“Financial Globalisation and Financial Sector Development in South and Central Asia”

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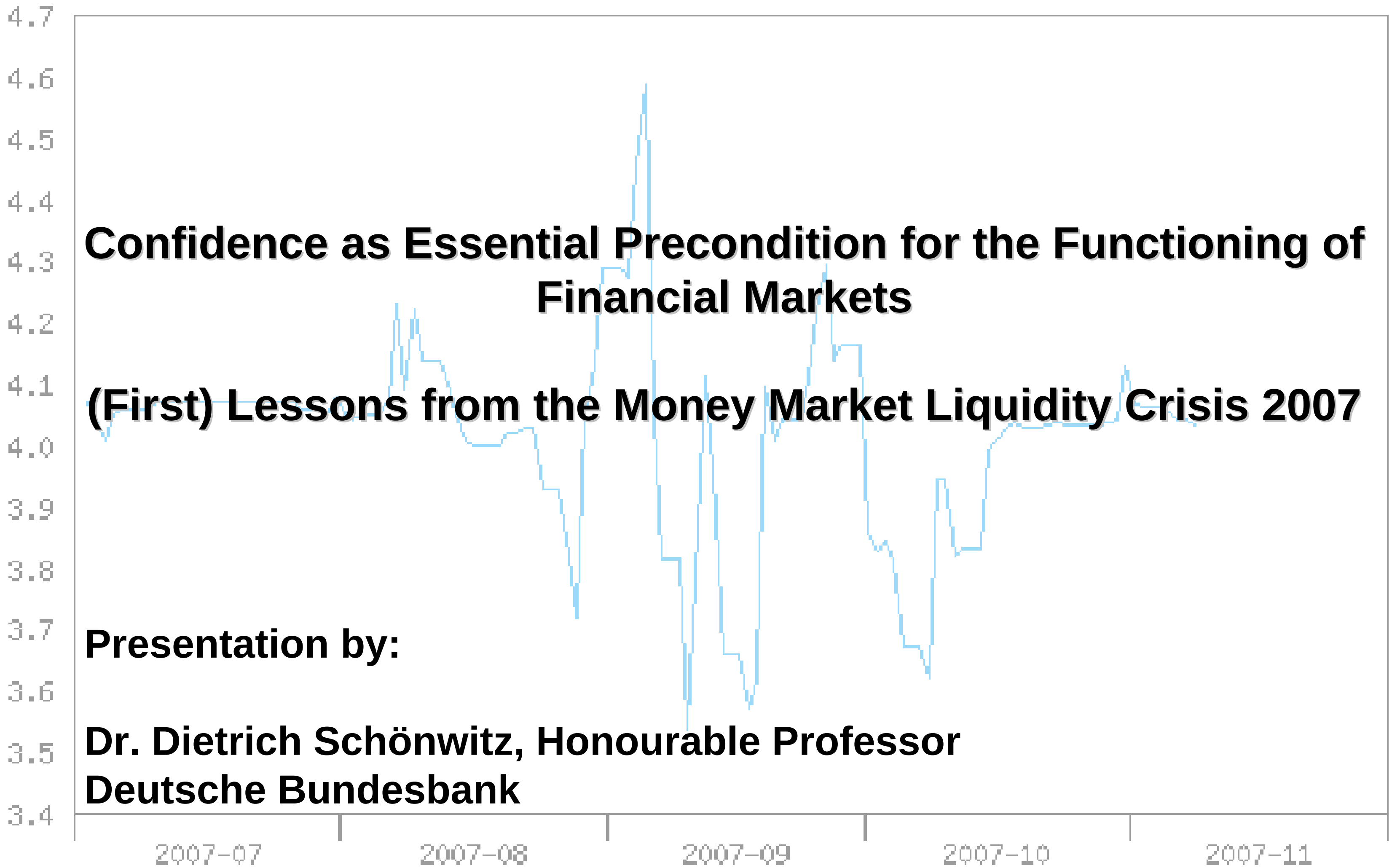

Confidence as Essential Precondition for the Functioning of Financial Markets

(First) Lessons from the Money Market Liquidity Crisis 2007

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I hope, we will be able to improve **<u>confidence</u>**. **<u>Confidence</u>** is essential to prevent spillover effects of the financial turbulences to the real economy.

