

THE INTERACTION OF MONETARY POLICY AND GOVERNMENT CASH MANAGEMENT

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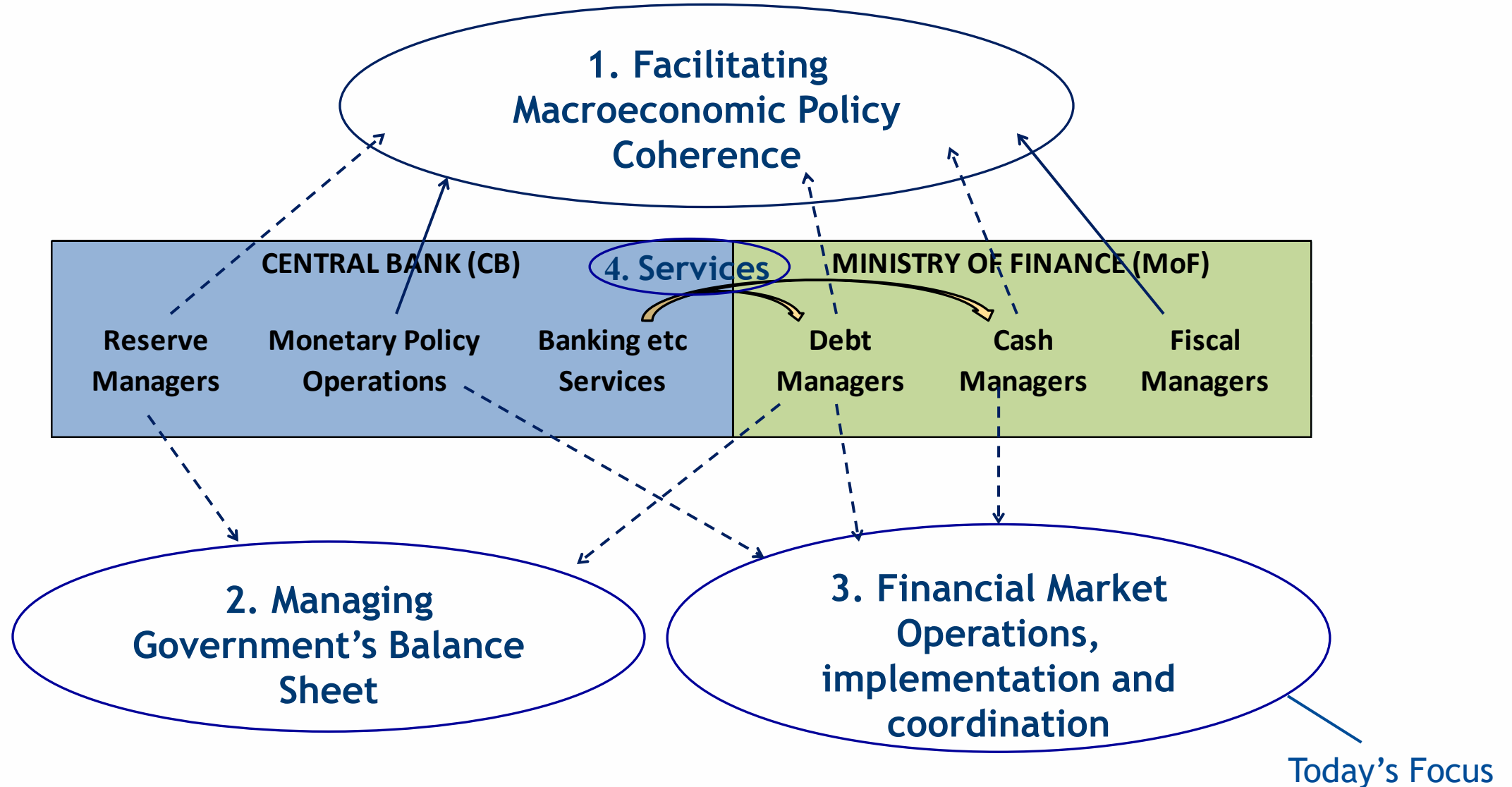
Outline

