



EUROPEAN CENTRAL BANK

# Central banking in the credit turmoil

## Marvin Goodfriend

**Discussion**  
**Frank Smets**  
**European Central Bank**

**International Conference**

**Bank of Japan**

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These comments are my own and should not be attributed to the ECB. I would like to thank Francesco Papadia (ECB) for giving permission to use many of the graphs in this paper and Kristina Morkunaite for updating them.

# Comment 1: Goodfriend's taxonomy

- **Goodfriend's taxonomy (in particular the difference between monetary policy and interest rate policy) is very much inspired by the Fed's monetary policy implementation framework.**
- **I am not convinced this is the best way of describing monetary policy implementation in many other countries, where a distinction between monetary policy and liquidity management policies is more appropriate.**

# Comment 1: Goodfriend's taxonomy

- **Monetary policy is setting and signalling the appropriate level of short-term interest rates, mostly through a tunnel system:**
  - **Determined by a marginal lending facility (against collateral), a deposit facility and a main policy rate.**
  - **Even in the absence of a remuneration of excess reserves, the deposit facility will put a lower bound on the short-term money market interest rate.**

# Comment 1: Goodfriend's taxonomy

- **Liquidity management policy consists of:**
  - Type, frequency, maturity, scope of market operations (typically repurchase agreements);
  - Reserve requirements, type and horizon of maintenance period, remuneration;
- **Main objectives:**
  - Keep money market rates close to the main policy rate.
  - Ensure a well-functioning, liquid, interbank money market, which is the core of the transmission mechanism.
- **Separation principle.**

# Comment 1: Goodfriend's taxonomy

- **The financial crisis has not fundamentally changed this approach (see, for example, Borio and Nelson, 2008).**
- **However, it has changed the focus in at least three different ways.**

# Central bank as market maker of last resort

- When liquidity in the interbank market breaks down because of adverse selection problems, the liquidity management by the central bank becomes crucial in avoiding that funding problems propagate into a systemic crisis.
- In effect, the central bank becomes the market maker of last resort.
- In doing so, a fine balance has to be kept in mind between replacing the interbank market and encouraging a reactivation of the interbank market.

# Lower bound and signalling

- **When short-term interest rates are hitting the lower bound:**
  - **Signalling about future short-term interest rates becomes even more important:**
  - **Liquidity management policy may help this signalling process by, for example, lengthening the refinancing operations.**

# Collateral policy and liquidity

- **Through its collateral policy, the central bank may also affect activity in other markets than the interbank market.**



## Comment 2: Fiscal aspects of credit policy

- **Goodfriend lays out the fiscal policy aspects of the Fed policies (in particular the credit policy) ;**
- **“It is important to appreciate the difficulties to which the Fed exposes itself in the pursuit of credit policy initiatives that go beyond traditional last resort lending to depository institutions”:**
  - **Reach, pricing, allocation, ...**
- **He argues the Fed must be accountable for these fiscal policy aspects and this may undermine the central bank’s independence.**

# Fiscal policy aspects of central bank

## policies

- **Proposes an Accord :**

- Fed should adhere to “Treasury only” asset acquisition policy; Cooperation on exit.
- The use of monetary policy for the fiscal purpose of funding credit policy should not undermine price stability;
- Agree on long-term inflation objective;
- Allow Fed to build up surplus capital to guarantee financial independence;
- Agree on those principles so that the Fed can act preemptively, flexibly and aggressively against either rising inflation or a deepening contraction and deflation, if either demands Fed action

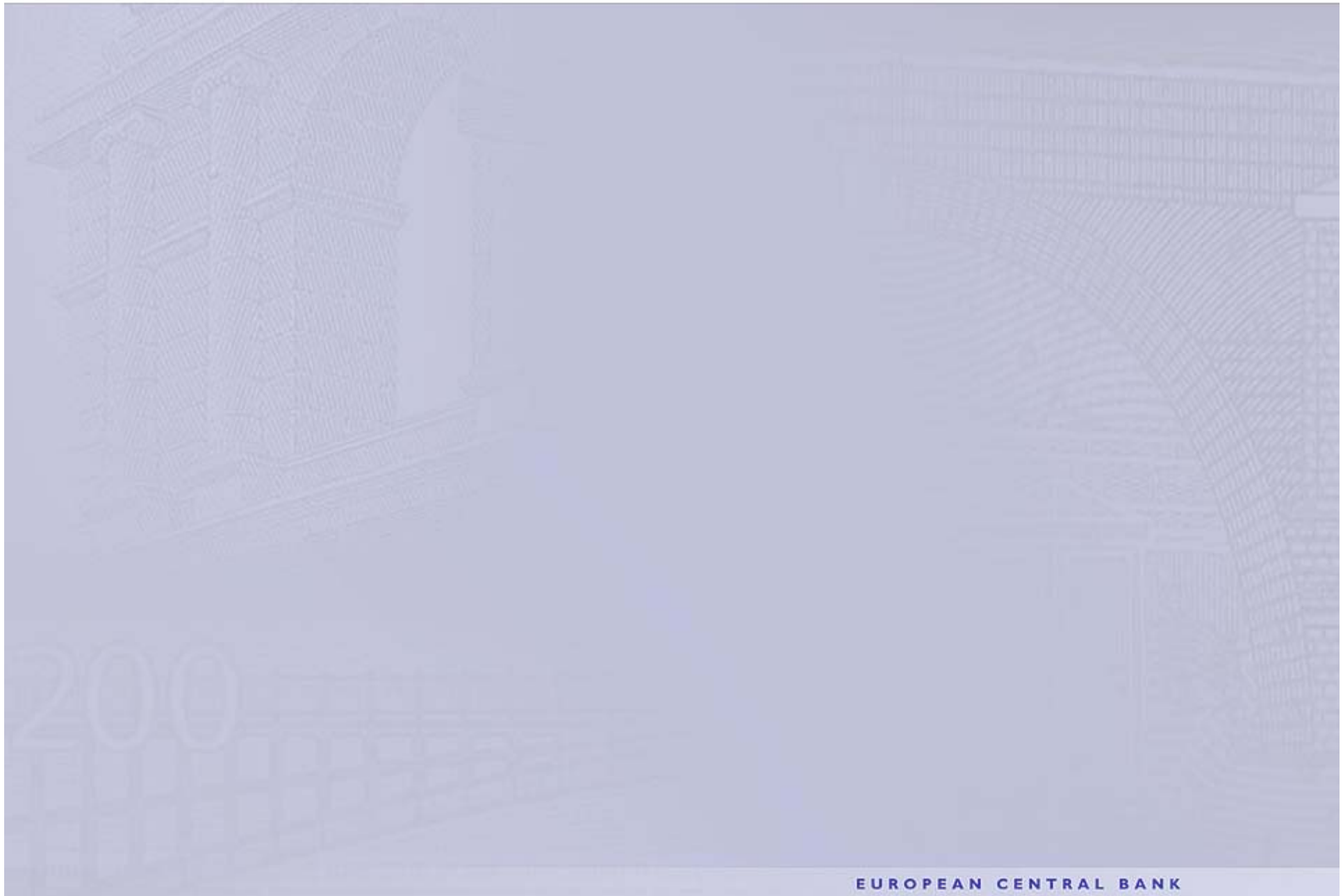
# Credit versus liquidity risk

- It is important to make a distinction between credit risk and liquidity risk; between insolvency and illiquidity.
- While central banks are in the business of creating liquidity and can thus solve liquidity problems, they can and should not address solvency problems. That is in the realm of fiscal policy.
- Of course, it is not easy to distinguish credit from liquidity risk and in the process central banks will take on more credit risk.

# Monetary financing of government debt

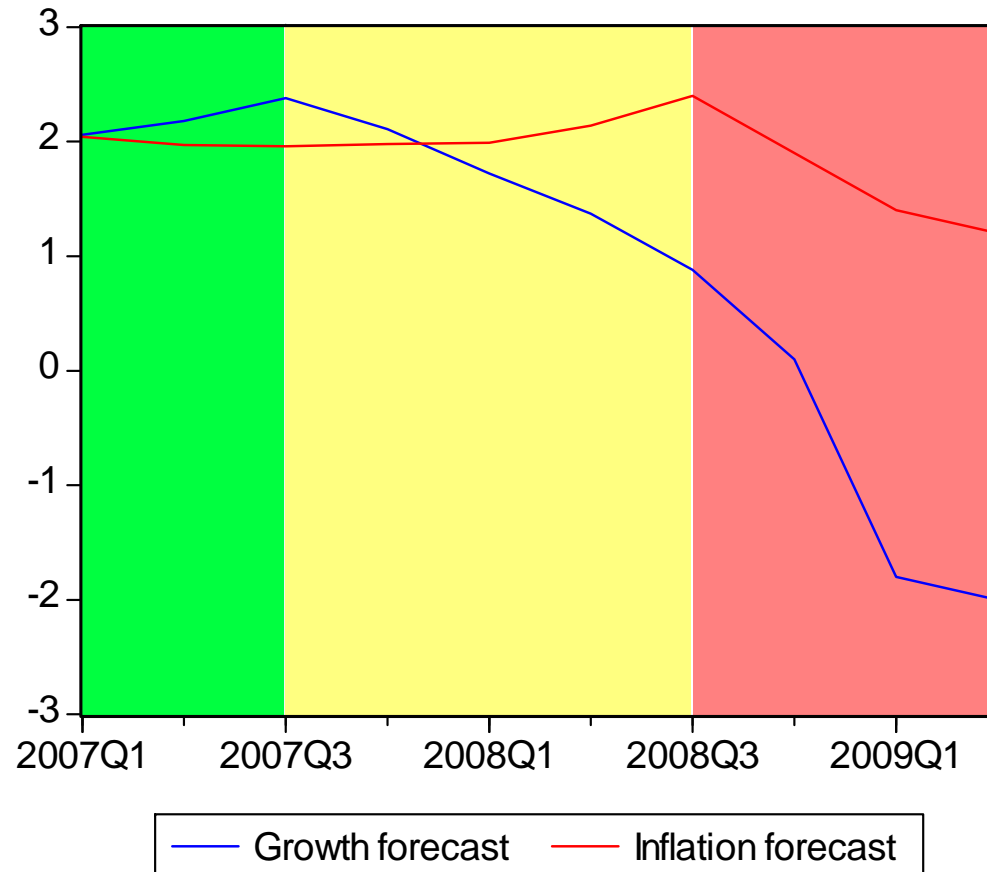
- **There are risks from large purchases of government debt.**
  - **May turn into pressure for monetary financing of the debt, with possibly negative effects on inflation expectations.**
  - **Related to this, there may be an exit problem, leading to financial losses when interest rates start to rise, undermining the financial independence of the central bank.**