Joaquin Almunia, EU-Commission, in October 2007

After the turbulences the banks are concerned to reestablish **<u>confidence</u>** among each other and with respect to the customer.

Josef Ackermann, Chairman of the Board, Deutsche Bank, in October 2007

Agenda

1. Introduction: On the relevance of soft factors in economics and the liquidity crisis 2007

2. What happened first: Houseprice bubble and subprime mortgage defaults in the US

3. Transmission of turbulences to the money markets by structured financial innovations and risky refinancing behaviour

4. Liquidity crisis as confidence crisis

5. The ECB's concept of crisis management and the open market operations from August to September 2007

> **5.1.** Acceptance of lender of last resort commitment
> **5.2.** The ECB's flexible liquidity management

6. Lessons and some proposals – a tentative approach

Chart 1: Origin

The crisis began in the American province and not at Wall Street.

- promoted by very low interest rates and a liquidity surplus
- risky subprime mortgages for people with low income and standing (100 % credits, 2/28 mortgages, "Ninja-loans")
- irrational exuberance on both sides of the loan market
- house price "bubble"
- estimation of possible subprime defaults: 20 %.

"...we are deeply concerned about the potential contagion effect from poorly underwritten or unsuitable mortgage and home equity loans."

(Association of Mortgage Insurance Companies of America - MICA, July 2006)

The warning from MICA came exactly one year before the money market turbulences in the US, in the Euro Area and in Great Britain began and central bank's assistance actions started.

Chart 2: Contagion

Spread of risks around the world by securitisation

- asset backed securities (ABS) respectively mortgage backed securities (MBS)
- possibility to sell risks and get them out of the books
- estimation: for about 50% of the mortgage loans in America in 2005 and 2006 ABS were issued.

Structured products as collateralised debt oblogations (CDO's) affected transparency and adequate rating of risks.

Conduits financed capital market investments in CDO's about 30% short by revolving Commercial Paper issue on the moneymarket and thereby did not follow the traditional banking principle of machting maturities.

Transmission of turbulences to the money markets because of subprime defaults and loss of confidence.

Even banks with a liquidity surplus cancelled their credit lines to counterparts as soon as possible.

Dramatically declining market for Commercial Paper.

Chart 3:

ECB’s commitment and national private support for special institutes

The Governing Council of the ECB accepted a lender of last resort commitment because the risk of a systemic crisis affecting even otherwise solid banks.

This was a deliberate decision without undue hesitation against a “hands-off-concept” because of moral hazard apprehension and bail out arguments.

Flexible liquidity management in addition to the prescheduled refinancing operations to provide central bank liquidity and restore confidence, no interventions on the capital market.

Banking supervisory authority, Deutsche Bundesbank and Minister of Finance engaged for assistance by the banking community for special institutes in need (e.g. Sachsen LB) – no bail out by taxpayers money in Germany.

Chart 4: Benchmark allottment

The **daily liquidity need** and the **benchmark allottment** for central bank money is determined by

- minimum reserve obligations
- currency in circulation
- foreign assets
- government deposits with the Eurosystem

Chart 5: Eurosystem's frequently used tools of monetary policy

1. Open market operations

- Longer term refinancing operations as variable rate tenders (*2006: about 30% of liquidity supply)*
- Main refinancing operations as variable rate tenders with minimum bid rate (*2006: about 70% of liquidity supply*