The Macro
Context

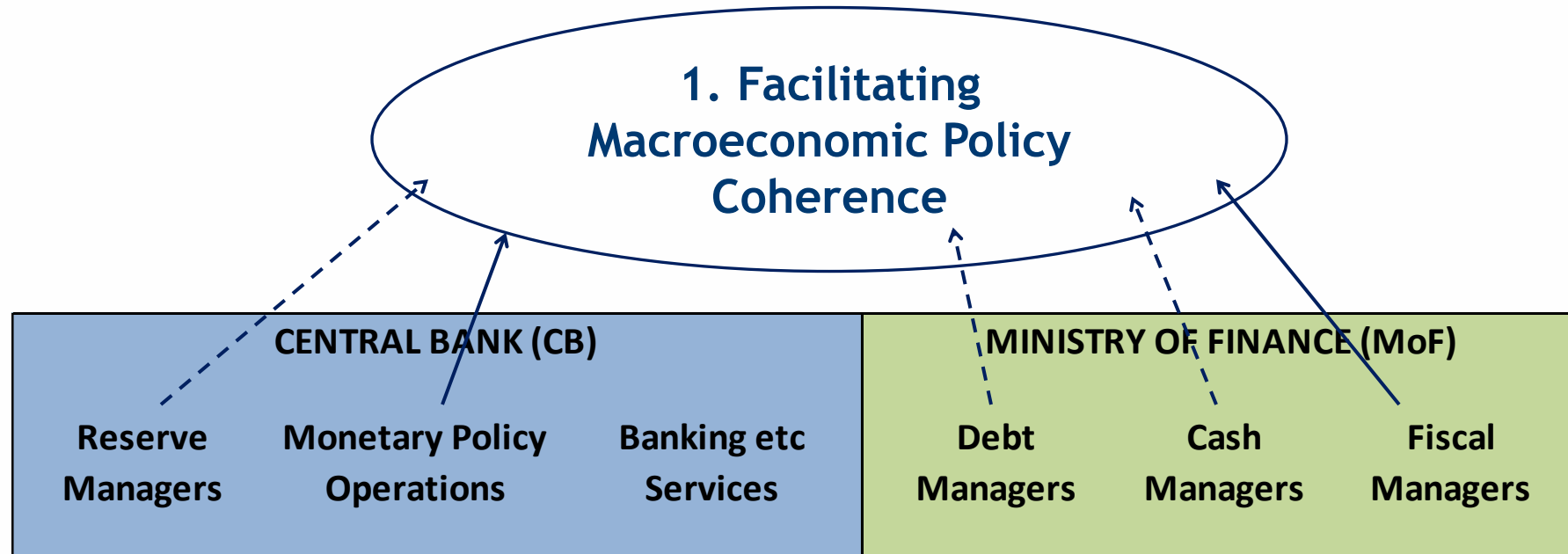
Moving to
Active Cash
Management

Clashes and
Coordination

An Overview – Policy and Operational Interaction



An Overview – Policy and Operational Interaction



The Model

- Different instruments for different objectives
 - ▶ Separation brings greater transparency and predictability enhancing policy credibility, effectiveness, accountability
 - ▶ In OECD countries separation also justified by the weak links between debt management choices & monetary conditions

Fiscal Policy

- Manage the levels of the deficit and debt; and the composition of spending and taxation

Debt Management

- Execute the financing requirement; manage the composition of the debt portfolio

Cash Management

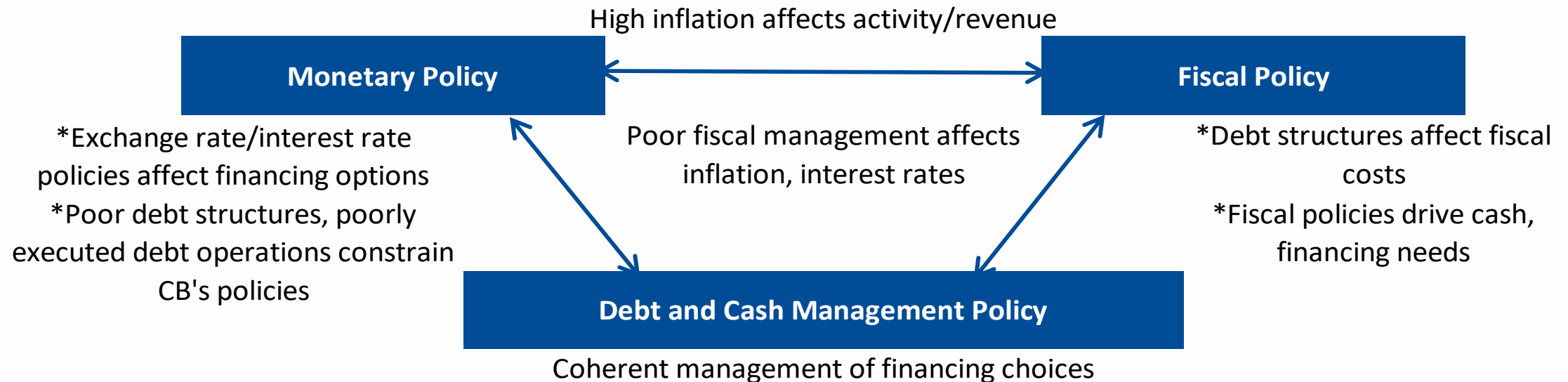
- Support the smooth execution of the budget

Monetary Policy

- Manage monetary anchor through interest rate, exchange rate or money aggregates

The Model was always Qualified

- Consensus that debt management, fiscal policy and monetary policy should be treated as separate macroeconomic policies with separate instruments: Improves credibility and effectiveness
- BUT: Model assumes highly liquid markets, and independence of policy instruments
 - ▶ Not the case in less developed markets (and not currently in many of the more developed markets); cash and debt operations may affect monetary policy operations & vice versa



Adapted from Togo, Eriko "Coordinating Public Debt Management with Fiscal and Monetary Policies: An Analytical Framework," (World Bank 2007)

