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Jean-Paul Fitoussi

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The rationale for or against expanding central bank eligible collateral in times of distress

Jean-Paul Fitoussi

Executive Summary

The current crisis is testing the capacity of policy makers to give adequate answers to the possibility of a major financial meltdown. The crisis began in the subprime sector, a relatively small segment of the mortgage industry. It is thanks to an insufficiently regulated system of financial innovations that it spread to the balance sheets of all financial institutions around the world. The briefing paper does not deal with the issue of what regulatory framework we should design. It rather focuses on the short run policy response to the crisis. I will conclude that most of the burden in this specific moment falls on fiscal policy, monetary policy having reached a liquidity trap situation. Nevertheless, monetary policy still has an important role (that it played already in the past months) in providing liquidity to the markets, and in facilitating the task of fiscal policy. In this perspective, I agree with Anne Sibert's BP of March 2008, in considering appropriate a wider definition of acceptable collateral, to include also "troubled assets". This should be done in the short run, though, and a number of medium term consequences, notably on the coordination between strictly interconnected fiscal and monetary policies, should be evaluated

Last September the largest economies of the world came close to the collapse of their financial systems. The bankruptcy of Lehman Brothers triggered an uncontrolled panic, and a domino effect was averted only by a series of urgent and thus uncoordinated measures by most governments of the G7 countries.

The crisis has begun with the banks (in the US and then in Europe), to spread to all the financial institutions. Today, the whole set of financial assets is heavily depreciating, with the first effects on the real sector that begin to be felt.

This briefing paper will quickly trace the development of the crisis, and then analyze what are the tools that policy makers have available to tackle the crisis. Coherently with the request, it remains focused on the short run measures. I will not deal with the different issue of what regulatory framework should we design in the future to prevent other crises like this one to happen again. I will conclude that most of the burden in this specific moment has to fall on fiscal policy. Nevertheless, monetary policy still has an important role (that it played already in the past months) in providing liquidity to the markets, and in facilitating the task of fiscal policy. In this perspective, I agree with Anne Sibert's BP of March 2008, in considering appropriate a wider definition of acceptable collateral, to include also "troubled assets". This should be done in the short run, though, and a number of medium term consequences should be evaluated

1. The Mechanism of the Crisis

The financial crisis, triggered by a modest number of defaults on subprime mortgages, has now the proportions of a global recession. The original defaults may be evaluated at around 300 billions of US dollars, an amount that is of an order of magnitude much lower than the financial distress it created. The mechanism is by now well known: a number of households in the US were able to access to subprime mortgages, in which the very home they were buying was used as collateral. The increase of housing prices allowed them to renegotiate the loans at better rates and/or to roll over their mortgages. When the housing market began unravelling, this refinancing scheme broke down, leading to defaults and foreclosures.

The total amount of subprime mortgages is rather small, around 1 500 billions of US dollars. Even if we add credit card debt, we don't go beyond 2 300 billions. This represents about 20% of the total housing mortgages, and less than 4% of total household assets in the US (around 60 000 billions dollars).

The losses linked to the subprime mortgages could have been easily absorbed by the system with losses limited to the imprudent lenders. But these mortgages have been the heart of a chain of financial innovations that multiplied the effects of the initial shock. Thanks to these innovations the original lenders have been able to reduce their exposure to risk by packaging the mortgages into high yield securities sold to third parties. These securities were supposed to reduce the risk because of the lack of correlation between their components, and the dispersion of risks on a multitude of investors.

The party ended when the housing market slowed down; mortgages that would be viable only because the price of the collateral they were based upon was increasing, became “toxic”. The sources for refinancing households dried, and lenders driven to sell collateral of defaulting borrowers had to do it at very low prices, that imposed large losses. Risks turned out to be correlated, and their scattering through securitization, instead of being a source of security, was the vehicle for spreading the infection to the whole system. Since the summer of 2007, a defining feature of this crisis has been the deep uncertainty of financial institutions about their own health, and the health of their neighbours

This deep uncertainty made banks reticent to lend to each other, and the interbank market dried up. This forced central banks to intervene since August 2007, to refinance banks and to inject liquidity into the system (see my Briefing Paper of March 2008)

The increasing distrust among banks is at the source of an important increase in risk premia (the spread between interbank market rates and main financing rates of central banks), that has never gone back to normal since the summer of 2007.

The crisis quickly engaged in a vicious circle, as banks tried to sell their assets in order to buy safe (public) debt, and stop the deterioration of their debt to capital ratio. But this race to sell further depressed prices and the value of their assets, thus worsening things even more

Today the crisis is spreading to the real sector. In an attempt to recover more reasonable ratios, banks hoard the liquidity they obtain, and if they lend they do so at extremely high rates. On the other hand, firms tend to use their own cash flow to restore more prudential ratios of debt to capital – especially in view of the shrinking value of their shares -- thus postponing investment. Households suffer from a negative wealth effect, as the value of their assets dropped sharply, and hence are reducing consumption. The result is a generalized decrease of aggregate demand that pushes the majority of economists to forecast a recession for at least the year 2009.