# The ECB's response to the credit crisis

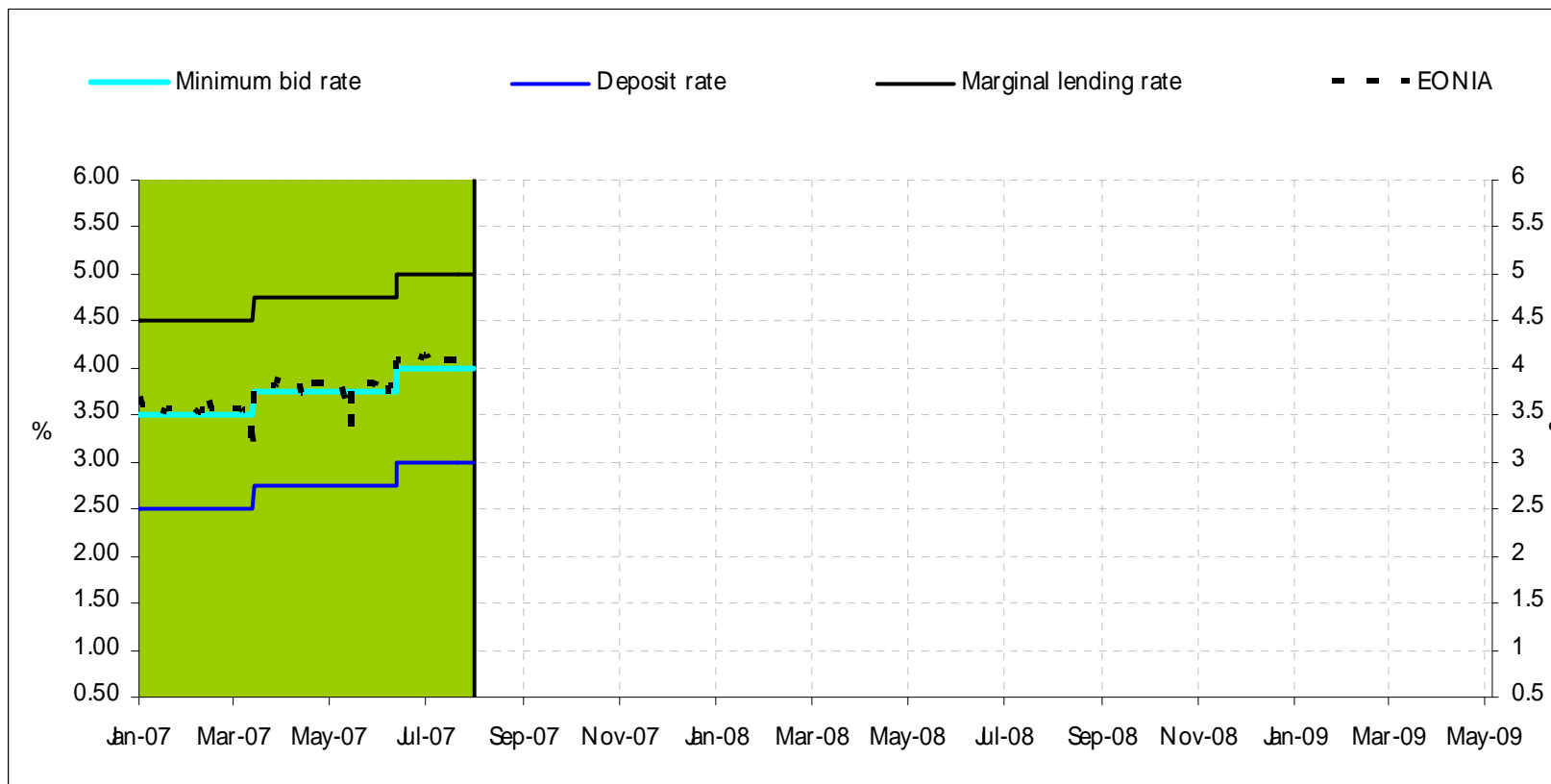


# Inflation and growth outlook (SPF)

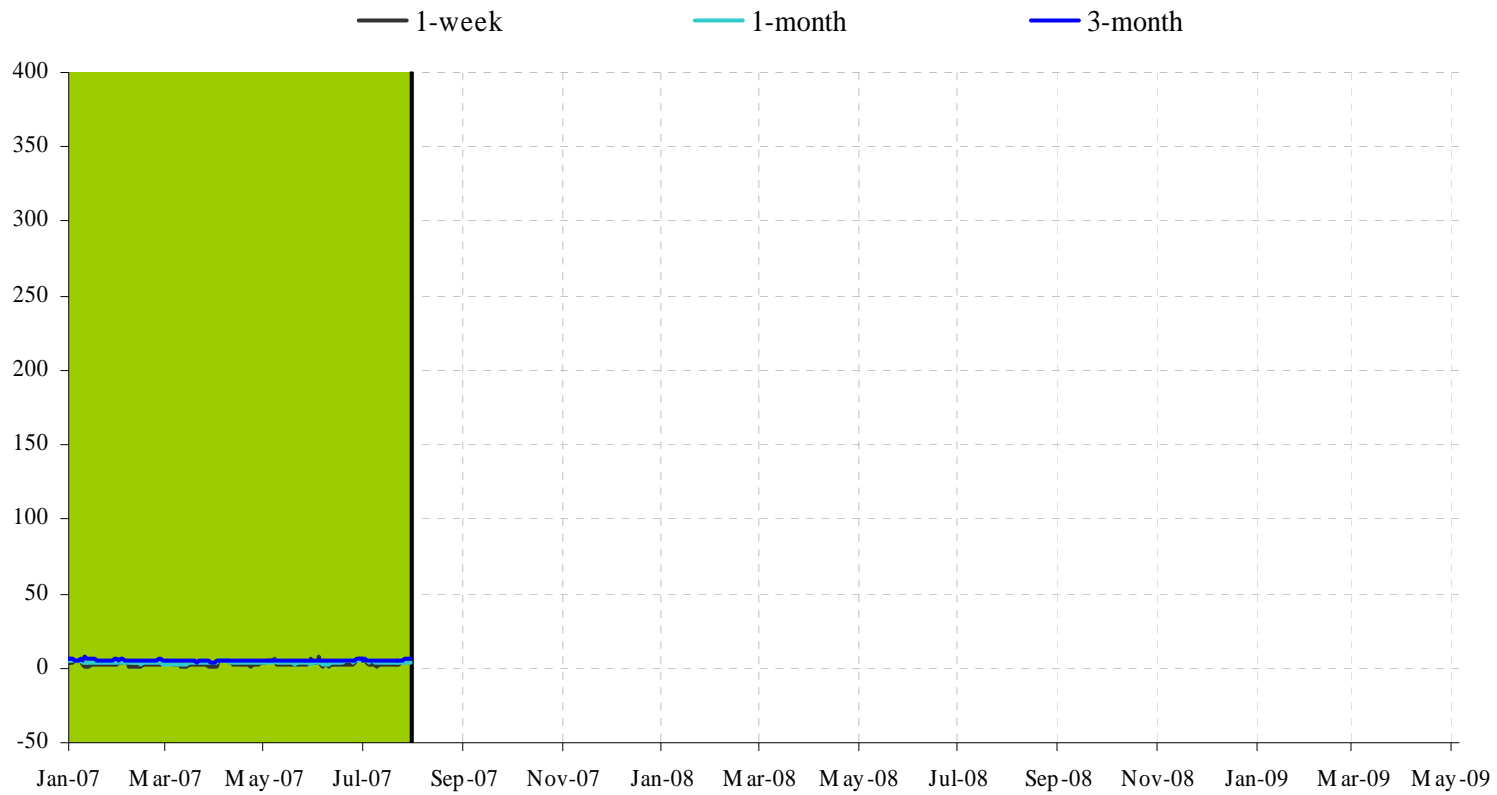
Inflation and growth outlook in the euro area  
Survey of Professional Forecasters - One-year ahead



