BRIEFING PAPER

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

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Executive Summary

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

The expansion of the collateral framework by the ECB from October is a good idea as long as the crisis lasts, as since then inflationary dangers are very much subdued and markets have been calmed down a bit. But as soon as the crisis is over, the ECB should return to previous standards. This leads to a very important question. There have to be commonly accepted criteria when there is a crisis. Furthermore all major advanced economies that are important in terms of the global financial market should also agree on what central banks should do in times of crisis and how that differs from normal times. On a European level it means we need special guidelines for the ECB probably agreed upon by ECOFIN, the ECB and the European parliament on what the central bank is allowed to do in times of crisis and when she has to return to a "normal" behaviour.

1. Introduction

On October 15 the ECB announced that it would expand the collateral framework to expand the provision of liquidity. The reason of doing so is to keep the financial market institutions solvent at these times of distress. This is another step in the fight to overcome the financial market crisis and to prevent a melt-down of the financial system that could trigger a major economic crisis in turn.

The expansion of collaterals however can prove as a risky measure since it means that all those institutions eligible to deposit collaterals at the ECB not only have easier access to liquidity. They also can deposit assets of higher risk at the ECB. If worse comes to worst this may leave the ECB with those risks. In other words, banks and other financial market institutions get rid of their risky investments at the expense of the central bank. Furthermore there is fear that with the extended liquidity provision, the danger of a future rise in inflation rate above the target rate increases.

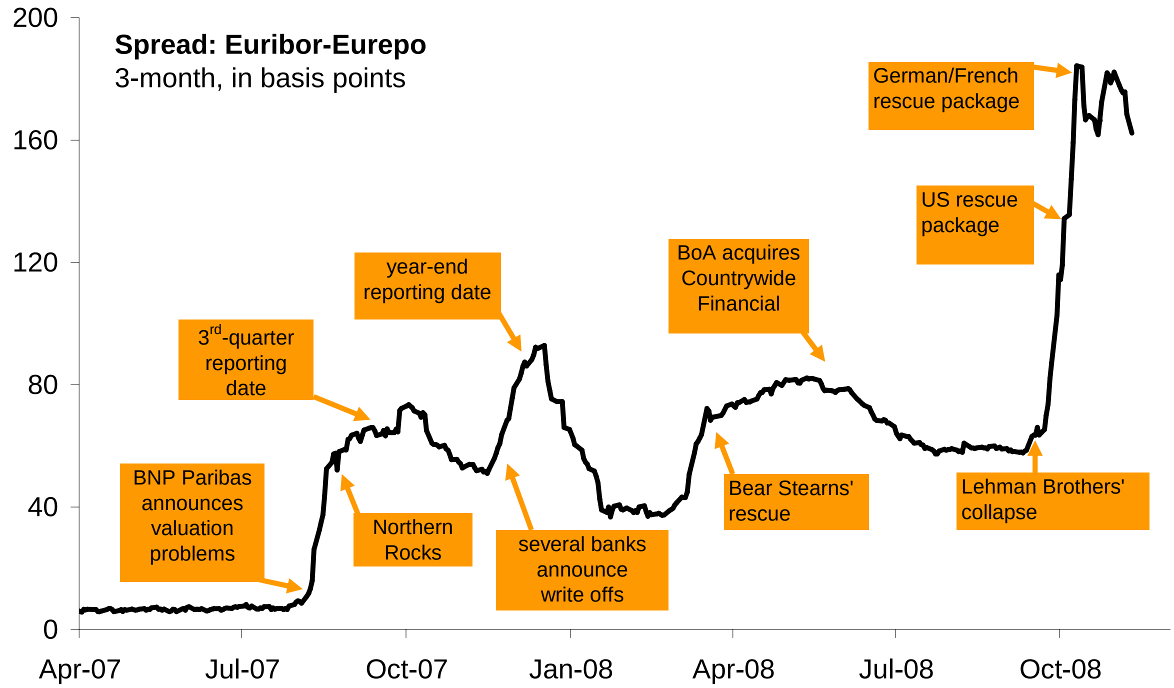
In the following the pros and cons of a more lenient behaviour of the ECB will be discussed. In a first step the issue will be discussed in a rather technical sense. In a second step the scope will be broadened. In this section the issue will be analysed against the backdrop of the financial market crisis.

The conclusion is that the expansion of the collateral framework is a good idea as long as the crisis lasts, as since then inflationary dangers are very much subdued. But as soon as the crisis is over, the ECB should return to previous standards. This leads to a very important question. There have to be commonly accepted criteria when there is a crisis. Furthermore all major advanced economies that are important in terms of the global financial market should also agree on what central banks should do in times of crisis and how that differs from normal times. On a European level it means we need special guidelines for the ECB probably agreed upon by ECOFIN, the ECB and the European parliament on what the central bank is allowed to do in times of crisis and when she should return to a “normal” behaviour.