2. The Policy Response

There is an ongoing debate on the long run lessons to learn from the current crisis, and on whether (and if) the financial sector should in the future be more regulated. This being said, we can notice the unusual phenomena that economists are rather consensual in their analysis of what should be done in the short to medium run to contrast the crisis and shorten as much as possible the slowdown.

The tools that are debated are the standard ones, monetary and fiscal policy. I will discuss them in what follows.

2.1 Monetary Policy

Monetary policy has been rather active, and within limits it had been effective. As said above, since the beginning of the crisis central banks have flooded the markets with liquidity, and eased credit conditions; this happened through conventional and non conventional interventions, and as I argued before (Briefing Paper March 2008), with different macroeconomic effects: while the Fed proceeded with both aggressive rate cuts (3.75 points from August 2007 to October 2008) and liquidity injections, the ECB privileged the latter measures, and started cutting rates only last October (after an increase in July 2008!). The two strategies were equally successfully in terms of providing liquidity to the interbank rates and to contrast the tendency of short run rates to increase, but had different effects on long term rates, and hence on the macroeconomic environment (European long rates remained substantially larger than their US equivalent. We may start to feel the difference now that the crisis is quickly spreading to the real sector.

Central banks also put in place non conventional interventions, with the specific objective of ensuring sufficient liquidity to the interbank market, and *de facto* substituting commercial banks in that market. Open market operations have been reinforced notably by expanding the range of assets required as collateral, and including assets whose value was difficult to determine in the market. Furthermore, central banks have increased their exposure, by engaging in longer term loans to the banking sector.

This set of measures has not been as effective as it was hoped, in restoring confidence in the interbank market. Whatever the amount of liquidity injected into the market it was of an order of magnitude much lower than the one usually reallocated through the interbank market. Until very recently, when governments intervened directly, that market remained substantially non-functional.

As successful as it has been in avoiding a financial meltdown in the 15 months passed since August 2007, basically by partly substituting commercial banks in the interbank market, monetary policy has not been able to restore confidence. Commercial banks are forced to take an important rate (and reputation) risk when they access to the central banks' lending facilities. The massive injections of liquidity into the system have been hoarded (or invested in safe public bonds) by banks in an attempt (vain, given the sharp reduction in stock market prices) to restore more sensible prudential ratios. The liquidity trap re-emerged from economic history books, and is presently well installed in our financial systems. Monetary policy has run out of steam, at least as the main tool of policy intervention.

2.2 Fiscal Policy

Fiscal policy came late into the picture. It is only with Freddy Mac and Fanny Mae in September, that governments started asking how to intervene to stop the crisis. As of today, because of the difficulties experienced by monetary policy, governments are the main actors in the management of the crisis

Like for monetary policy, fiscal policy intervention may happen by conventional and unconventional means. The consensus among economists on the unconventional means is amazing¹. While details on the implementation may differ, the consensus is that the UK plan unveiled by Gordon Brown on October 8 contained all the elements needed to address the crisis².

- a) The priority was to address the malfunctioning of the interbank market, caused by both substantial mistrust among institutions, and by insufficient capitalization of financial institutions
- b) That was done through equity injections (debt/equity swaps), and with specific conditionality (executive pay, dividend policies, and above all lending requirements) to minimize the cost on taxpayers.

¹ See for example the instant books published by VoxEU.org : “Rescuing our jobs and savings: What G7/8 leaders can do to solve the global credit crisis” (October 9, 2008), and “What G20 leaders must do to stabilize our economy and fix the financial system” (November 11, 2008). Both instant books are edited by Barry Eichengreen and Richard Baldwin, and are available for download at www.voxeu.org

² See for example “Gordon does good”, by Paul Krugman, *The New York Times*, October 13, 2008.

- c) In addition to deposits, bank loans were guaranteed by the government, in order to eliminate the counterparty risk that had frozen the interbank market.

The Euro group first and quasi simultaneously, the European Union then, adopted a similar programme.

. The fact that most European countries put in place a similar framework for intervention has to be applauded, because coordination increases the chances that guarantees will not be used (hence minimizing the actual cost to taxpayers) and, even more importantly, it reduces conflicts and free riding problems (as for example the ones experienced when Ireland unilaterally decided to guarantee bank deposits). Similarly, the initiative of a special short term lending facility of the IMF will be extremely important for countries (like Switzerland) whose GDP is largely inferior to their banks' exposure.

After some initial hesitation, the American Treasury adopted a very similar strategy, and abandoned the idea of simply buying the toxic assets

As a consequence of these measures, confidence is slowly being restored, and we lately observed a slow "unfreezing" of the interbank market.