# ECB rates and EONIA

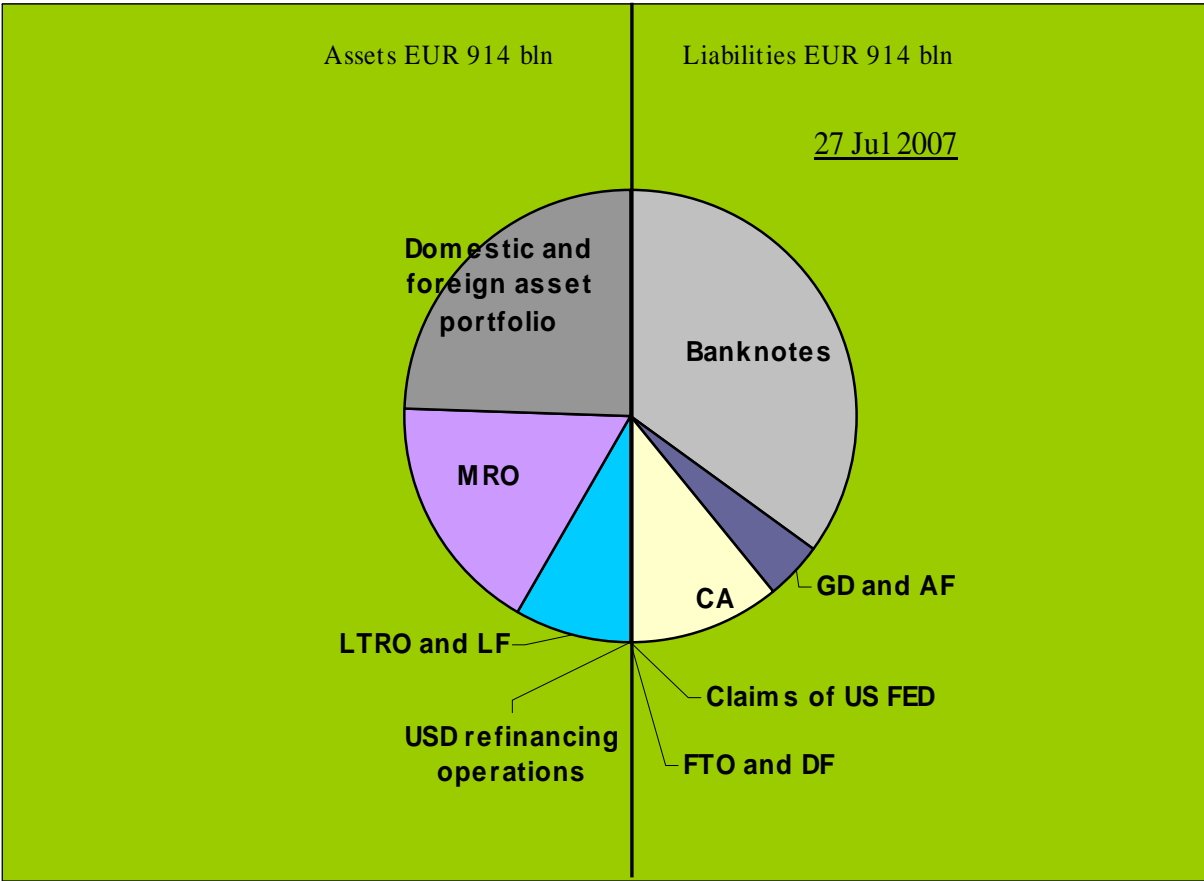


# Euribor – Eonia swap rate spread (1)

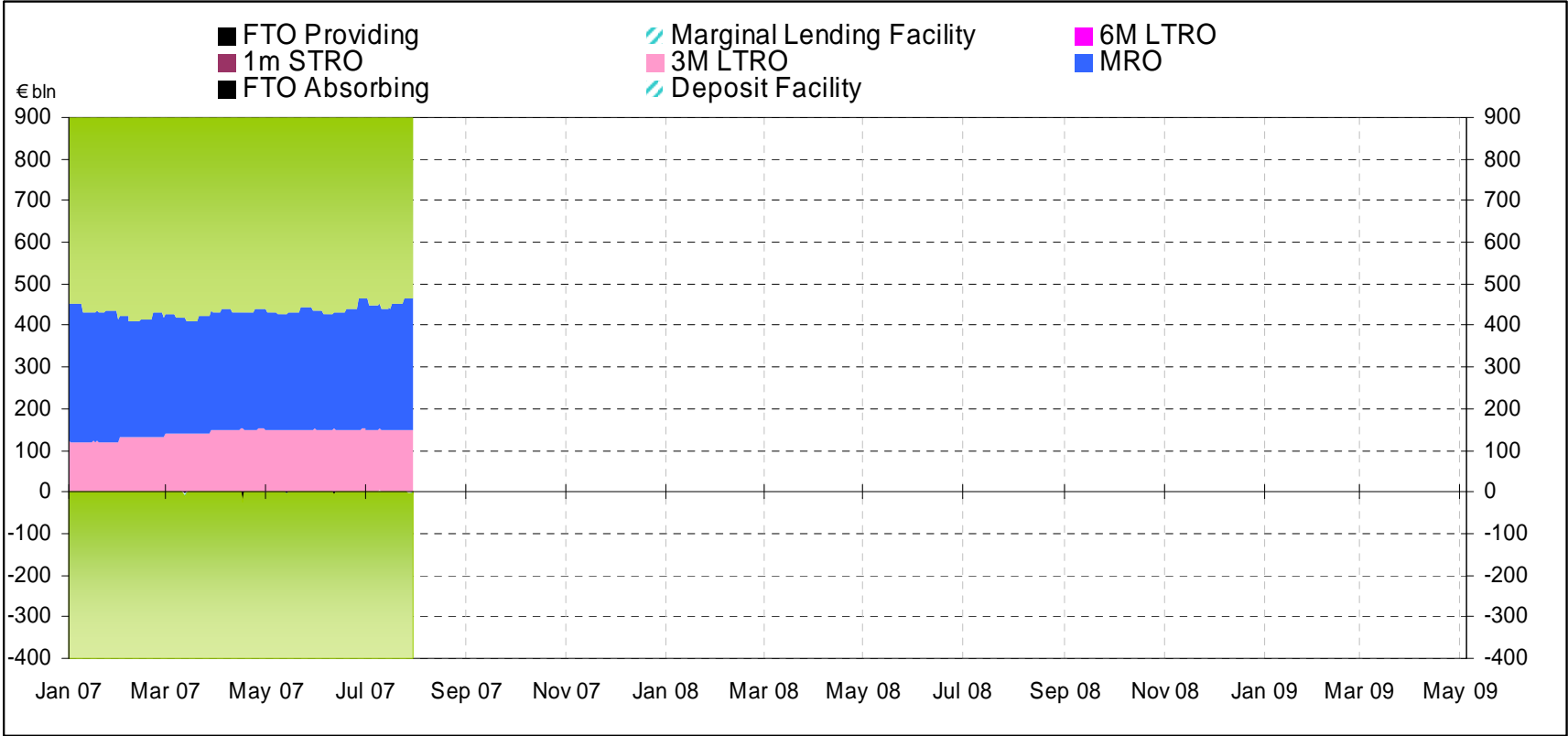




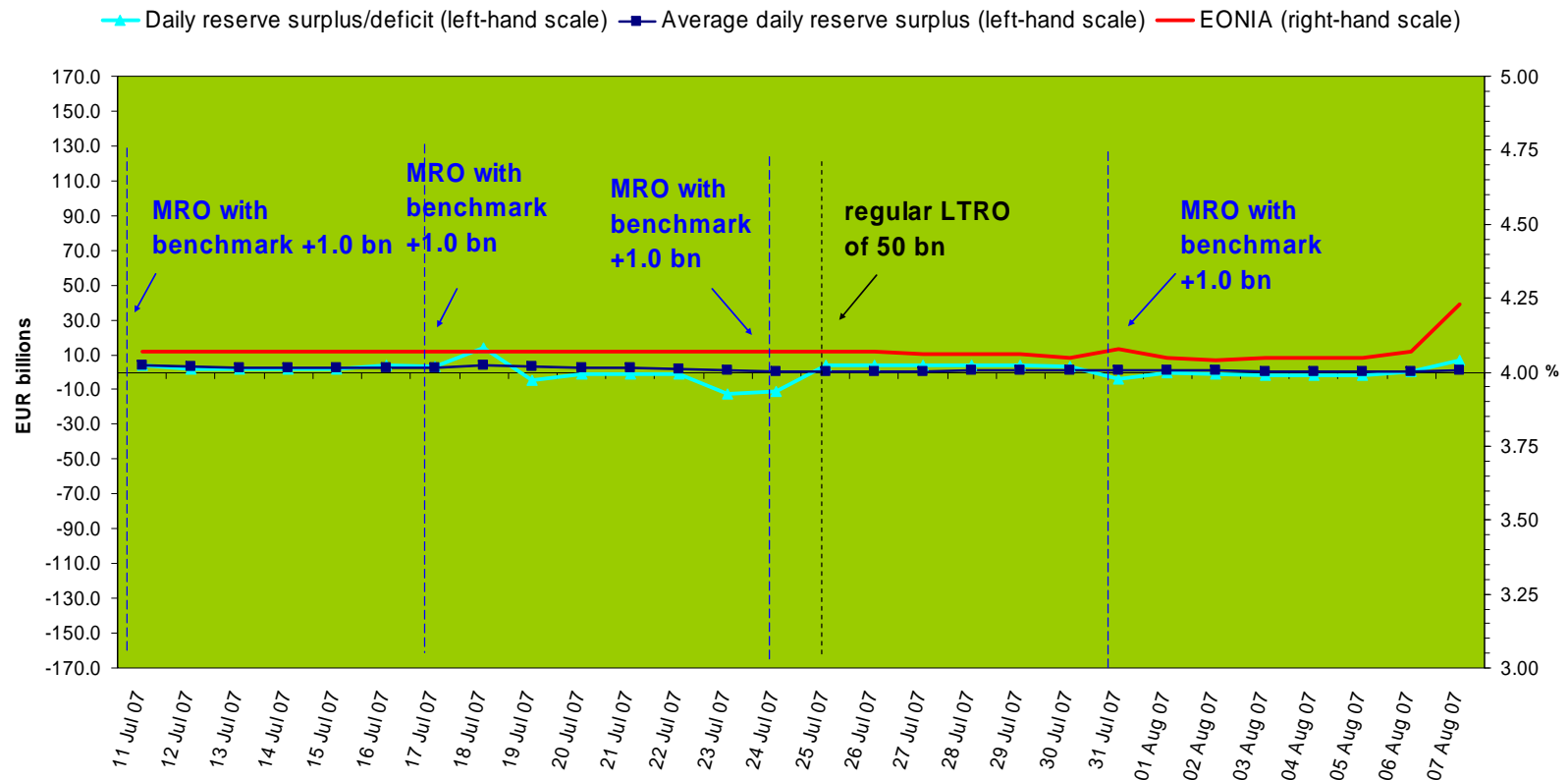
# Consolidated balance sheet of the Eurosystem



# Euro liquidity operations: outstanding amounts



# Maintenance period 11 July to 7 August 2007



# Other features of operational framework

- **Large number of counterparties;**
- **Wide set of collateral;**
- **Different maturities;**
- **When MFIs stop trusting each other, this turned out to be important for the ability of the central bank to step in as a liquidity provider and market maker of last resort:**
  - **No need for TAF, TSLF, PDCF in the euro area.**