Monetary Policy is Multi-Dimensional

Even in developed markets, model under strain from QE/QT

- Shape of yield curve may affect debt management operations

Monetary conditions have 3 dimensions

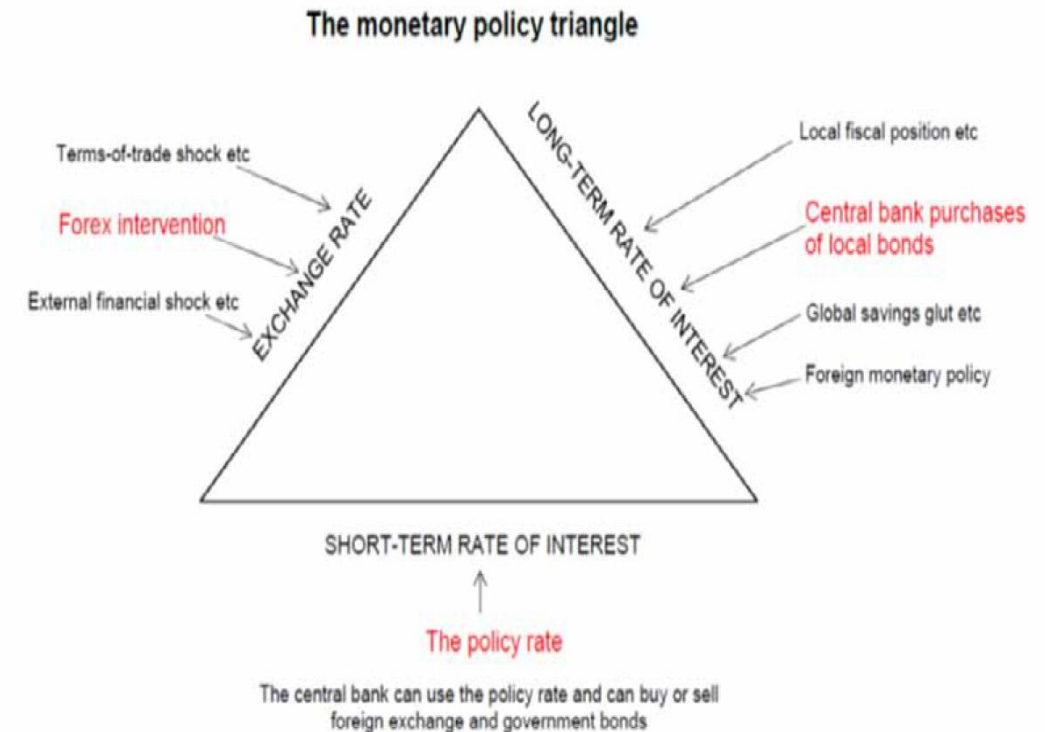
1. Short-term policy rate
2. Exchange rate
3. Long-term interest rate on government debt

2 & 3 may be more important at times of stress and can be influenced by CB

Impact of US interest rates on capital flows weakens CBs' monetary policy independence, espec. in EMCs

But separation has worked well in practice

- Benefits from focus on objectives, transparency and accountability
- Little pressure to change functional separation of mandates



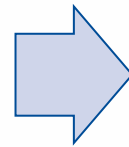
Philip Turner “The global long-term interest rate, financial risks and policy choices in EMEs” (BIS 2014)

➤ **Policy separation still requires mechanisms to facilitate high-level policy coherence and coordination at operational level**

High-Level Facilitating Mechanisms

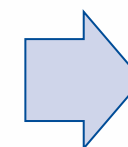
In practice, CB not always completely independent

- Close to complete independence in Eurozone
- But Government (or Parliament) may retain some responsibilities, for appointments or target setting, or even policy override



Different mechanisms

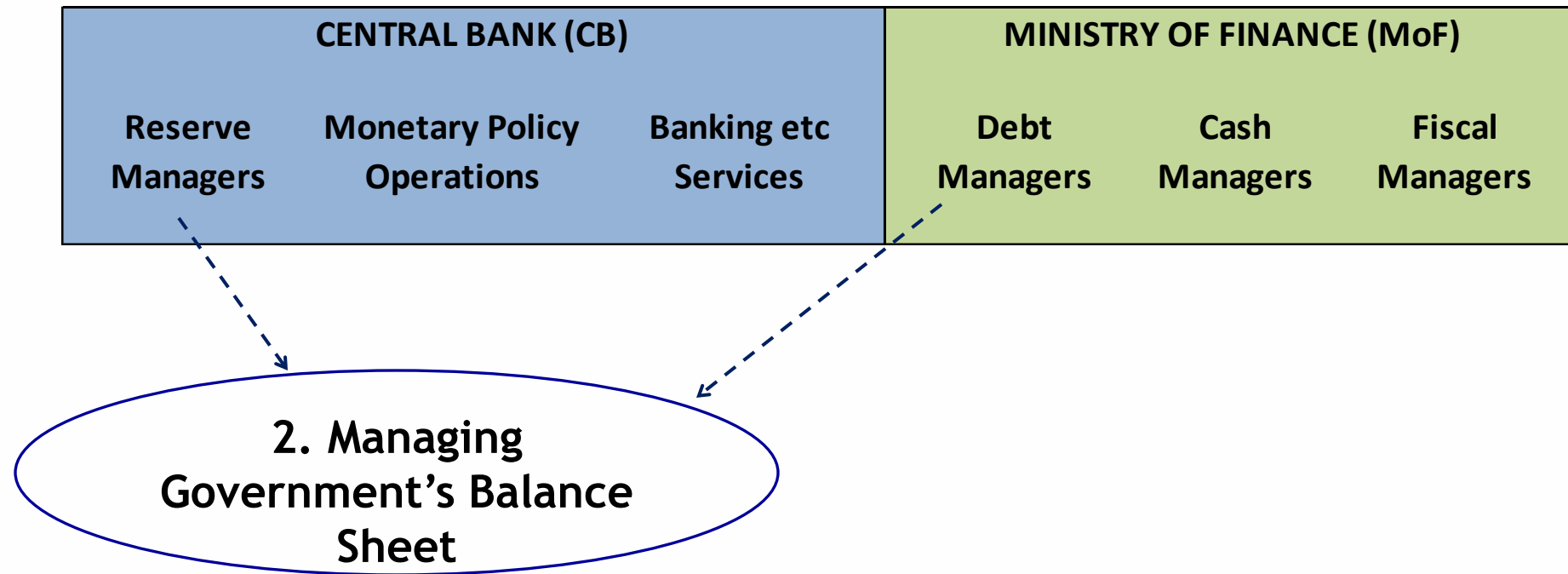
- Ranging from information exchange to policy coordination
- Eurozone: stability and growth pact is being replaced by a treaty setting tighter budget rules
- Fiscal Responsibility Laws that include target or ceiling deficit and debt levels
- MoF observers on Monetary Policy Committee (eg UK, China)



