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Confidence as Essential Precondition for the Functioning of Financial Markets
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(First) Lessons from the Money Market Liquidity Crisis 2007

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(1) The author emphasizes the soft factor “confidence” and its importance for the smooth functioning of financial markets referring to the liquidity crisis with turbulences on the money markets of main developed western economies in the second half of 2007. The question “What can a central bank do to stabilise and improve confidence of the counterparties ?” is pointed out as a very crucial one.

(2) Irrational exuberance on both sides of the US loan market, a house price bubble and subprime mortgage defaults are identified as the very source of the crisis, which was transferred globally from the capital markets to the money markets. Driving forces for this transmission were the securitisation of credits, the financing short of investments in structured products, as “collateralised debt obligations” (CDO’s), and “off balance sheet” conduits conducting such risky business.

(3) The ECB’s concept of money market crisis management by liquidity providing fine tuning tender operations in addition to the prescheduled main refinancing operations and supplementary longer term operations was based on three insights:

- immediate risk of a systemic crisis if loss of confidence resulted in a lasting credit crunch on the inter bank money market,

- certain near money assets turned out to be not liquid any more,

- distinction between the confidence crisis on the money market and a still existing but not completely accessable liquidity surplus in the Euro Area and therefore prevailing level of minimum bid interest rate.

(4) To restore confidence the ECB based its crisis management on a careful and open real time communication. Hence, the Governing Council made clear that acceptance of lender of last resort commitment does not imply a weakening of the medium term price stability priority. This was a deliberate decision under the special circumstances of a confidence crisis even affecting otherwise solid banks against a “hands off concept” due to moral hazard apprehension and bail out arguments.

(5) In a first and tentative approach to draw conlusions the author proposes a programme of eight points for further discussion:

1. Central banks' actions of rescue as lender of last resort in addition to the final target commitment to avoid inflation must be decidedly the exception and should be justfied only when otherwise solid financial institutions are endangered (fear of systemic crisis).
2. As far as possible the principle of subsidiarity, of help yourself at first, should be obeyed. A liquidity pool for money market assistance founded by the banks could make them less dependent on central bank actions and thereby contribute to systemic confidence.
3. Careful communication, openness and clear, quantitative final target orientation of central banks, as practised more and more all over the world, improves the understanding of measures and their efficiency. Modern central banking saves confidence not at least by management of expectations. Private banks who endangered restored confidence by their piecemeal strategy to report expected losses should definitely join this trend.
4. The strategy should prefer prophylactic measures instead "mopping up the mess". The control of monetary expansion is an important contribution to act prophylactic and to steer against asset price bubbles. Therefore it is important to stick to the relevance of money stock developments and a monetary analysis and not to follow Neo Keynesian proposals to abandon this monetary column of central bank strategy.
5. To contribute to financial market stability it may be appropriate not only to analyse asset prices, but to include their valuation into the monetary policy strategy. A prophylactic policy of "leaning against the wind" of an incoming bubble implies a tightening of monetary policy stance more than it is required to keep traditional consumer price inflation on target.
6. Initiatives to improve transparency should work out proposals for the rating of complex structured financial innovations and for the transparency of distribution of risks – I think with a particular consideration of the "off balance sheet practice" of conduits and maybe implementing restrictions for credit lines from "mother" enterprises to them.
7. The risk transfer by securitisation, especially CDO's, caused irresponsible lending and default problems. This negative effect could be reduced if the originator that issued the security remains personally involved by the obligation to hold a note of the structured product.
8. Capital-liquidity requirements could be varied counter-cyclically (Goodhart). Thus the loan-to-value ratio (LTV) could be raised

when mortgage growth (and house price inflation) was low or declining, and lowered during a boom.

(6) Experts in banking supervision point out that the implementation of the Basel II rules and in this context precautions to give better account on the securitisation of credits and on credit lines for conduits by capital requirements will be an additional contribution to transparency.