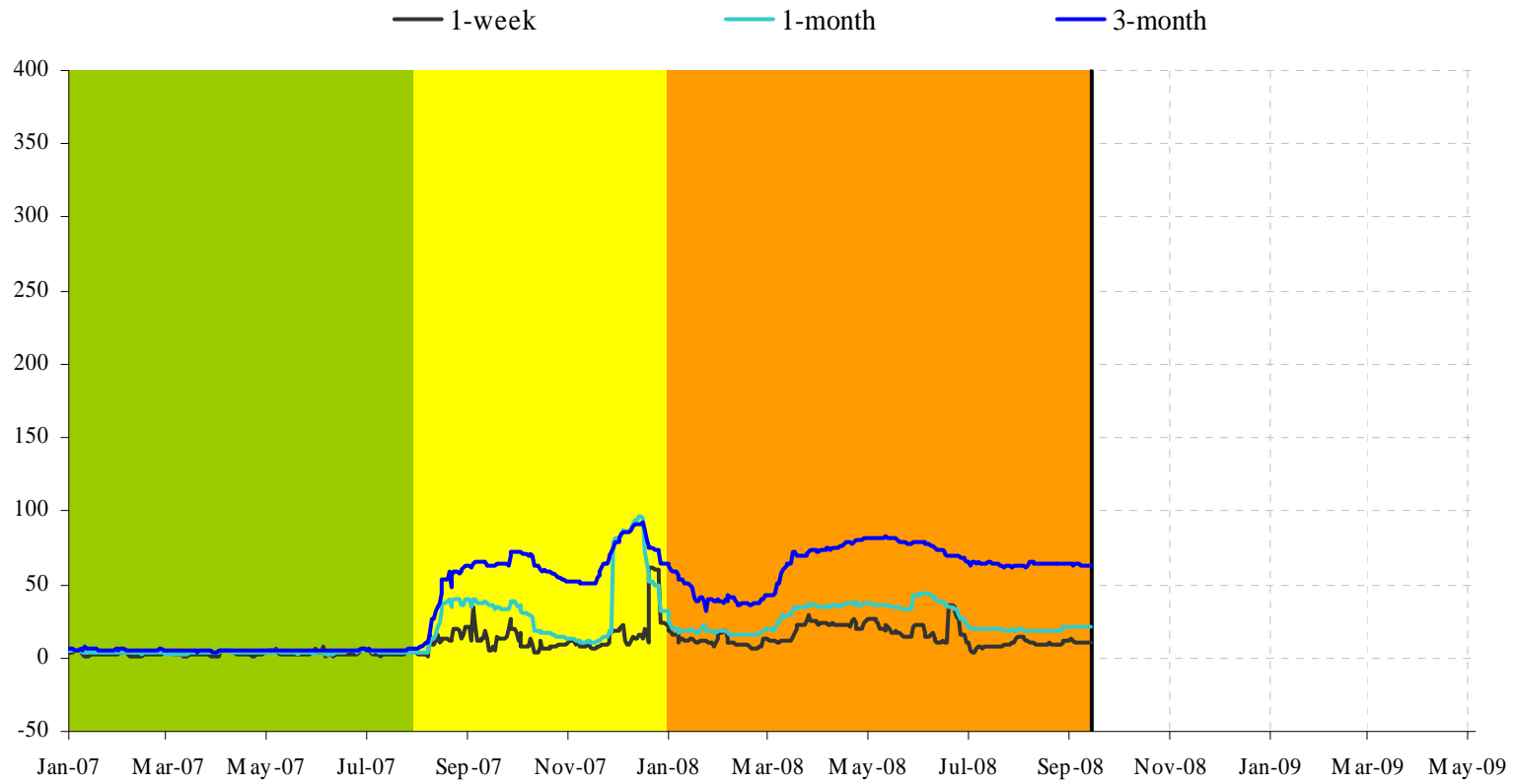
# Important features of financial system

- **Significant differences in financial structure in the US versus the euro area:**
  - Much larger share of MFI loans in household and business financing in the euro area (more like Japan);
  - Much less important securitisation activity. At its peak 3% of GDP in the euro area versus 17% in the United States.
- **Less need for direct intervention in credit markets (CPFF, TALF); more focus on funding of the MFI sector.**

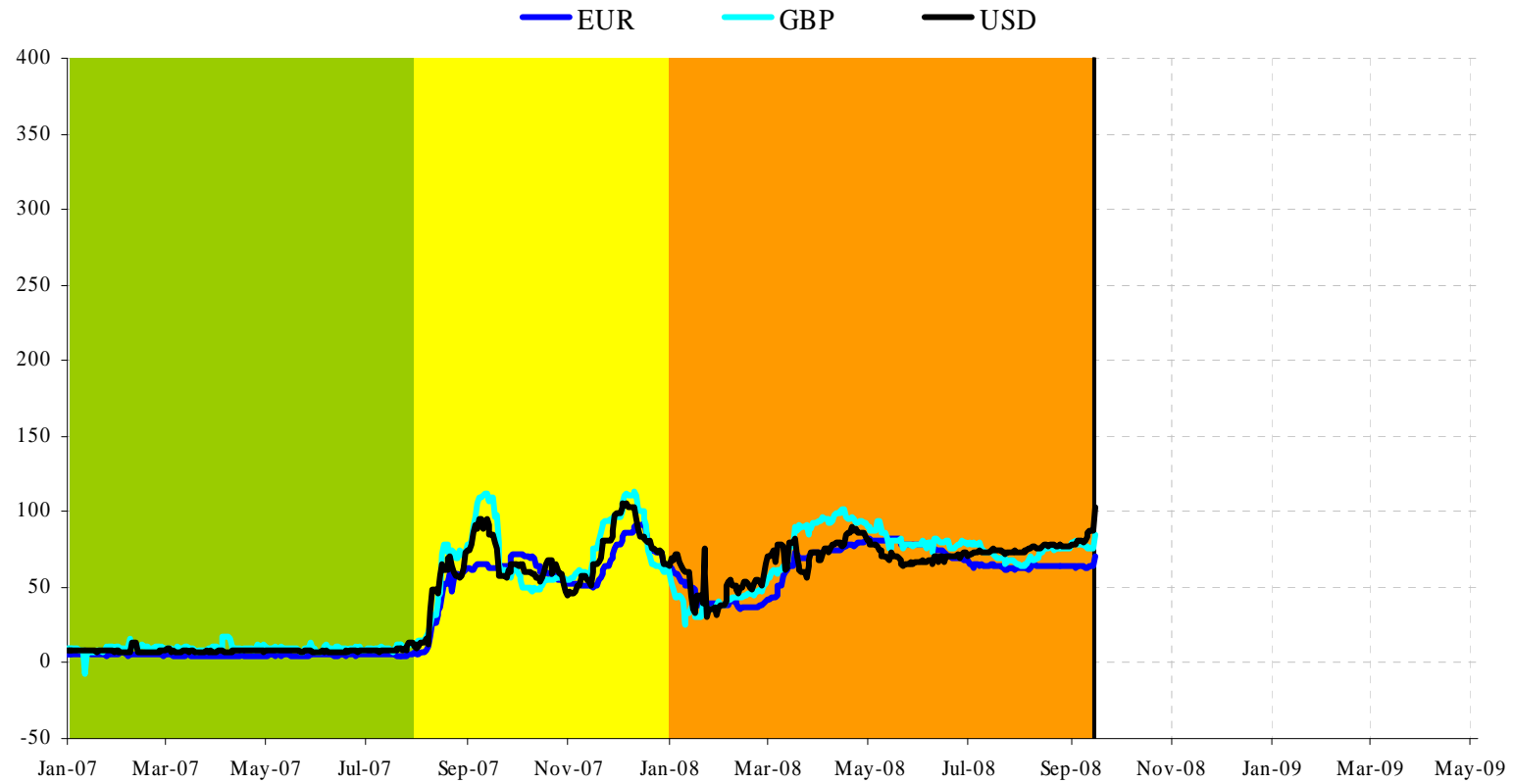
# Financial turmoil phase (Aug07-Sep08)

- **Separation principle maintained:**
- **Liquidity management policy much more active to avoid that MFI funding problems turn into solvency problems:**
  - **Front-loading of liquidity in the maintenance period;**
  - **Fine-tuning operations to keep EONIA close to the minimum bid rate;**
  - **Lengthening of maturity of operations to increase certainty in liquidity management;**