In middle income countries potential use of Public Debt Committee (PDC) or similar to facilitate coordination

- Brings together representatives of main macro policy functions to ensure that debt management decisions are properly embedded in wider macroeconomic policies

The Government's Balance Sheet



Debt Management Strategy

Development of the Debt Management Strategy

- All countries increasingly taking account of structure of assets as well as liabilities
- Risk minimized when characteristics of assets and liabilities match

Important analytically; but can be problematical

- Substantial assets (FX reserves) under control of CB not MoF

CB should be consulted in preparation of MTDS

- Identify conflicts with monetary policy, comment on financial market realism
- But often reluctant to bring FX assets into purview - a governance challenge

Annual borrowing plan (ABP) prepared by MoF

- MoF also prepares more detailed quarterly calendar, and leads on consultation with market and relationship with primary dealers
- ABP in consultation with CB (may be reluctant to leave it at that?)

Public Debt Committee (PDC) has a potential role to facilitate coordination

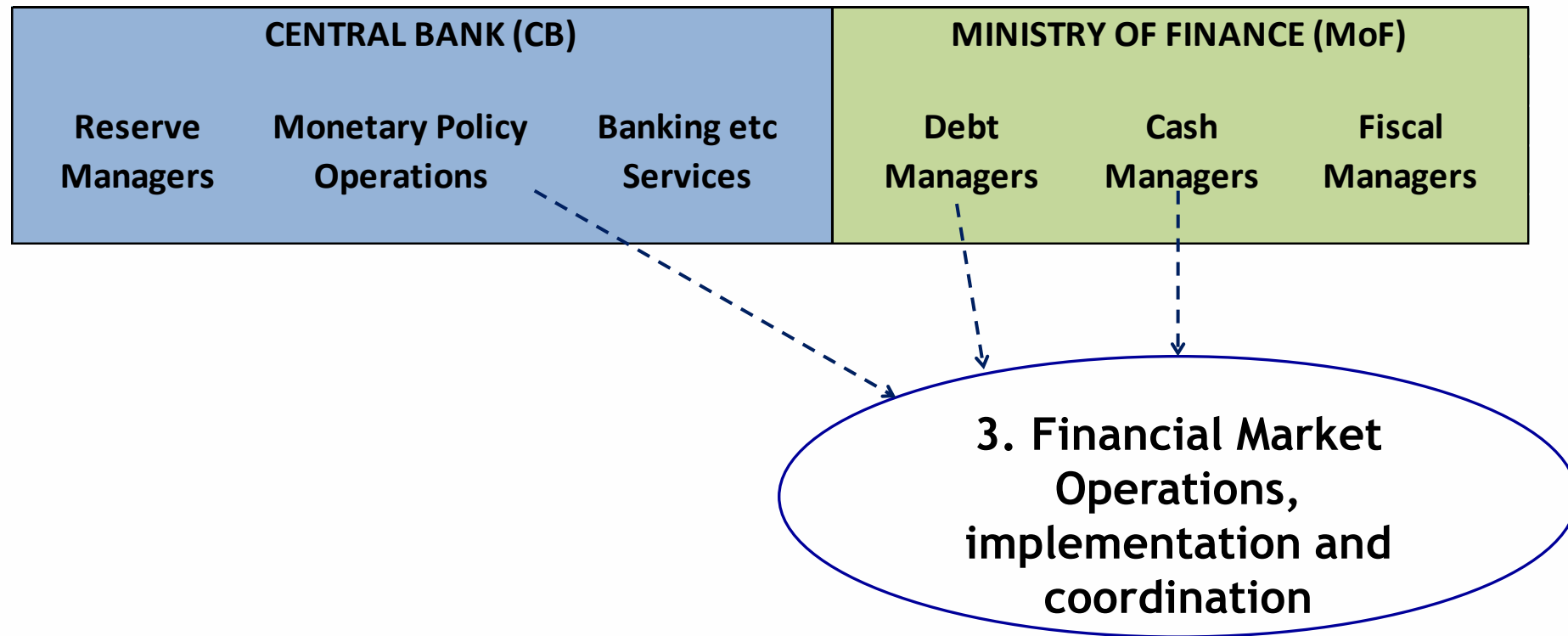
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Operational Interaction



Changing Roles of CBs and Treasuries

Traditional Roles

- Treasury: Treasury primarily a gov't payment office; TSA incomplete; limited cash management
- CB: managing domestic monetary conditions, including impact of gov't cash flows
- Directly influencing cash and debt management policies through its role as fiscal agent; range of services supplied to treasury

