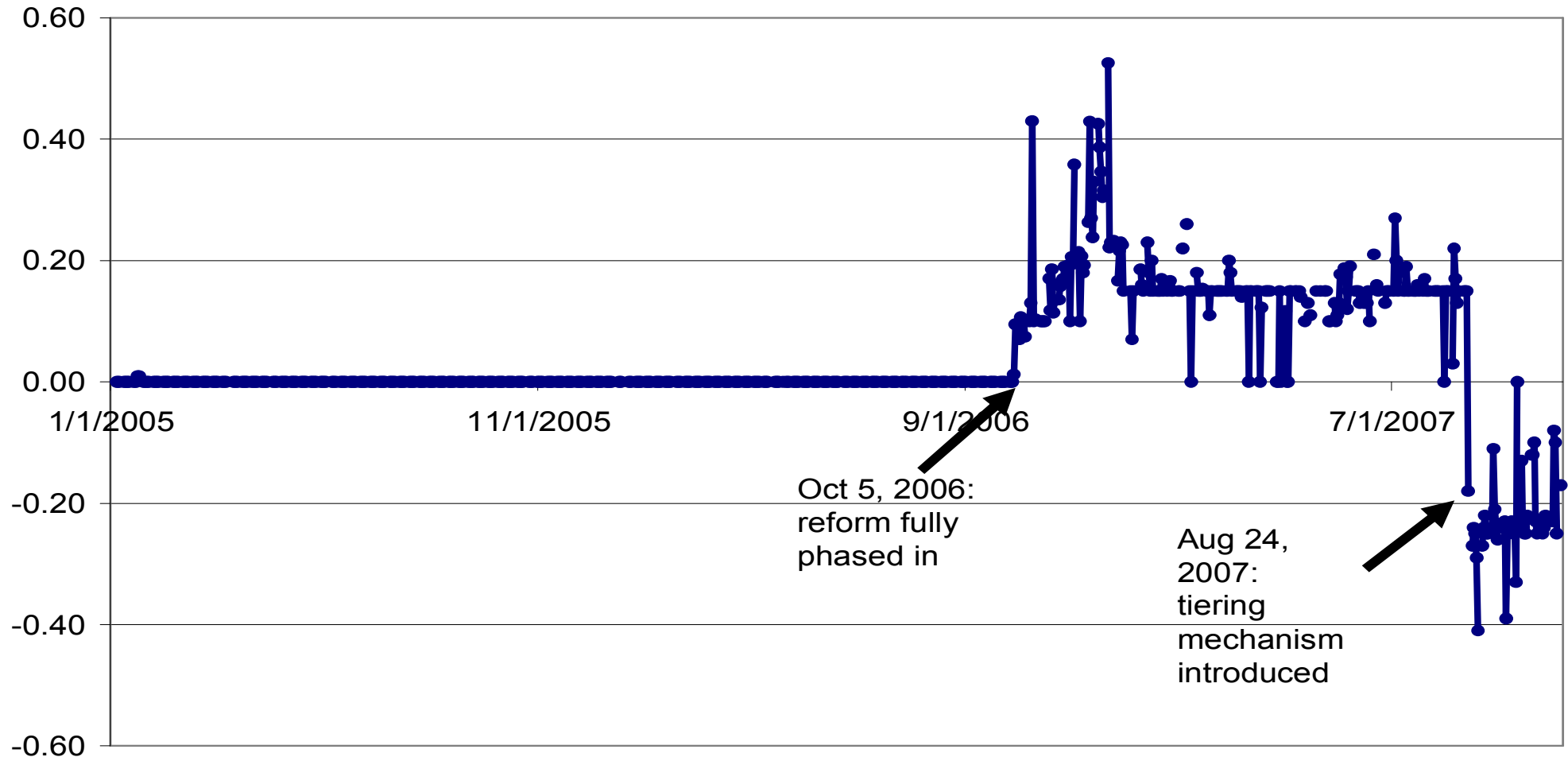
... in practice, not quite...