# Euribor – Eonia swap rate spread

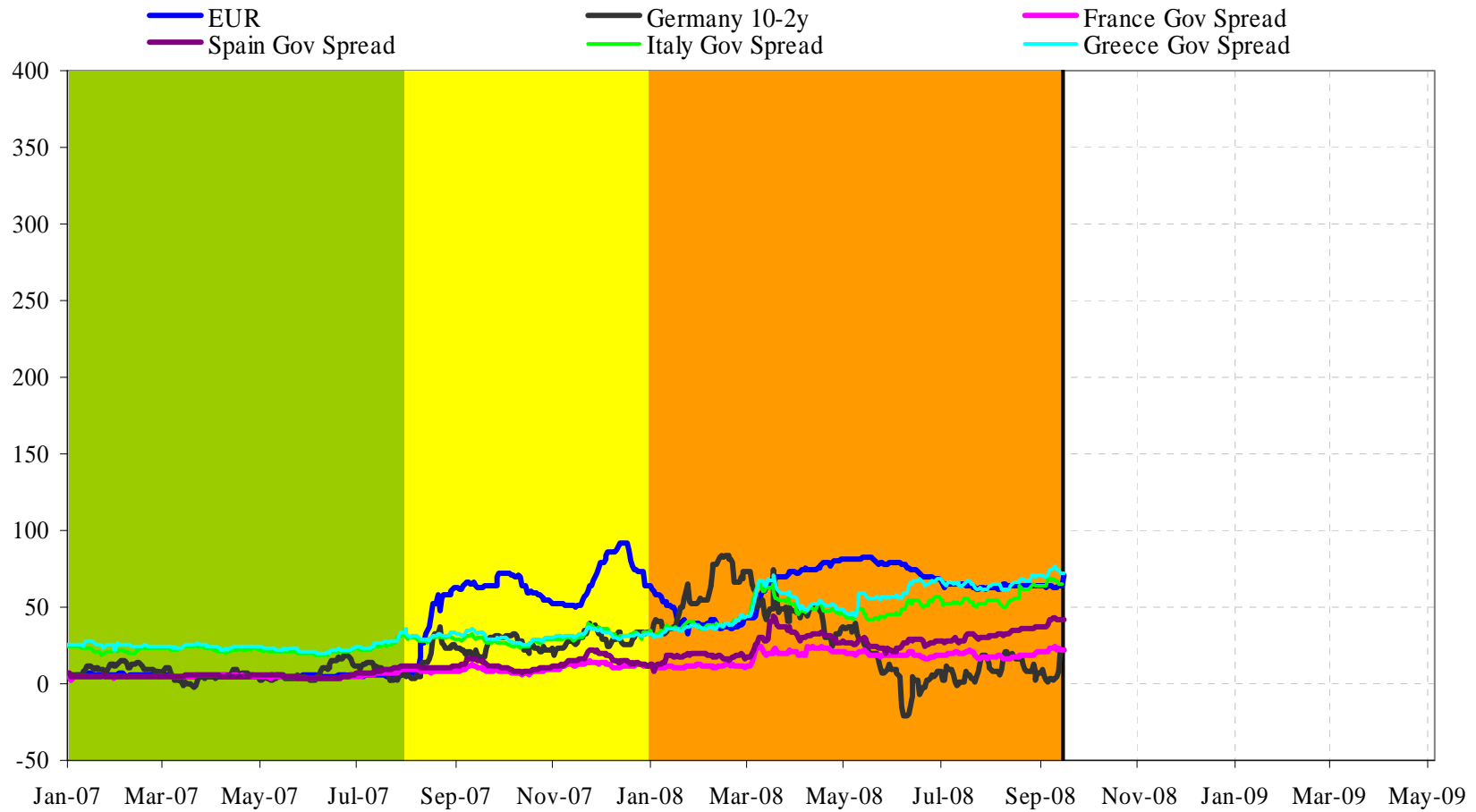


# Spread between 3-month Deposit and Overnight Index Swap rates

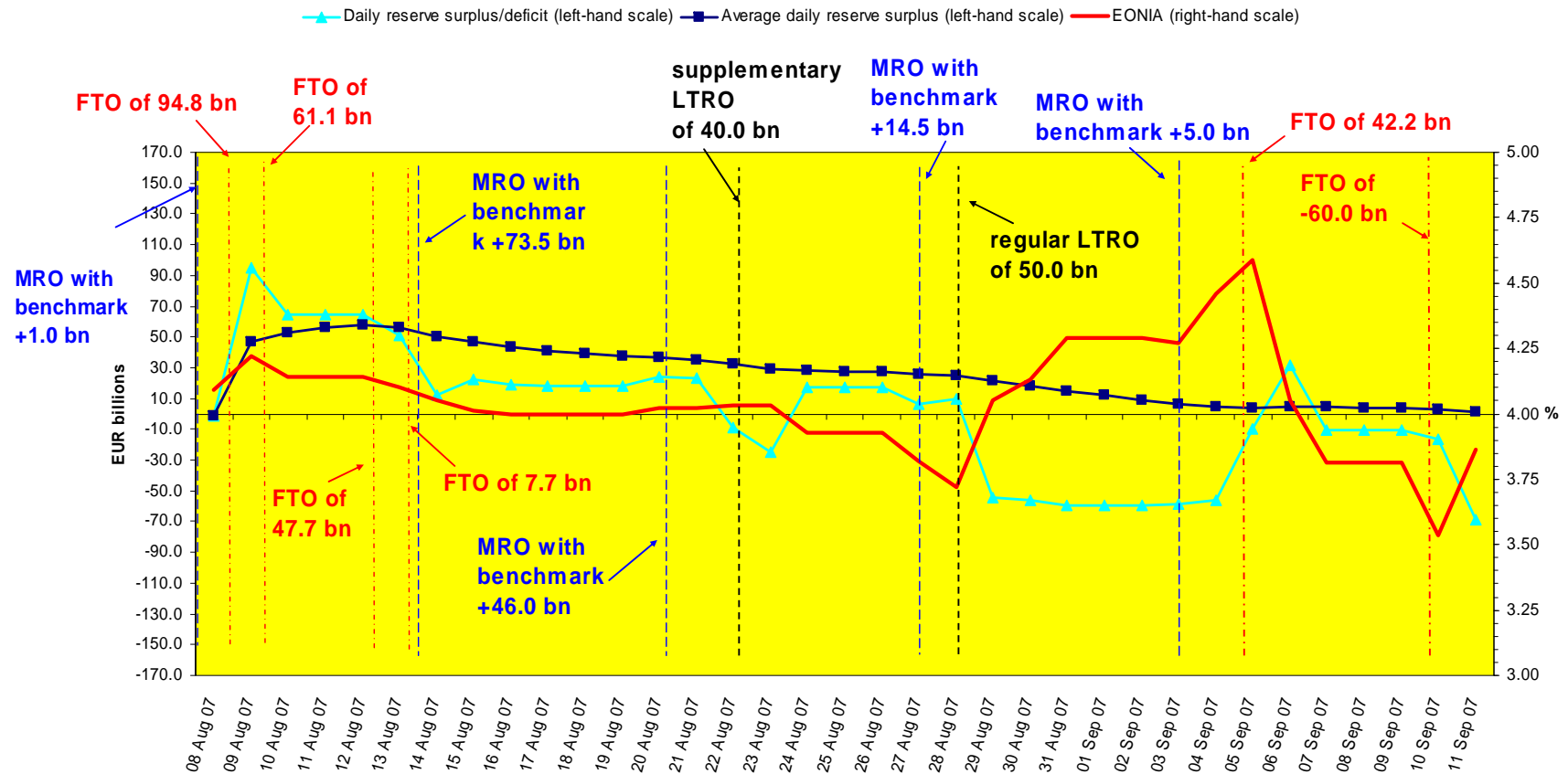




# Intra-euro area government bond spreads

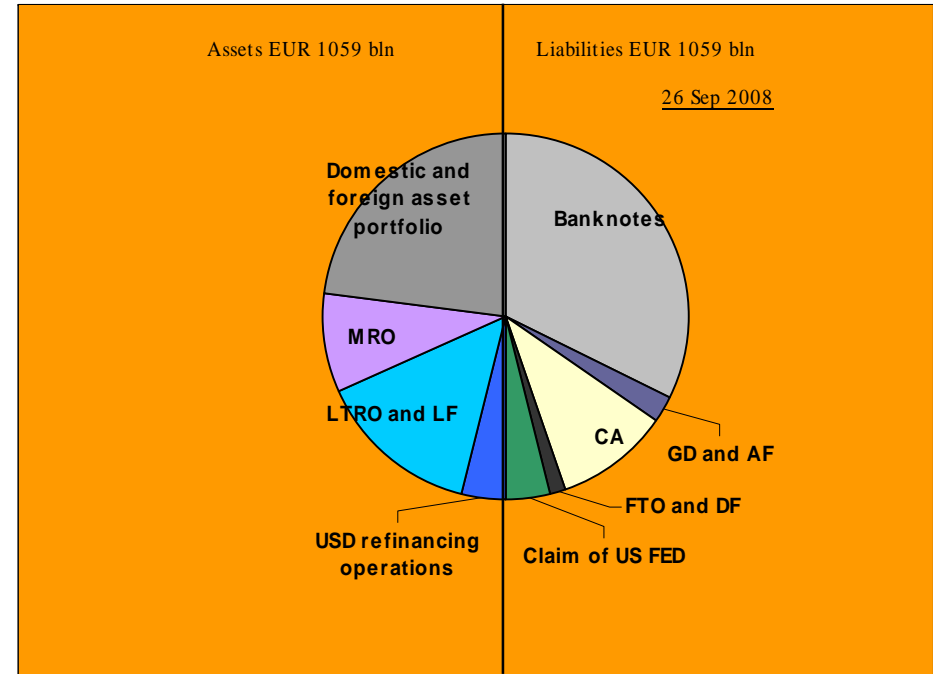
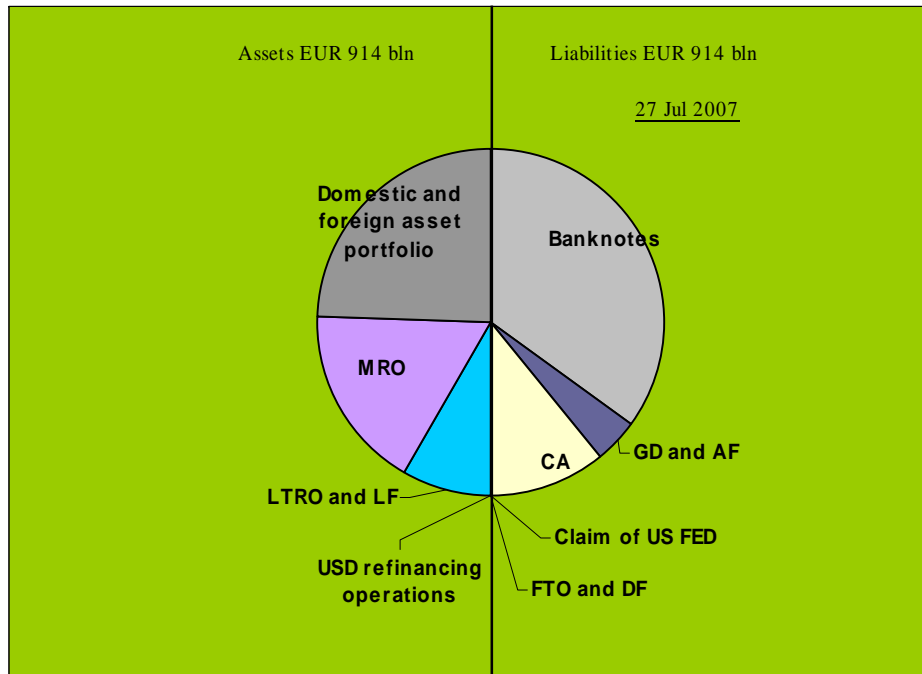