2. Standing facilities

- Marginal lending facility
- Deposit facility

both have only marginal influence on the liquidity situation

3. Minimum reserve

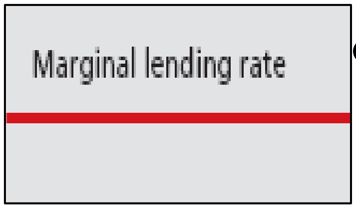
causes 40% of the daily liquidity need

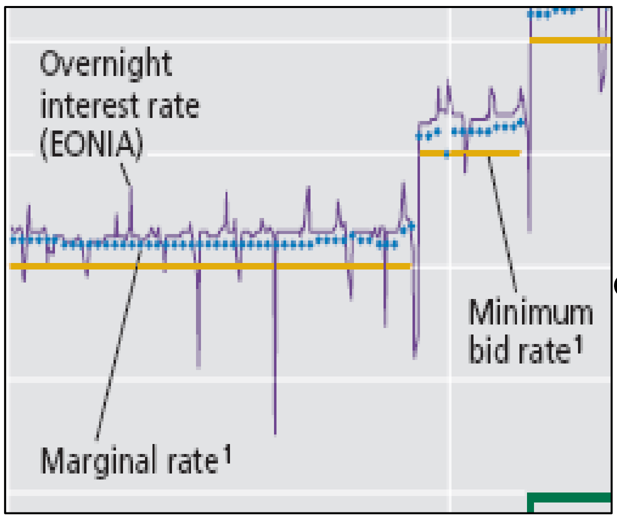
4. Fine tuning operations mainly at the end of a minimum reserve period to provide or absorb liquidity resulting from wrong expectations

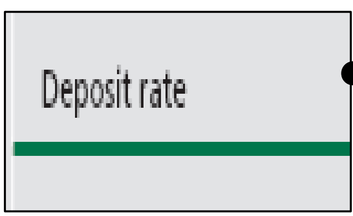
- Variable rate quick tenders with minimum bid rate (*providing)*
- Fixed rate quick tenders (*absorbing)*

