Chief economist's comment

Are central banks sucking liquidity from financial markets?

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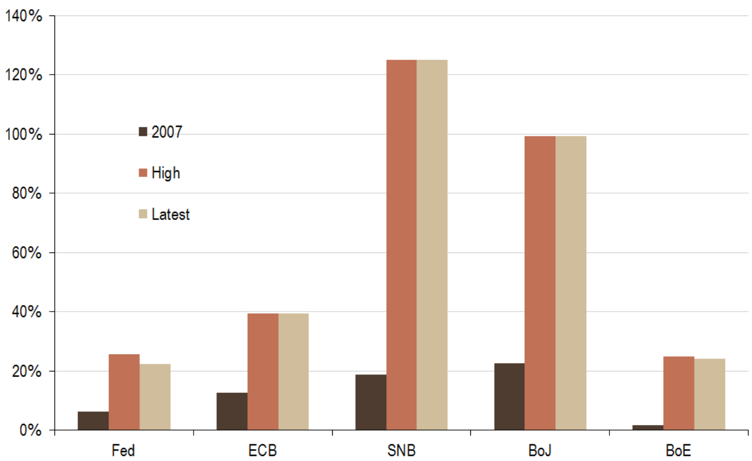
- Central banks are slowly changing quantitative policy. Central banks are cutting cash supply.
- It would be a very big mistake to focus on cash supply alone. Cash demand matters just as much.
- Central banks are likely to reduce cash supply as cash demand falls. This means that the liquidity available to financial markets need not change as central banks change policy.
- The problem for investors is that there is no simple measure of cash demand. Whether cash supply and cash demand are in balance is a complicated judgment.

The US Federal Reserve has continued to cut the number of bonds that it owns. This means that the Fed is taking cash out of the economy. The Bank of England stopped buying bonds some time ago. We expect the European Central Bank will stop buying bonds by the end of this year.

Central banks are slowly reducing the supply of cash to the world economy. Does this mean that central banks are sucking away the amount of cash or liquidity that is available to financial markets? If that were true, it might be a problem for investors. Fortunately, this is not what is happening.

Central bank balance sheets as a % GDP



Source: Central bank data, Haver, UBS, as of 29 May 2018

Don't forget demand

One of the reasons central banks began printing money (cash) was that the financial crisis produced a surge in demand for cash. Ordinary people used credit cards less, and needed more cash to pay for goods. Savers wanted some cash at home where they could see it. Companies demanded cash in advance before they would consider sending out goods. When companies got the cash, they hoarded it as "cash on balance sheet." People and companies stopped using credit, and started using cash. That is what a credit crunch means.

In most countries, the only legal supplier of cash is the central bank. As demand for cash increased after the financial crisis, central banks increased the supply of cash to match demand. This kept things steady in the economy. If central banks had not increased the supply of cash, interest rates would have soared. Whenever demand is greater than supply, the price will rise. The interest rate is just a way of measuring the price of cash.

The fact that central banks increased the supply of cash to match an increase in demand for cash explains why printing money did not cause inflation. Inflation occurs when the supply of cash is greater than the demand for cash. Keeping supply and demand in balance should not affect the value of cash. Inflation is a just a way of measuring the value of cash.

Economists never look at supply alone. Economists are interested in the balance of supply and demand. This was important when cash supply rose, and it is important when cash supply is falling. Central banks like the Federal Reserve are happy to reduce cash supply because they believe that cash demand is falling.

The technology company Apple provides a good example of this. Apple has been holding a lot of cash on its balance sheet in recent years. Apple recently announced that it does not want to hold so much cash. Demand for cash is falling, particularly in the US.

If the Federal Reserve did nothing, Apple's decision would be pumping cash into the economy. Cash supply would then exceed cash demand. That would run the risk of inflation. If the Federal Reserve takes Apple's unwanted cash, there is no economic impact.

This is why central banks cutting cash supply may not cut the cash or liquidity available for markets. Imagine a company handed over their unwanted cash directly to the central bank. In that case, the cash that exists in all other parts of the economy and financial system would not change. The process is not quite as simple as that, but this is basically what is happening in the world economy today.

Appendix

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