# Maintenance period 8 August – 11 September 2007



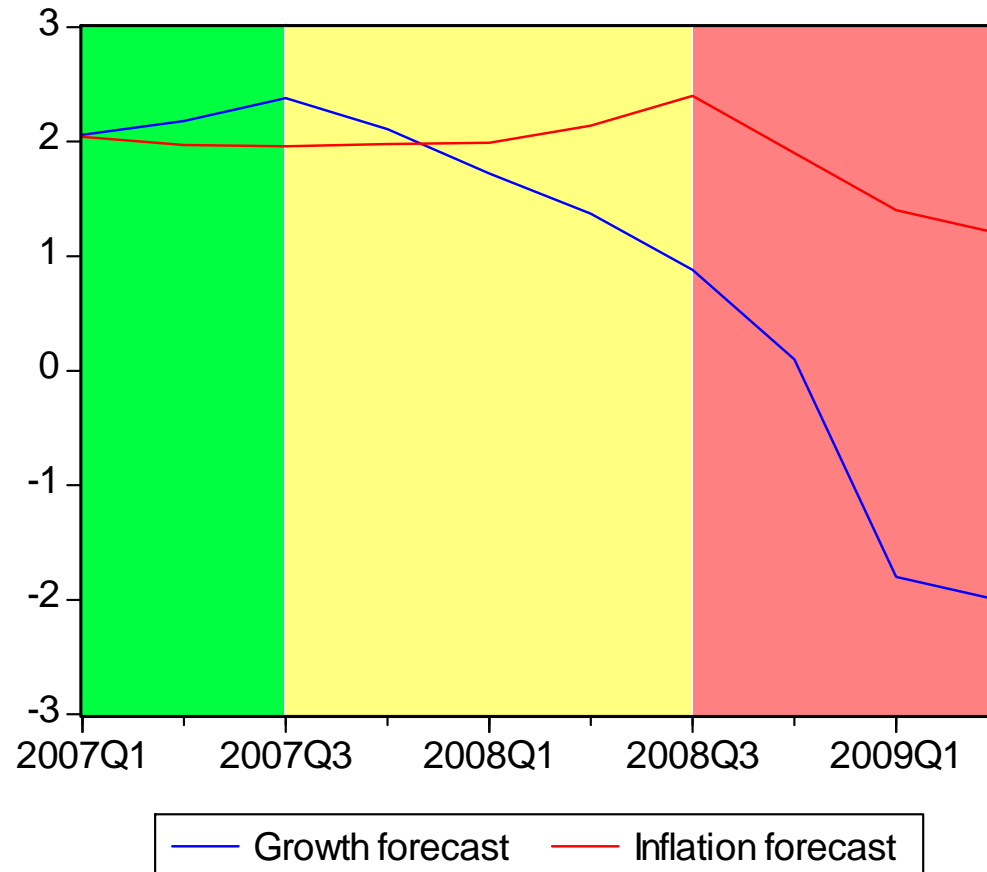


# Consolidated balance sheet of the Eurosystem

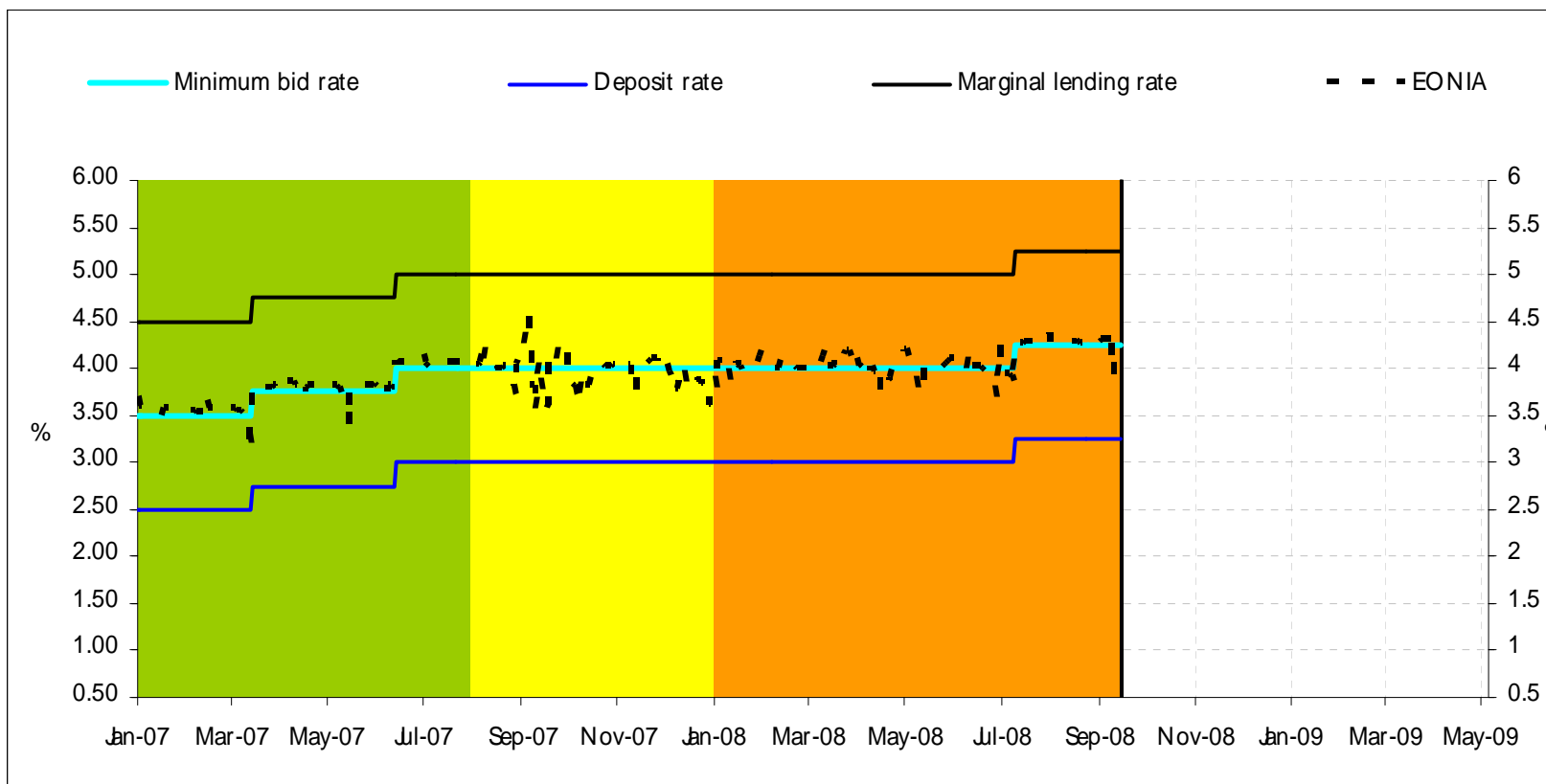


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# ECB rates and EONIA



# Financial and economic crisis (Sep08-?)

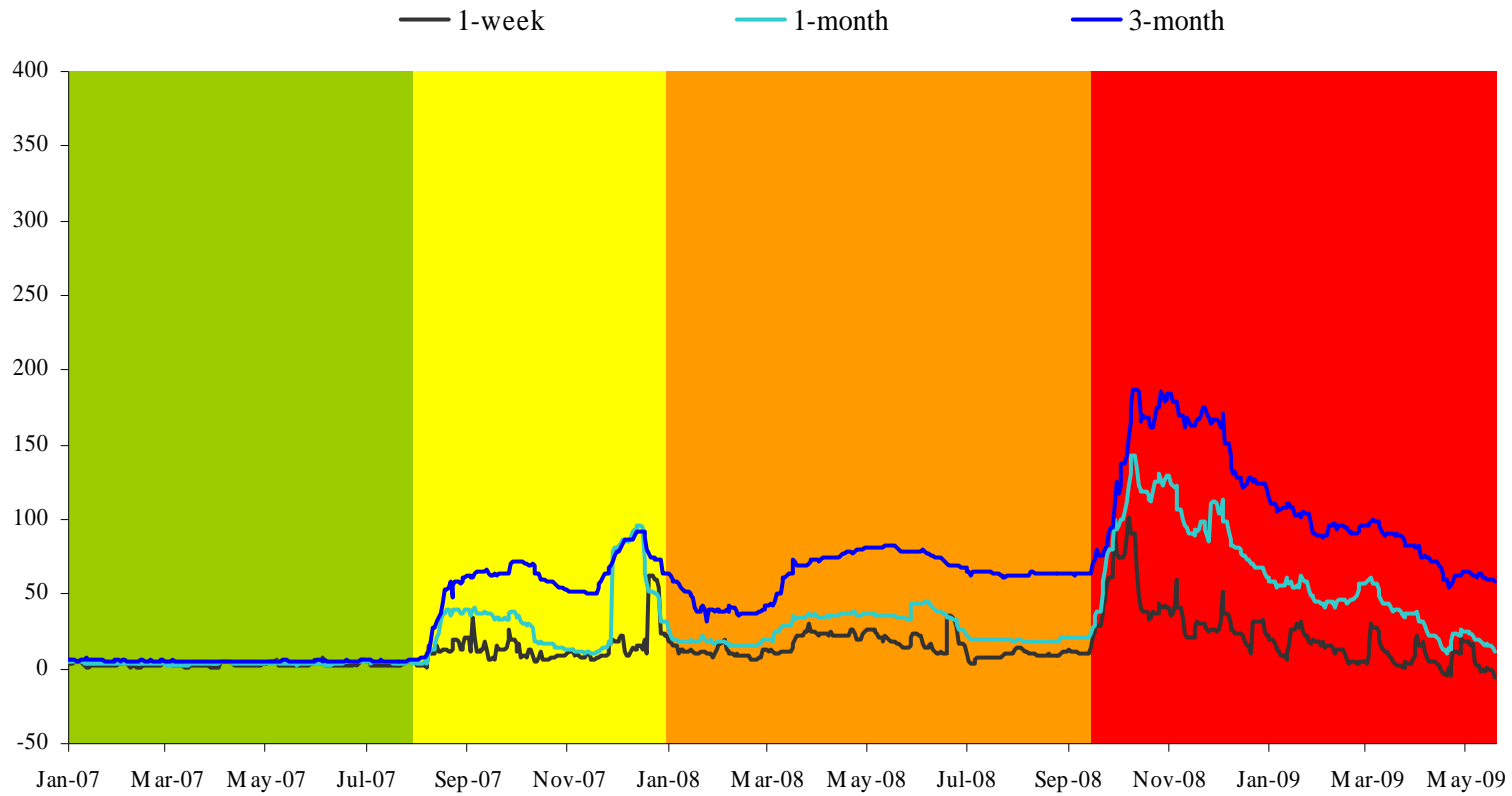
- **High uncertainty following the collapse and near-collapse of a number of financial institutions:**
  - **Complete breakdown of the interbank market;**
  - **Clear feedback loops to real economy and geographically.**
  - **General rise in risk aversion.**