both have only marginal influence on the liquidity situation

Chart 6: Money market liquidity management







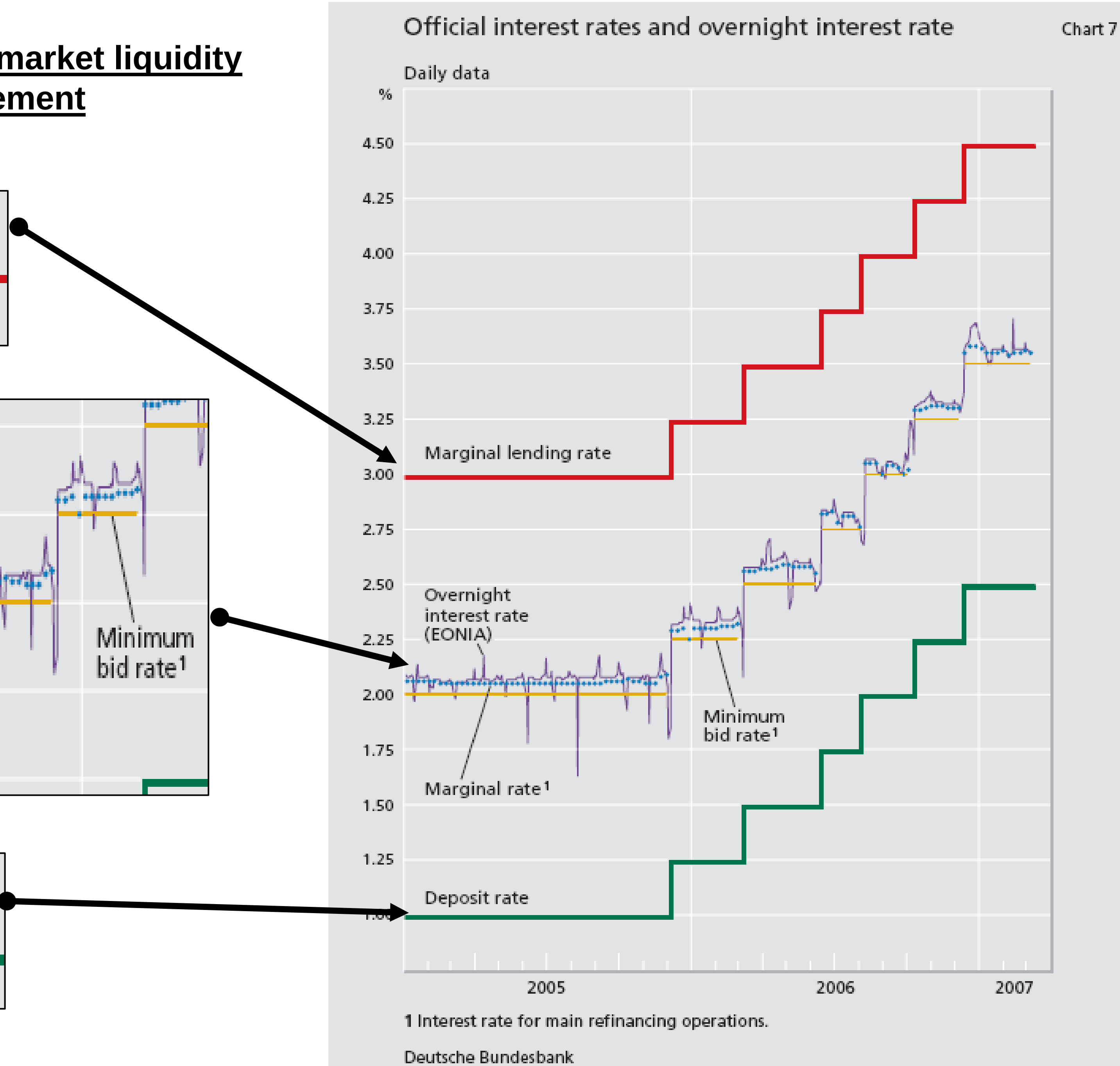


Chart 7: Careful communication

The ECB prepared and accompanied the additional tender operations by careful communication to the public.

“The ECB notes that there are tensions in the euro money market, notwithstanding the normal supply of aggregate euro liquidity. The ECB stands ready to act to assure orderly conditions on the euro money market.”
(Monthly Bulletin, Sept. 2007)

This follows the insight of modern central banking that management of expectations by means of communication policy - by openness and not secrecy, by transparency and not closed shop behaviour - contributes to the efficiency of monetary policy.

Communication of private banks to the public during the turbulences contributed not always to the restoration of confidence (e.g. information about depriciations with some delay).