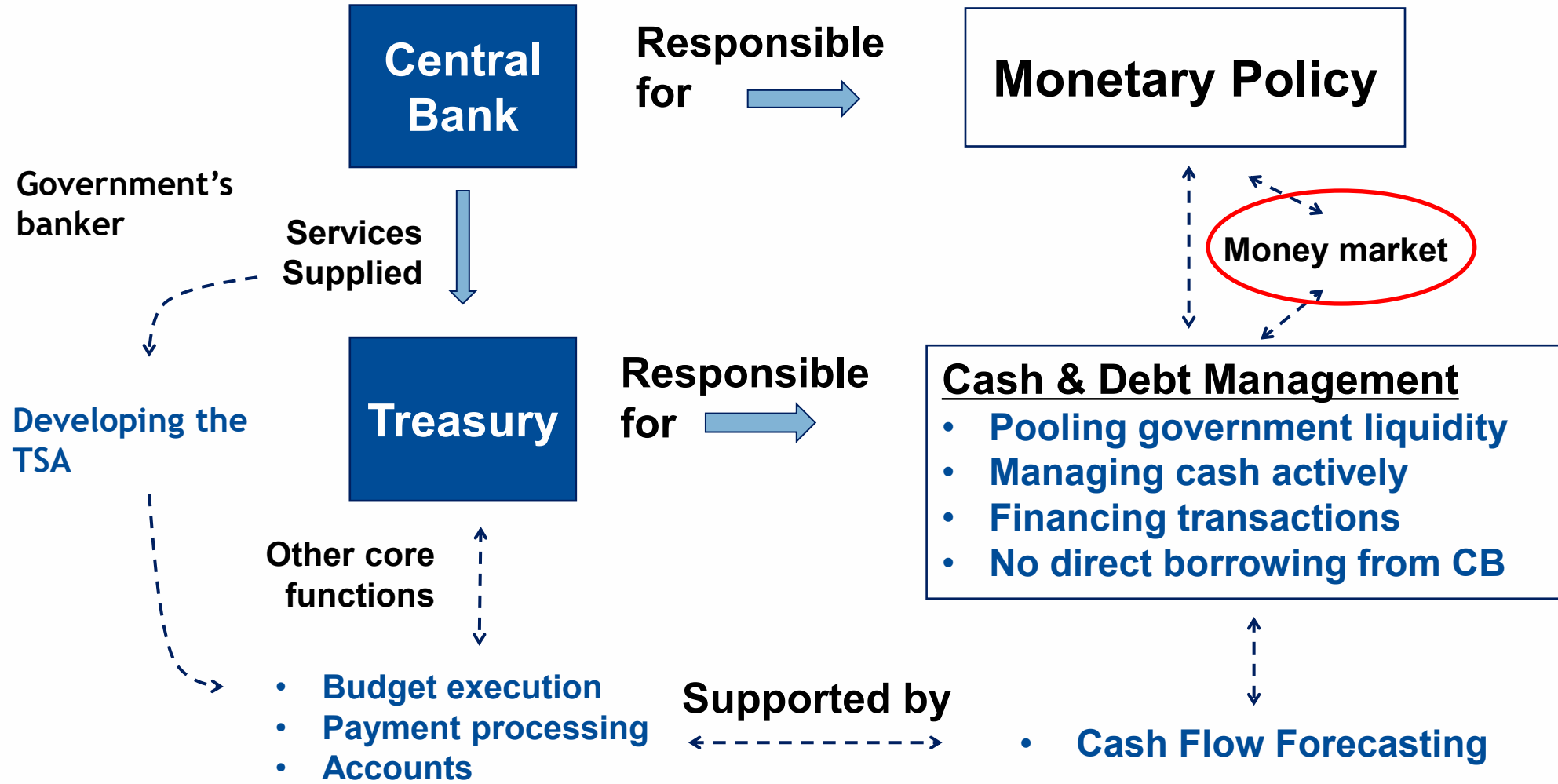
Problems

- Excess government liquidity; lack of interest on balances => a subsidy to banks
- Volatile government cash flows complicate monetary policy operations
- CB's implementation of debt and cash management policy potentially conflicting with monetary policy goals
- CB lending to government risking adding to inflation

More Active Cash Management

- Targeting a cash buffer, Treasury borrowing and lending in money market
- Reduced volatility in TSA balances implications for monetary policy operations
- Bank may remain as fiscal agent – but clarity important

The Modern Treasury Framework



Cash Management and Monetary Policy

- Liquidity of the domestic banking sector depends on:
 - ▶ Monetary policy operations of central bank - borrowing or lending to credit institutions, reserve requirements, deposit services, etc.
 - ▶ "Autonomous" Influences - demand for notes & coin by the public (predictable), net inflow of FX (depends on intervention policy) and changes in government deposits at the central bank (ie, changes in the balance of TSA)
- Less fluctuation in government cash flows across the TSA, implies less fluctuation in monetary conditions and banking liquidity (other factors being equal)
 - ▶ Less weight should be assigned to monetary operations to control liquidity
 - ▶ Active cash management facilitates the task of central banks

Assets	Liabilities
Refinancing facility for banks	Banks' current account deposits
Marginal lending to banks	Banks' required deposits
Net foreign Assets	Bank notes in circulation
Other (net)	Government deposits

Can be rearranged

Liquidity supply through monetary policy operations

Refinancing facility for banks
plus Marginal lending to banks
less Banks' required deposits

Equals "Autonomous" factors

Bank notes in circulation
plus Government deposits
less net foreign assets

Plus

Other factors / Residual

As Cash Management Develops...

Initial movement of liquidity from the banking system; but in time...