New Zealand: Overnight interbank cash rate - official cash rate
(daily data; percentage points)



- On August 23, following sub-prime turmoil, RBNZ amended system, de facto, eliminating interest rate floor. As a result:

New Zealand: Overnight interbank cash rate - official cash rate
(daily data; percentage points)

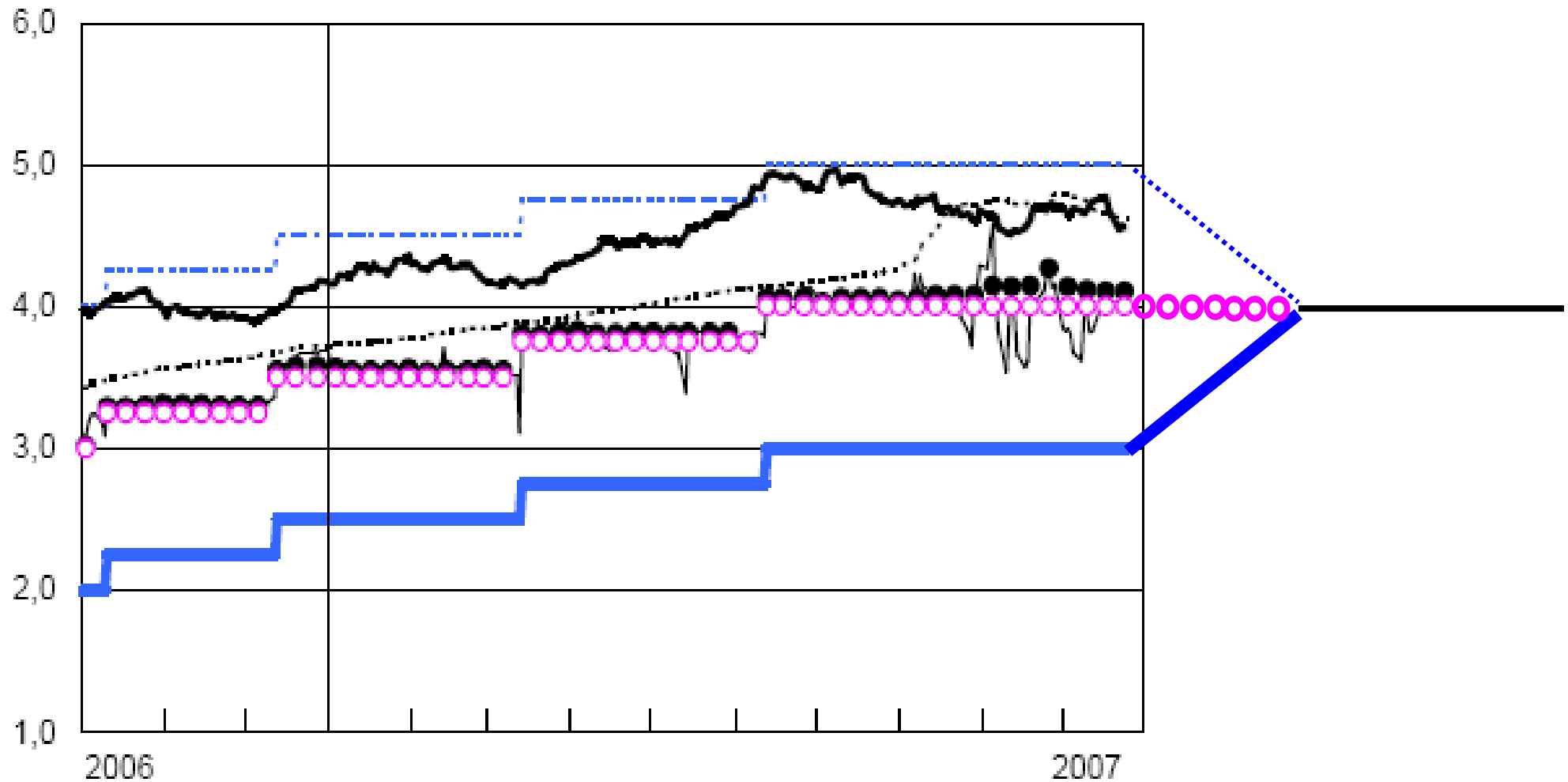


→ It seems that the NZ new system, perfectly suited (in principle) to address instability in liquidity demand, went back to a corridor system as soon as the first episode of instability occurred!

Questions prompted by the NZ experiment:

- What happened to the NZ overnight interbank market(s) throughout these changes? Did transaction volumes increase or decline?
- Problems that prompted the RBNZ to modify the system in August: are they NZ-specific, or would they materialize in general under such a system?

- What if the move to the new system had been bolder? E.g. one could bring the width of a corridor system down to zero:



- What would be the drawbacks of such a system?
 - Rate differentiation based on creditworthiness not possible
 - Performance under stress?
 - ...