Chart 8: Turbulences

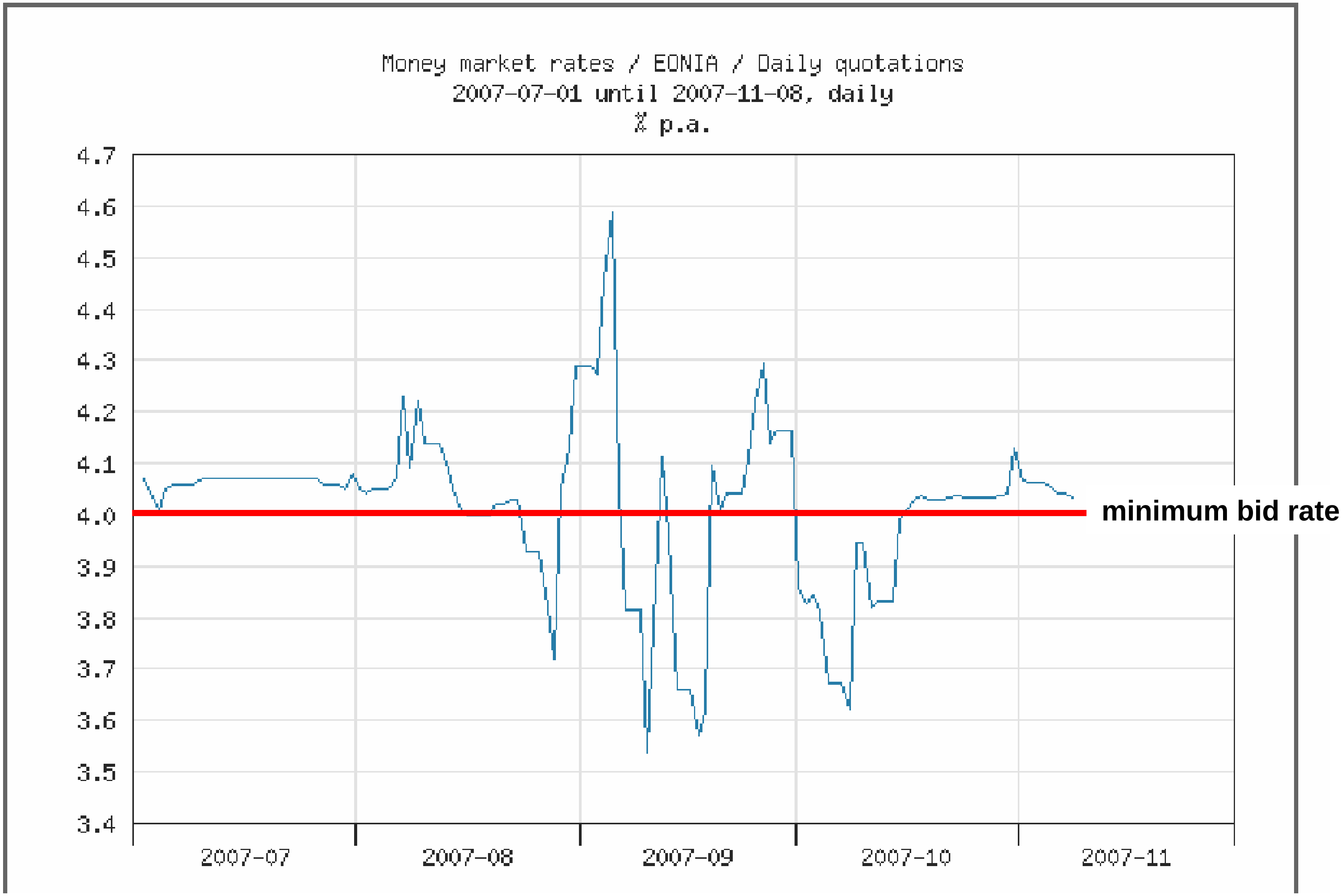


Chart 9: ECB's fine-tuning operations in August 2007

Date	Maturity	Allottment amount (bill €)	Rate (in %)			Number of bidders	Bid-cover-ratio
			fixed (f) minimum (m)	marginal	average		
9	overnight	94.8	4.00 (f)	-	4.00	49	1.00
10	overnight	61.1	4.00 (m)	4.05	4.08	62	1.80
13	overnight	47.7	4.00 (m)	4.06	4.07	59	1.77
14	overnight	7.7	4.00 (m)	4.07	4.07	41	5.97

Chart 10: Strategy

Distinction between the confidence crisis tensions on the money market and the still existing – but for a certain period not completely accessable liquidity surplus in the Euro Area.

"Against this background, and with money and credit growth vigorous in the Euro Area, the ECB's monetary policy stands ready to counter upside risks to price stability as required by its primary objective."
(ECB, Monthly Bulletin, Oct. 2007)

Lender of last resort commitment, this is the clear message, does not imply a weakening of the medium term price stability orientation, on the contrary. To manage and anchore expectations in line with price stability *"... is the more important at times of financial market volatility and increased uncertainty."*

(Jean Claude Trichet, President of the ECB, Press Conference 9 November 2007)

Contrary to the FED and the BOE the ECB reacted to the crisis on the Euro money market not with a reduction of the minimum bid interest rate – but with a combination of short term and longer term liquidity management.

Chart 11: Eight proposals for further discussion

1. The possibility of a systemic crisis justifies to weigh a lender of last resort commitment against moral hazard and bail out arguments.
2. The principle of subsidiarity should not be neglected (e.g. liquidity pool founded by the banks).
3. A careful communication to the public, openness and not secrecy plus final target orientation contribute to confidence (modern banking as management of expectations by means of communication policy).
4. Preemptive orientation supports crisis prevention, requires monetary indicator orientation and monetary analysis in addition to the analysis of economic indicators as columns of central bank strategy.
5. Asset price valuations could be included directly into the monetary policy stance (policy of “leaning against the wind” of an incoming bubble).
6. More transparency especially in context with structured financial innovations (CDO’s), rating practices and off balance sheet conduit practice is necessary.
7. The risk of irresponsible lending could be reduced if the originator of a structured product is obliged to hold permanently a note of it and thereby remains personally involved at risk.
8. Capital-liquidity requirements (loan-to-value ratios) could be varied counter-cyclically.

„There will always be intelligent people who find some back door to outwit the regulator.“

Anonymous banker

Thank you very much for your attention!

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