- Treasury will reduce cash balances
- Reduced volatility of cash balances will benefit central bank – the counterpart is reduced volatility in banking sector liquidity
- Treasury transactions interact with monetary policy operations

Implications for finances of commercial banks

- Less interest free money from government
- But government should remunerate transactions services
- Improves transparency and incentives
- [Immediate loss of liquidity can be eased by monetary policy – see later]

Need for coordination and cooperation becomes apparent

- Clarity on responsibilities and information flows
- Operational interactions – eg auction timings
- Mutual development of money market

[In practice many central banks have been reluctant to endorse more active approach]

- For good and bad reasons
- Genuine concerns in some countries about MoF's competence (e.g. in cash flow forecasting, ability to intervene properly, wrongly signalling to market)

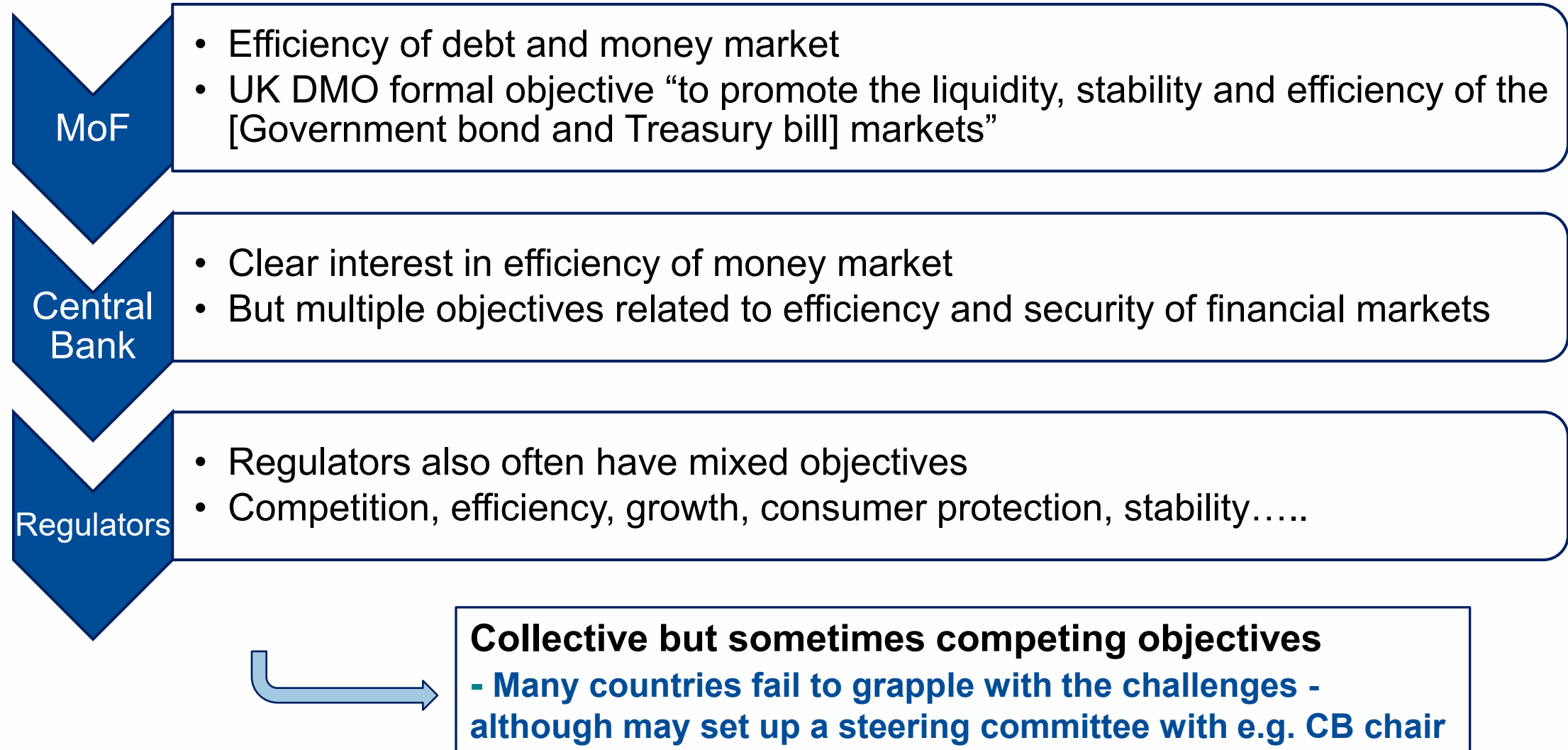
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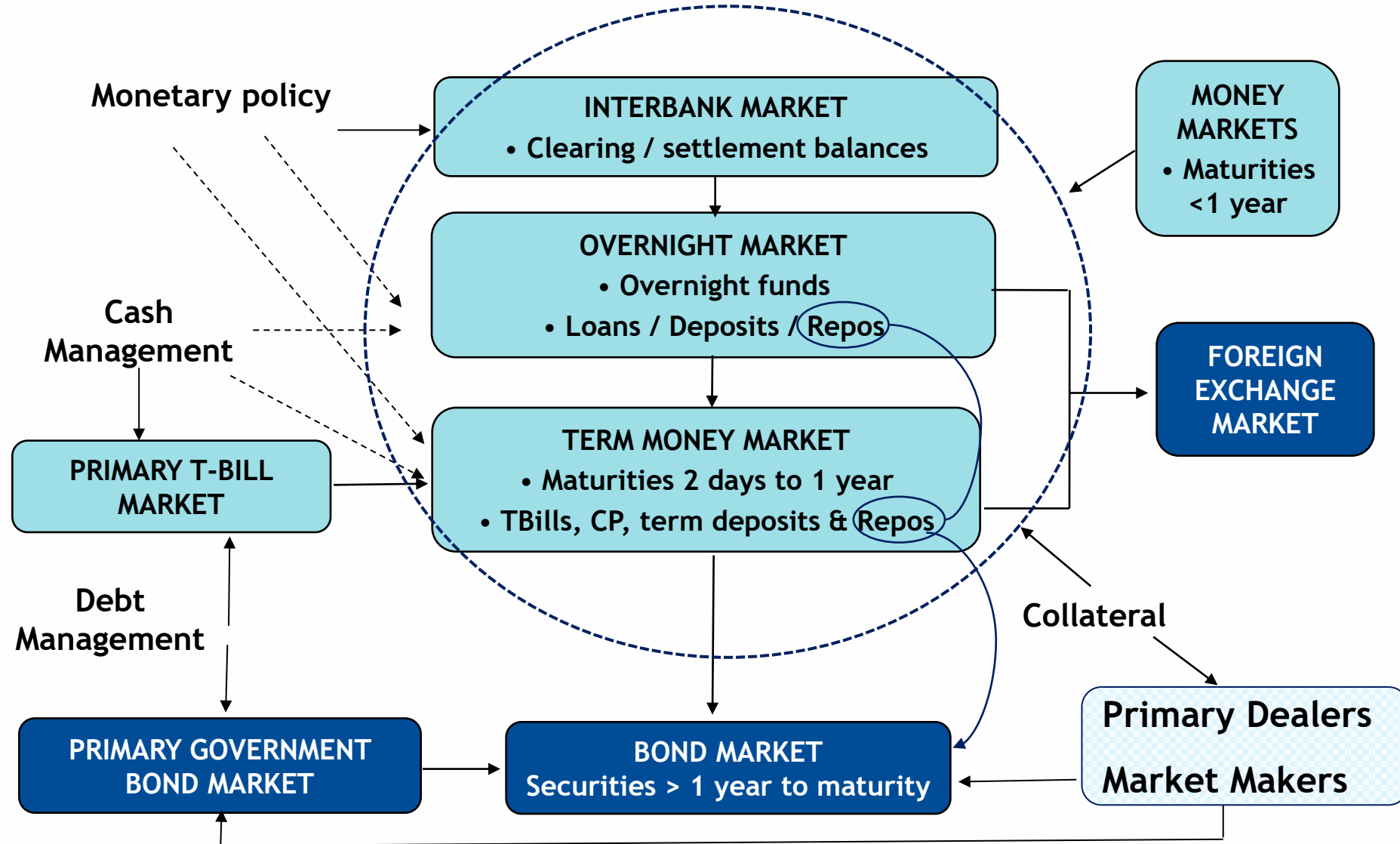
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Common Interest in Money and Debt Market Development