Even the conventional tools of fiscal policy are being put in place or considered, to sustain aggregate demand. Last spring the American government sent a check to all households, and on November 9, 2008, China announced a fiscal stimulus package that will bring 586 billion of US dollars of spending (roughly 7 per cent of the country's GDP) on railways, airports and other infrastructure, and on social welfare projects. Japan followed suit. The European Commission and the Council certified that the current situation represents the "exceptional circumstances" that the Treaties recognize as justification for a softening of SGP constraints.

Nevertheless, the need for traditional stimulus packages is less consensual among economists and policy makers. The G20 communiqué of November 15 takes a bold and unusual stance, in stating that, among the immediate measures to contrast the crisis, governments should

"Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability."

Nevertheless, large European countries are proceeding in sparse order, and in particular Germany, is resisting the pressure for an important fiscal

policy stimulus³. This is unfortunate, because a coordinated effort would first and foremost be more effective, and then once again avoid free riding of countries increasing their exports thanks to their partner's fiscal stimulus packages.

I believe that an important and coordinated fiscal stimulus, (quantified at the OFCE to be of the order of 2-3 percentage points of GDP), is necessary in European countries to soften the impact of the crisis on the real economy and on investment expectations. The director of the IMF proposed a fiscal stimulus of the same order of magnitude (2%)

3. Fiscal and Monetary Policy Coordination

In the preceding sections I clearly stated that the main actor in today's management of the crisis is fiscal policy, both via the conventional and unconventional instruments described above. The injections of liquidity by central banks had an important role in preventing a meltdown of the financial sector, but were less effective in restoring the normal business conditions.

Nevertheless, central banks still have a very important role to play to support the effort of fiscal policy and to help shorten the transition out of the crisis, thus substantially reducing the costs for society as a whole.

First, in the case of the ECB, interest rates should be lowered significantly. It is today very clear that the rate raise of July 2008 was a mistake. And the two cuts of October and November 2008 were too small and too late. While this may not be the recipe for a better functioning of the interbank market, it will certainly help sustain the efforts of treasuries to provide the guarantees needed to restore confidence. Furthermore, lower ECB rates should drag down long term rates and ease borrowing constraints for firms that today pay prohibitive interest (see my Briefing Paper of March 2008).

Second and we come to the main question of this briefing paper, the ECB should consider accepting toxic assets as collateral at its lending window. As Anne Sibert convincingly argued in her March 2008 Briefing Paper, the banks needing liquidity are those who can only offer toxic assets as collateral, while those with good assets will more likely need less liquidity. Reducing the rates without expanding the range of collateral would have the effect of channelling the liquidity where it is less needed.

³ "Call for German Stimulus", *Financial Times*, November 20, 2008

The situation resembles the one of Japan in the 1990s. Had the central Bank of Japan intervened earlier to buy the toxic assets held by the banking system, the episode of deflation would have been shorter and less pronounced.

A number of things have to be considered nevertheless. Contrary to most observers, I do not believe moral hazard to be a major problem in the current situation. Certainly it is a problem but the formal statement of most heads of governments that no bank would be let go bankrupt supersedes the risk for the ECB to give wrong incentives in accepting toxic assets as collateral. And at any rate, the risk of moral hazard could be minimized first by explicitly making it a short term measure, and then by devising a sanction for banks using the lending facility to dump toxic assets on the ECB without really needing it (a temporary or even long banning from the lending facility?). On the other hand, what I believe to be a potentially serious issue is the effect on the balance sheet of the ECB. Any serious problem deriving from this deterioration of the balance sheet would most likely have to be covered by government intervention. How to split the burden across Euro area governments may be a difficult problem, but the solution is strictly technical. Secondly, I don't see as realistic the threat of a political problem, in the form of a loss of independence of the ECB; even if this were possible, the number of governments involved would of course be a guarantee for independence.

The only potential problem which may turn into an opportunity is the fact that the current crisis is substantially blurring the distinction between fiscal and monetary policy. The boundary becomes fuzzy. Some central bank interventions have direct fiscal consequences, as it was crystal clear in the action of the Fed before the "nationalization" of Freddy Mac and Fanny Mae. Lending by the States to the private sector out of public borrowing is similar to the business of a bank and it has the effect (through the credit multiplier) of increasing the global amount of credit, that is a money counterpart, and thus of increasing the "quantity" of money.

Managing this mix of monetary and fiscal policy will require an unprecedented (and much awaited) effort of coordination between the European Central Bank and the governments of 15 euro zone countries. This is uncharted land even from a theoretical perspective, and a potentially dangerous situation if we look at the poor track record of cooperation between the ECB and euro zone governments. But it may also constitute the opportunity to finally think about redesigning the economic governance of the Euro area, as I have been constantly advocating in the past