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Jean Paul Fitoussi
Subprime mortgages meltdown and the behaviour of Central Banks*

How near of a financial crisis and thus of an economic crisis tout court, are we? The answer to this question depends a lot on the behaviour of Central Bankers. To understand why, a brief description of the present situation is in order.

At the outset there is the crisis of the subprime mortgage market in the US, which is rather small in size. The contagion to other compartments of the credit market, and eventually to the stock exchange arose for two reasons. The first is securitization of private debt which by itself is an intelligent way of spreading the risks so as to allow access to credit by a larger number of borrowers. It significantly reduces the amount of credit rationing in the economy. The structured finance markets allow thus the issuance of asset backed securities (ABS) and in particular asset backed commercial paper (ABCP). Usually most of ABCP are diversified, relying on a rather wide mix of assets, among which one can find in small proportion residential mortgage loans. Usually also, liquidity, in the case of an inability to roll (to pay CP on time) due to a market disruption is provided by bank liquidity facilities. Canada was a special case where the liquidity facilities are not as strong; the banks refused to pay, but market participants worked out rescue plans among themselves that will allow these conduits to be unwound over time. Some programs however are single sellers extendible ABCP, backed by mortgage collateral. But many of these programmes are insulated from market value declines by market values swap, which will ultimately protect investors; yet the banks have to buy the CP or the long-term assets that the conduits own, and the amounts are huge – ABCP programmes deleveraged by an average of €10 billion per day for the last three weeks of August. Other CP programmes lack structural protection and the investors may not get all their money or have to wait a long time before they do. Now one can understand why the loss of confidence in the latter propagates to all segments of the ABCP market, creating a liquidity crisis. The main responsibility for this contagion, and the second, but the true reason for the crisis, is borne by the credit rating agencies which did not properly distinguish between the different kinds of ABCP programs, because they were blindly believing in their sophisticated models. "Once the market lost confidence in rating agency models following the subprime debacle, the CP didn't look so safe." (Richard Robb)[1]

Hence the stepping in of Central Banks and especially the ECB was a proper reaction but it was obviously not sufficient. If confidence is lost because the market participants become conscious of their imperfect knowledge, the players would unlikely lend to each other. That arose even between banks themselves increasing the opacity of the risk structure of their assets. What begun as a liquidity crisis may well degenerate in a solvency one that could be stopped only by a decrease of the rate of interest. Apparently the President of the FED understood this point as testifies his decision of cutting the refinancing rate. The gesture was more important than its content, because of the expectations it led to.

In Europe things are moving more slowly in a context which requires exactly the reverse: a crystal clear discourse and a quick decision by the Lender of Last Resort. Only transparency and action can take care of a confidence crisis. At the contrary, the discourse of the President of the ECB is all but clear, as it sticks to its pre-crisis wording of the possibility of an interest rate hike, adding some obscure considerations about the consequences of the financial market turmoil in a way which is not increasing our understanding. What seems to be clear from his message is that the crisis helped to return to a normal pricing of risks. What was abnormal according to his view was the flattening of the interest rate curve in the pre-crisis period.

[*] I am indebted to Richard Robb and Roman Frydman for their comments on an earlier draft of this paper.
[1] This is a quote from a mail sent to me by Richard Robb, Columbia University.

There may even be some truth in this statement, but it does not help to cure a confidence crisis.

What may explain this European specificity is a convergence of two ex-ante contradictories lines of thought. The first seeing any alleviation of “the pain” of the market as a reward to speculators, the second stemming from the strong believers in general equilibrium economic theory according to which the variation in asset prices is just reflecting an exogenous shock, “a reduced appetite for risk”. Whatever their widely different roots the two lines of thought converges towards the conclusion that nothing has to be done, as if such passivity would not arm the “real economy”. And indeed the question is phrased in those terms: will the subprime crisis affect the real economy? Of course, it will: how can one imagine, even for a second, that a decrease of asset prices (especially housing prices) and an increase in the average rate of interest (through an increase in the risk premium) would not have negative consequences on growth and employment? As Chairman Ben S. Bernanke put it: “It is not the responsibility of the Federal Reserve – nor would it be appropriate – to protect lenders and investors from the consequences of their financial decisions. But developments in financial markets can have broad economic effects felt by many outside the markets, and the Federal Reserve must take those effects into account when determining policy”[2]. It is only recently on August 27 in Budapest, that President Trichet corrected its preceding statements – "What I said was before the market turbulence" – letting us know that the ECB is paying close attention to the liquidity crisis and may not tighten on Sep 6.

The ECB understands its mission as one of anchoring inflation expectations around its inflation goal. It does not seem to fully understand that it has also the duty of managing expectations about the real economy. Now what has been termed colourfully “a reduced appetite for risk” may well reflect a radical shift in expectations about the real economy. In this context, raising interest rate would not be a sign of independence from the ECB, but the sign that it is misunderstanding its role.

This episode reflects also the obvious, but not widely recognised fact that we are leaving in an imperfect knowledge world, one where uncertainty is pervasive. In this word, the informations for a perfectly rational calculus are just missing, and the framework of dominant economic theory can’t be applied. (See on these questions the remarkable book by Roman Frydman and Michael Goldberg: Imperfect Knowledge economics: Exchange Rates and Risks). This applies in particular to financial markets whose role is supposed to coordinate future intertemporal plans relative to saving and investment. In such a world, notwithstanding moral hazard problems, the main task of a Central Banker is to re-establish confidence by making known by all means that he will not leave the real economy to be affected by the sudden disruption of financial markets.

To summarize:

1. It was wise for the ECB to provide the market with liquidities
2. It was not appropriate to speak to the market in such an obscure way
3. The normal reaction of the ECB should to reconsider its former discourse of “strong vigilance” (August 2) and not to tighten at its 6september meeting. If the real economy in Europe starts to slow, there will be plenty of time to decrease the rate of interest. Monetary policy has to take into account the different shocks to the economy among which a financial shock can be the gravest, as it is generally reflecting a shift in expectations about the real economy. It is the only policy instrument which can be applied timely taking into account new information stemming from the very functioning of markets.

[2] Remarks at the Federal Bank of Kansas City’s Economic Symposium, August 31, 2007: “Housing, Housing Finance, and Monetary Policy”.