Debt and Money Market Interaction



Some Specific Sources of Tension

- Central banks do not always accept case for active cash management
- Central bank bills (CBBills) alongside TBills risks fragmentation of secondary market liquidity
- Timing and amounts of Government auctions should fit with bank's monetary policy operations
- Interest on the TSA and impact on central bank's costs
- Impact on Commercial Banks
- Central Bank portfolio of government securities: their roll-over, marketability and (post-QE) their run-off

Treasury bills or Central Bank bills?

Build up in domestic liquidity

- Often, linked with FX inflows (and unwillingness to let exchange rate float)
- CB issues own bills <= lacks other tools to absorb liquidity

Potential reasons for the issuance of Central Bank securities

- Greater transparency – helps to make explicit the costs of monetary policy
- Repo market not fully developed
- If government does not issue its own instruments (or if unavailable in needed amounts)

Can mitigate problem by CB and MoF agreeing to issue paper of different maturity

- Reduces problem but does not remove it

Preferable model but requires

- Trust between the MoF & CB (MoF willing always to accept a request from CB to issue extra Tills)
- May be difficult where the CB's requirements are >> MoF's; CB may want more control

MoF overfund the borrowing requirement, issuing extra Tills/ Tbonds

- Depositing surplus cash in a sterilized account at the central bank

Avoiding clashes with Monetary Policy

Treasury should avoid any operation that might be seen as “competing” with central bank

CB should be able to ask Treasury to adjust its operations if they affect CB’s ability to meet its monetary policy objectives

Requires understandings between the CB and Treasury/DMO

Eschew tenders at same time of day as CB’s repo tenders

Avoid lending to market at same tenor as CB lending in its repo ops

Avoid transactions immediately before monetary policy announcements

If CB trying to drain cash when Treasury has a surplus, CB should be able to ask Treasury to hold cash in TSA

But the CB should pay interest at a market related rate

Either body is able to trigger discussion at any time

CB must know MoF’s balance target (either on a daily or longer-term basis) and be informed if MoF can’t hit it that day

Discussion must not extend to interest rate prospects

Payment of Interest on the TSA

Agreement needed on the rates of interest paid on the TSA balance and any other government deposits at the central bank

International experience varies, but best practice to pay a market-related rate:

- Improves accounting transparency, avoids the implicit cross-subsidy associated with administered rates.
- Removes incentive for MoF to take economically inappropriate decisions, eg placing funds in banks with low credit ratings
- Much more common in Advanced Economies than LICs – MICs vary
- Analogue varies – often policy rate, sometimes lower corridor rate, or a market rate (sometimes excess cash over the buffer is remunerated at a lower rate)

Similarly, transparency and proper financial incentives => MoF should pay transaction-related fees

Payment of Interest – some Issues Arising

Constraints on payment of interest

- There may be legislative constraints.
- Paying admin fees requires room in the budget, even if net debt interest payments fall
- Payment of interest on government deposits will affect the CB's profits
 - If CB is loss-making or government cash balances are large, may financially undermine the CB: long run solution may be recapitalisation
- Impact on gross debt (not net debt)
 - Although not a problem for more sophisticated commentators/analysts
- Choice of interest rate analogue is important to give right incentives

Market distortions

- May still be periods when market rates unattractive
- Strong presumption that surplus cash is invested - an intrinsic part of active cash management – not least for the wider benefits
- If rates offered by banks are below market (below the corridor rate?) suggests excess liquidity and appropriate to leave cash with CB for monetary policy reasons.
- Wider problems also arise if cash not well distributed in inter-bank market (incumbent/new entrant banks, protected government-owned banks) – part of the wider reform agenda