# Financial and economic crisis (Sep08-?)

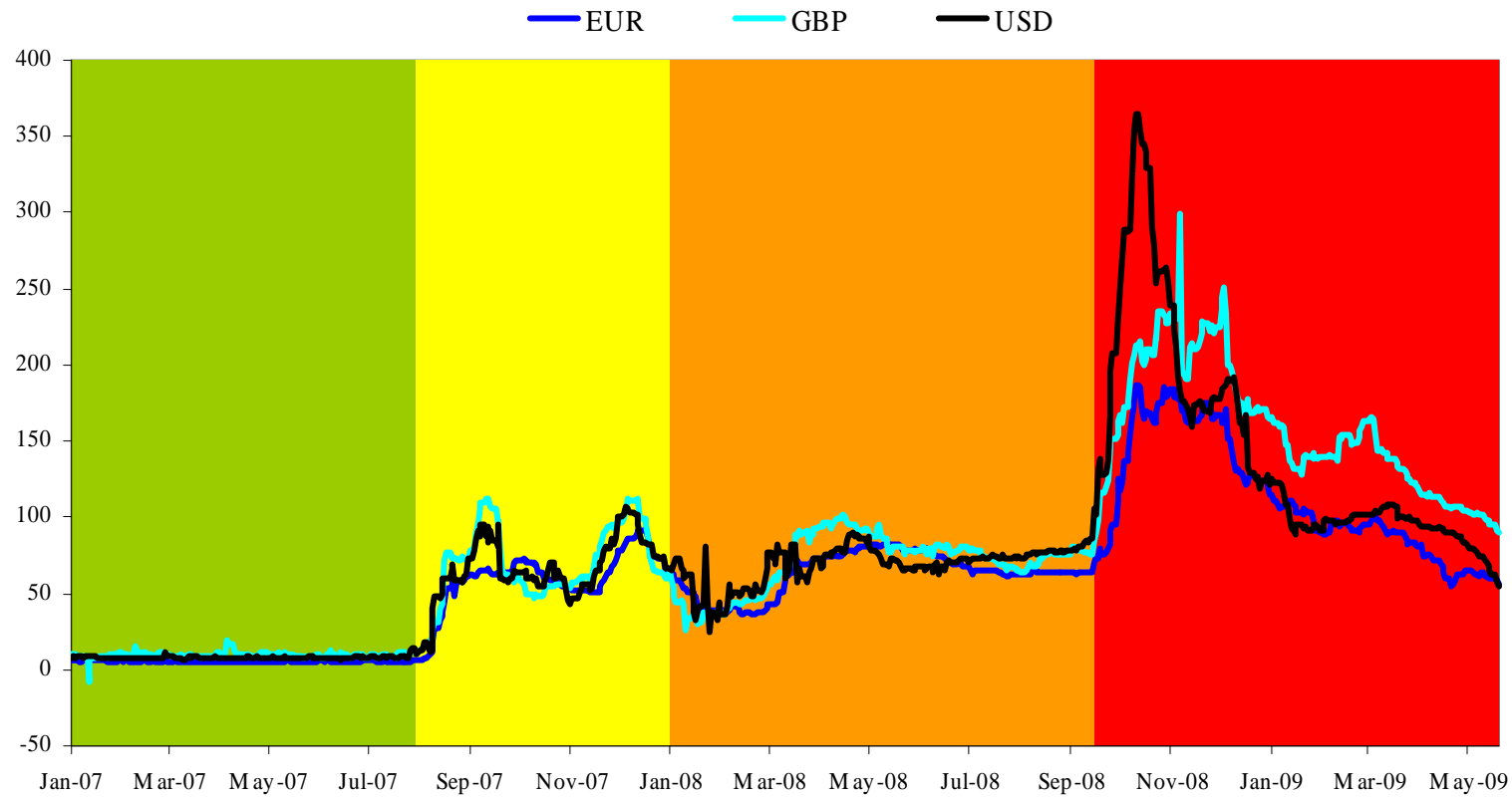
- **Coordinated interest rate cuts; and extended use of dollar swaps.**
- **Full allotment at fixed rate, no fine-tuning operations, but expansion of balance sheet.**
  - **As a result the MRO rate becomes the upper bound of the corridor and EONIA rate drops to close to deposit rate.**
- **Further lengthening of operations;**
- **Wider collateral set.**



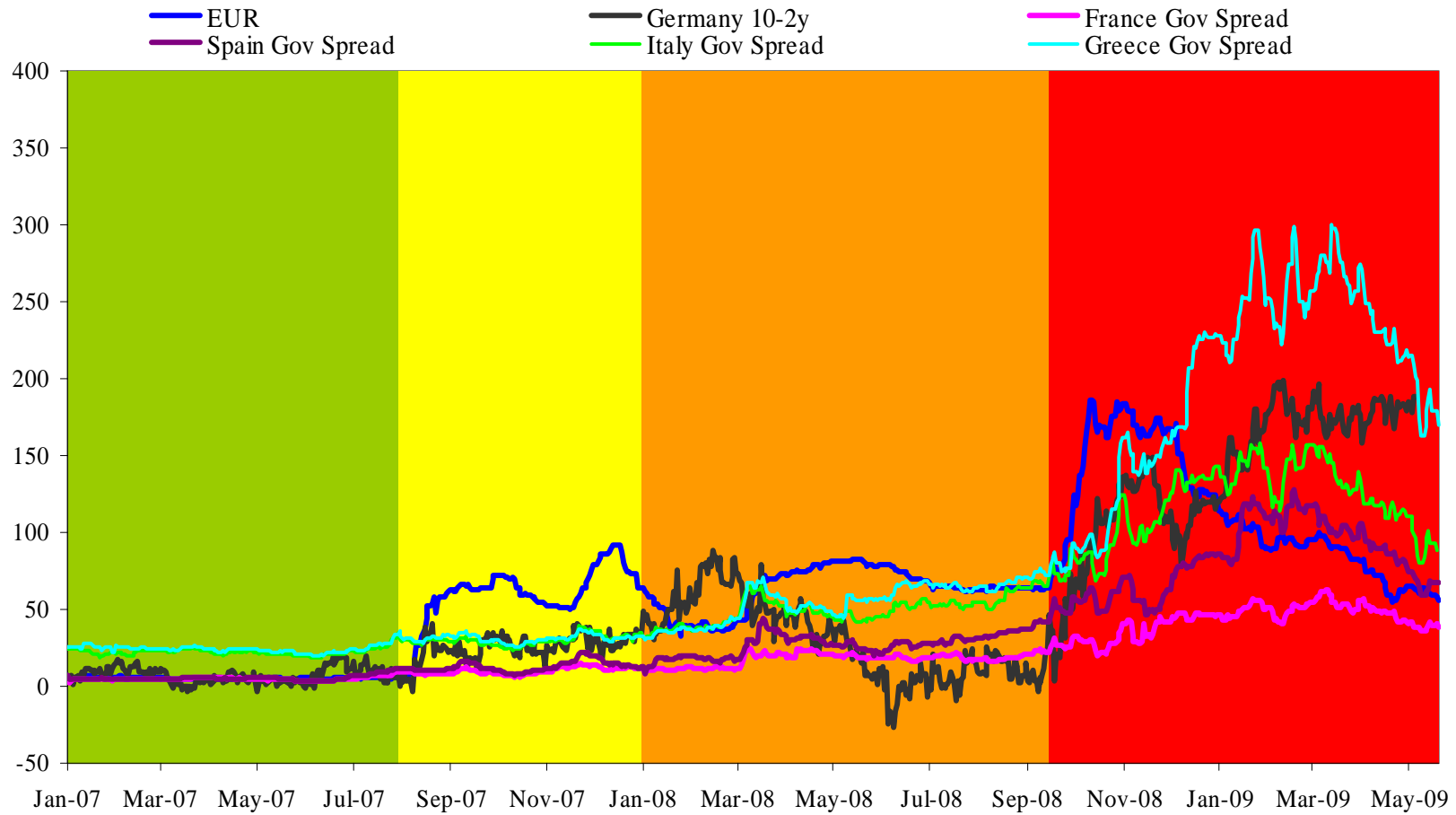
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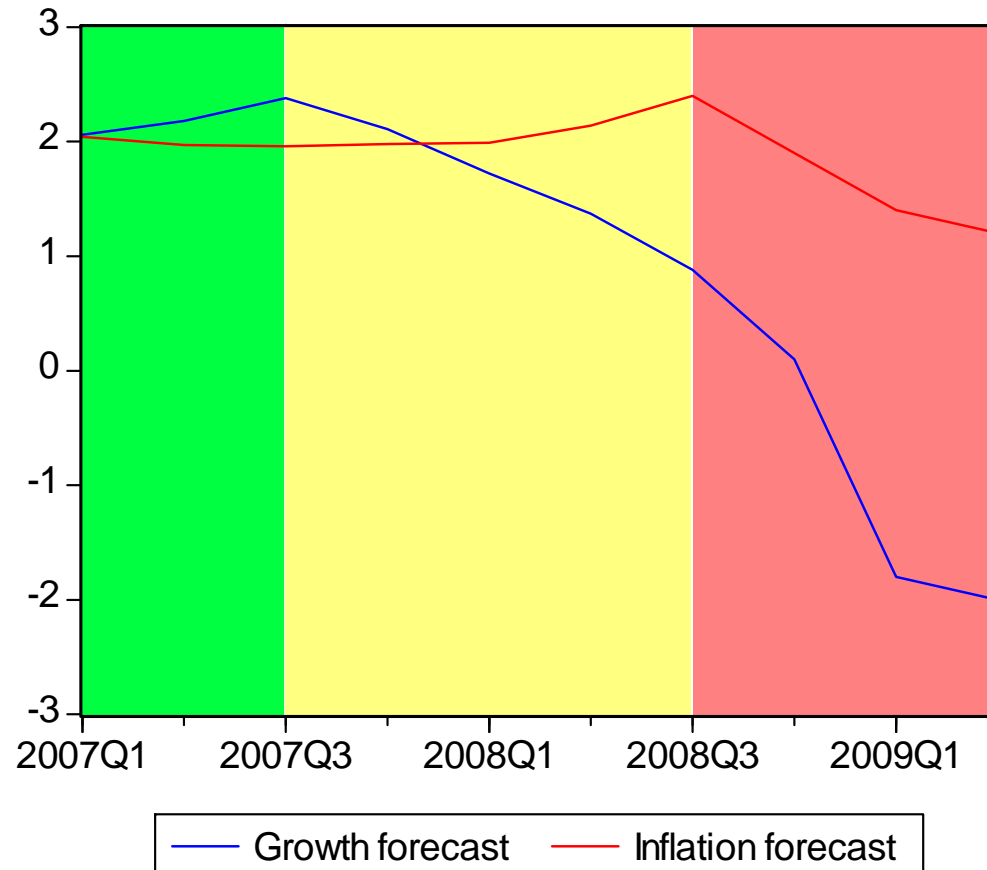