Impact on Commercial Banks

Movement of government deposits from banks to TSA

- CB or others may be concerned about impact on banks – from both prudential and market soundness perspective
- Deposit withdrawal will affect banks' balance sheet & P&L
- Potential impact on credit lending
- [Transfer SoE deposits potentially greater impact but not preferred]

Mitigation Measures

- Giving banks notice, and phasing the transfer
- CB temporarily modify regulatory ceilings; or recycle liquidity at a non-penal rate
- In due course extra cash will anyway flow back to private sector
- Active cash management (investing cash surplus) will help banks manage their balance sheet in future
- Few examples where these concerns have materialised in practice (ex Nigeria)

Level playing field between banks is important

- Treasury must encourage competition
- Allow a range of banks to compete at bond/bill auctions or for deposits (accommodate within credit risk policies)

Coordination Structures & the MoU

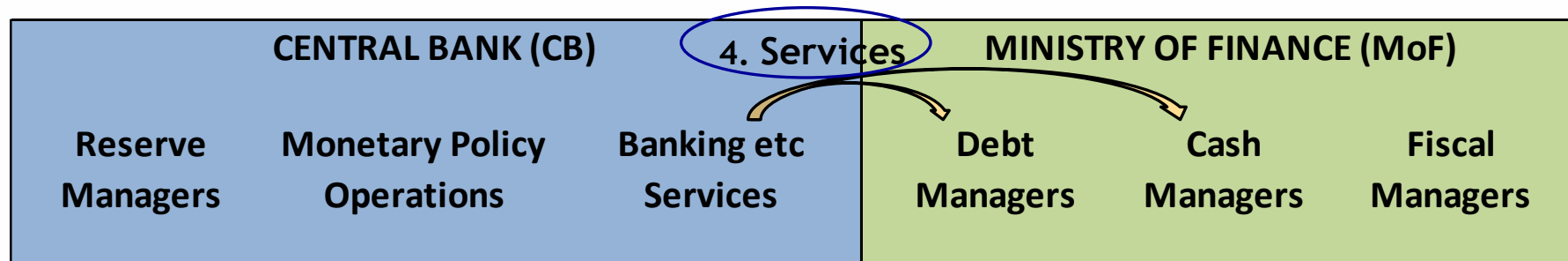
Coordination and Cooperation

- Mechanisms and structures must cover both policy and operations
- Based on
 - ▶ Clarity on responsibilities and information flows
 - ▶ Understanding about operational interactions
- At different levels
 - ▶ Minister/Governor
 - ▶ Formal committee structures, e.g.
 - Public Debt Committee for high level policy coherence
 - Cash Coordination Committee for daily or weekly operations
 - ▶ Technical working groups
 - ▶ Day to day operational interaction

High Level Policies Covered by MoU

- Joint program for the development of the money market
- Policies and operations for Tbill issuance and the respective roles of CBbills and Tbills
- How the CB reports its and the market's views about the debt and cash management program and operations
- Choice of primary dealers or auction counterparties
- Payment of interest on government balances at the central bank and associated mechanism/analogues
- Information exchanges – respective responsibilities
 - ▶ Mechanism of communication and issues covered
 - ▶ Determinants of e.g. the timing of respective auctions and the associated market announcements
- [Where the treasury is able to borrow from the CB], understandings of the limits (sums, maturities, ability to roll over etc.) of such borrowing

Coordination Structures: Services



Service Level Agreements (SLAs)

- Range of services supplied is potentially wide
 - As well as banker, often includes fiscal agent, settlement agent, registrar...
 - Important to clarify roles and responsibilities, and expectations – i.e. a SLA
- Wide variety of SLAs in practice
 - Often several, covering separate policy matters or services
 - Work in progress in many countries
- Services required from CB as banker (and of commercial banks) varies greatly.
Depends on:
 - TSA and payment structures
 - Whether there are regional branch networks of MoF and CB
 - Ability to control expenditures through IFMIS

The SLA

- Includes performance indicators or quantitative targets
- Some examples of issues covered
 - ▶ The notice that both sides would give of any impending change in the auction pattern or timetable
 - ▶ The turnaround times by the central bank in handling any relevant transactions, e.g. as fiscal or settlement agent.
 - ▶ Details of information flows in either direction, with intended timing, e.g. of cash flow forecasts or transactions across TSA.
 - ▶ The basis of calculation of fees paid for the services (potentially covering compensation for failure to meet the required service)
 - ▶ Details of the rate of interest to be paid on government accounts
 - ▶ Exchange of risk-related information (including audit reports)
 - ▶ The handling of any business continuity problem
 - ▶ The arrangements for handling disputes and for review of SLA
- SLA normally reviewed regularly , e.g. every year, fees reassessed

Summary: Central Banks and Treasuries

- Different policy objectives and operational requirements
 - ▶ Strains between fiscal and monetary policies
 - ▶ Inconsistent objectives for different parts of government balance sheet
 - ▶ Operational conflicts or clashes – including central bank reluctance to see MoF taking a bigger role



- Common interests
 - ▶ Efficient debt, cash and monetary policy operations
 - ▶ Development of the financial market, especially money market
 - ▶ Avoiding market disruption or confusion
 - ▶ Mutual benefits from more active cash management



- **Clarity and understandings about responsibilities, objectives & interactions**
- **Backed by effective governance and coordination arrangements**

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THANK YOU!