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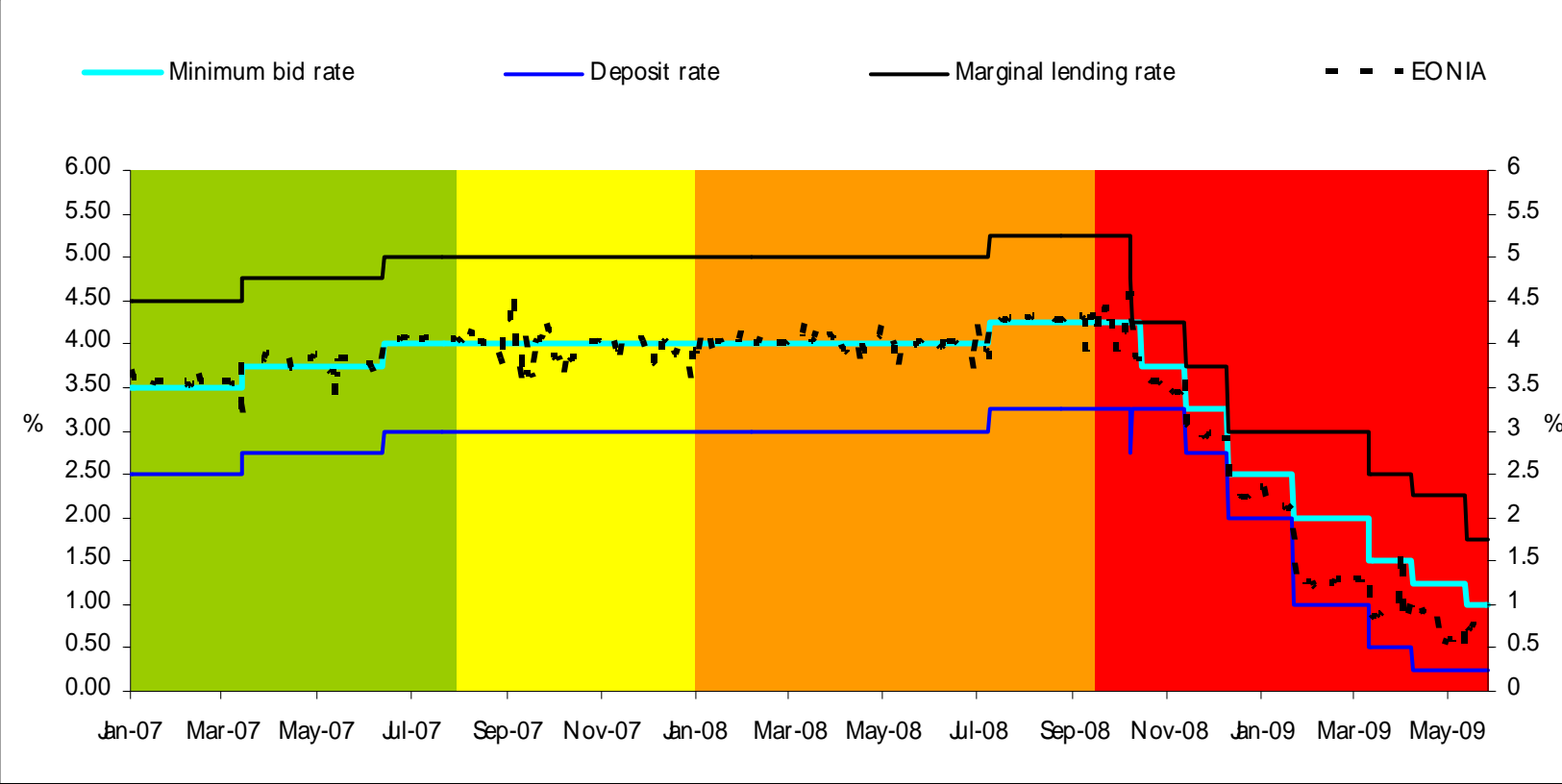


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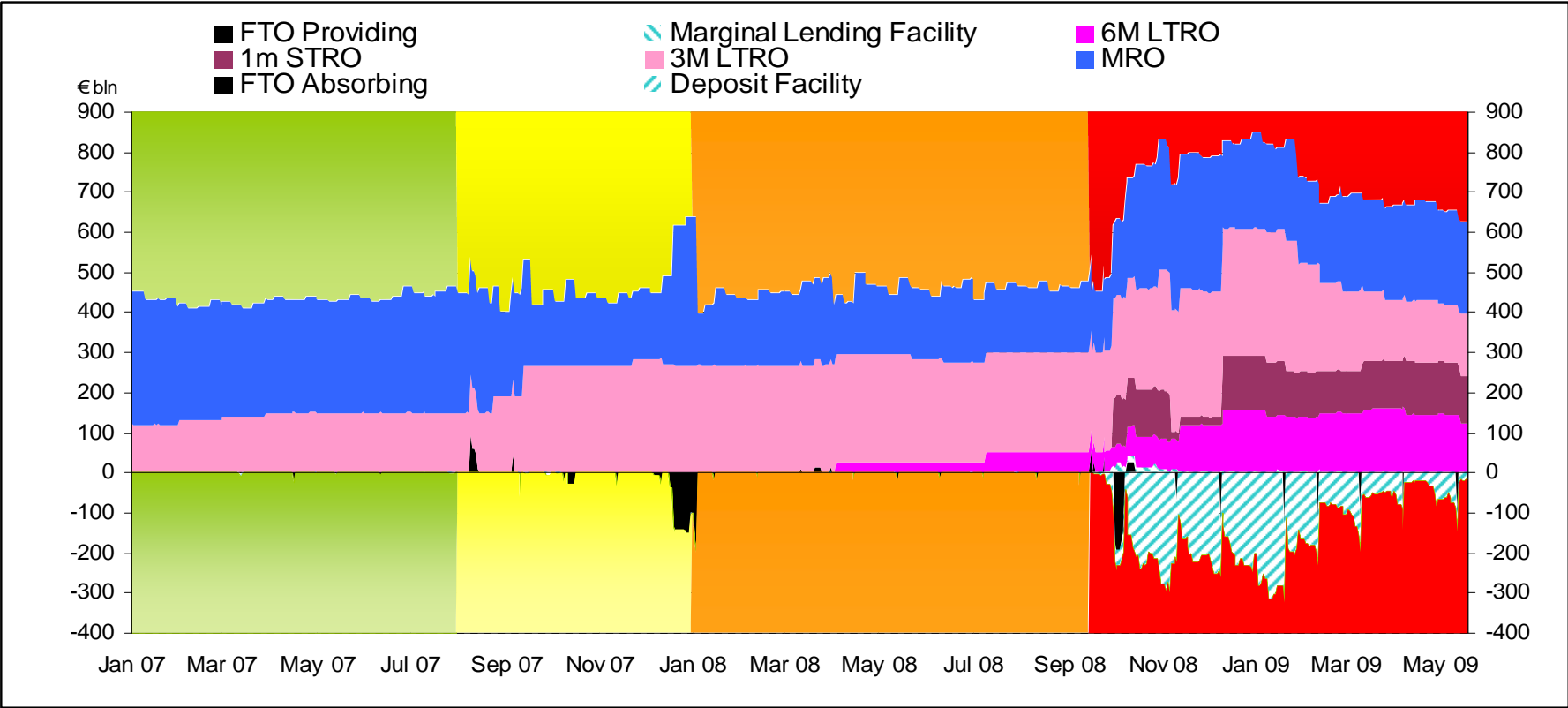
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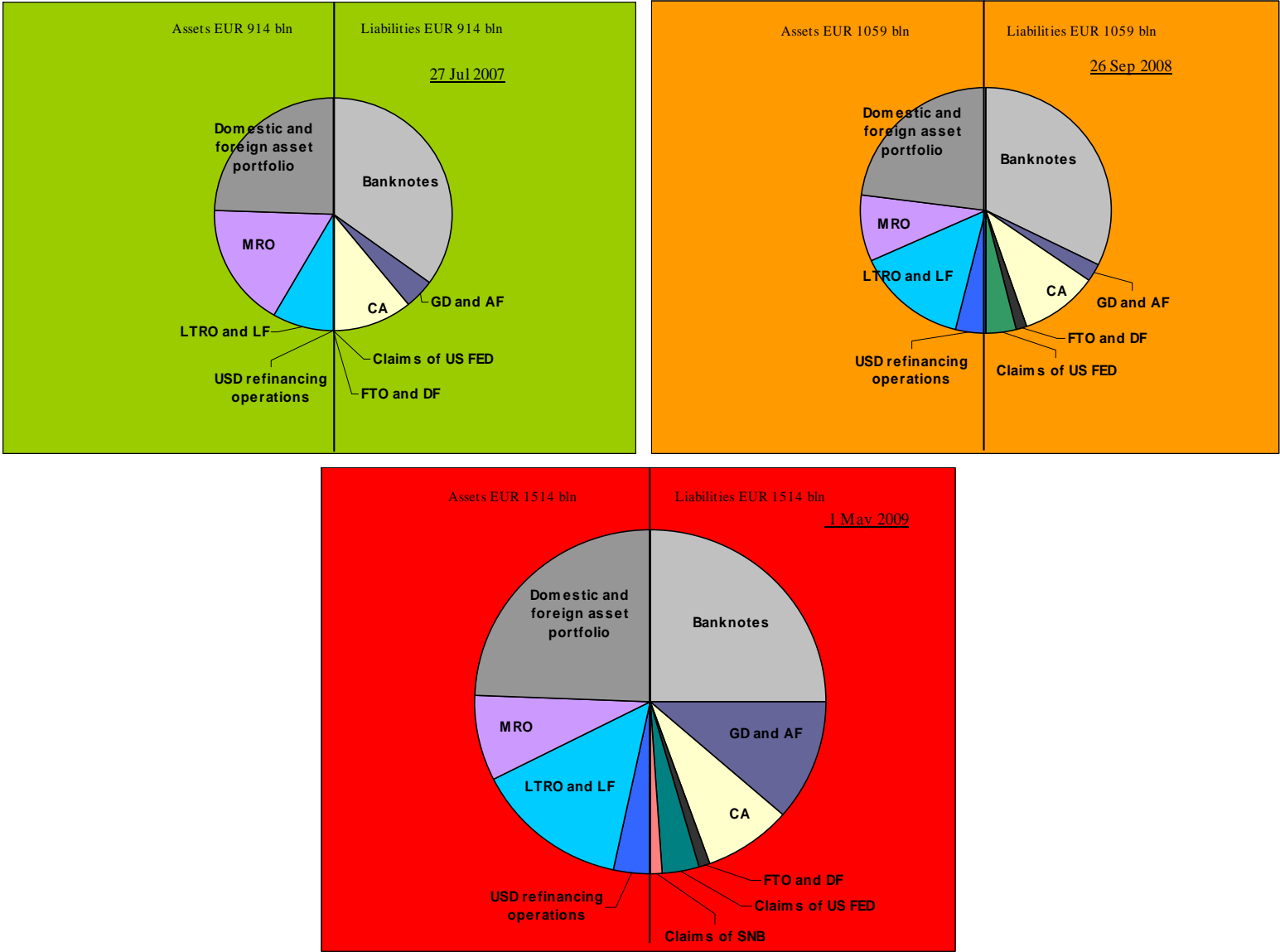
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# Phase IV?

- **Short-term interest rates close to the lower bound.**
- **What's next: Three measures have been announced:**
  - **EIB becomes a counterparty of the ECB;**
  - **Further lengthening of maturity of LTROs to one year; financing will be there till 2010;**
  - **Outright purchases of covered bonds**