These lessons should be learned from the present situation in order to improve future crisis reaction ability. Furthermore any long term damage in terms of high inflation triggered by the fight against the crisis should be avoided.

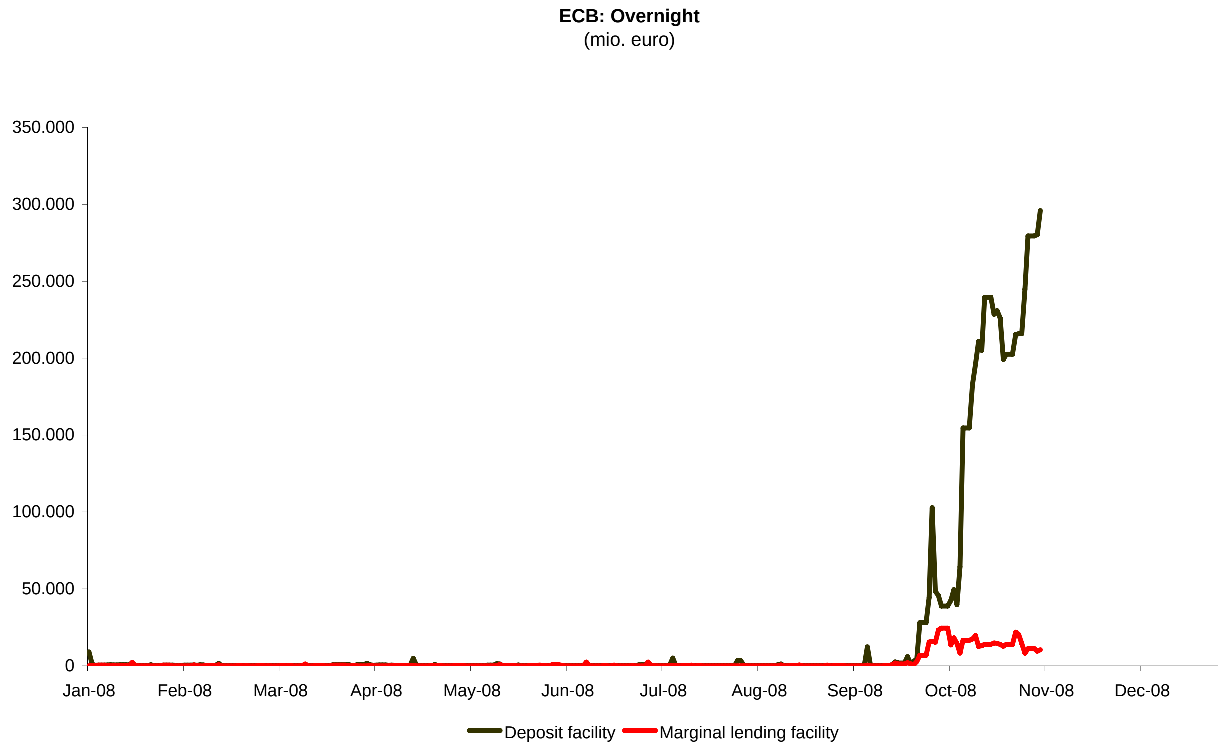
2. The expansion of the collateral system

In October the ECB expanded her collateral framework and started to accept collaterals with higher risks. The basic reason was that banks were still suffering from a severe liquidity restraint originating from a fundamental lack of trust among banks. Since the very beginning of the crisis lack of trust has been the major problem endangering the circulation of money within the banking sector. The situation had become even worse when Lehman Brothers collapsed. How intensive the crisis was at the end of September 2008, shows up in the spread between the two interbank interest rates Euribor and Eurepo that defines the risk premium of giving uncollateralized money to other banks. At that time it skyrocketed. At the same time, interest rates for ECB tender operations were also markedly higher than the ECBs’ target rate. Basically it meant that banks could get short term money only at high costs – probably too high to refinance longer term assets properly. As a consequence each day banks ran into danger to lose significant amounts of money. It was only a matter of time when more and more banks would collapse.



Therefore the ECB was under pressure to do anything to get the risk premium down in order to stabilize the banking system. By expanding the collateral framework banks could give more assets to the ECB and thus additional opportunities were given to increase liquidity. At the same time, the provision of longer-term refinancing was changed to a fixed rate tender procedure with full allotment. The result of these two measures is somewhat mixed. Although the spread has come down slightly, it is still much higher than before the crash of Lehman Brothers. Despite the less restrictive collateral system and full allotment, the crisis is not yet overcome. Nevertheless it would be worse when the ECB would not have acted in this manner.

A look on overnight lending of the ECB shows how great needs of banks still are.



Since the end of September figures have risen dramatically and they still remain on an extraordinary high level. The two graphs together show that banks are still in desperate need of liquidity and accordingly their demand is high even at the high interest rates. In other words the inter-banking market presently is almost completely in the hands of the central banks. Without central banks acting as lenders of last resort we would have seen a complete melt down of the financial market system.

However there are some caveats to be made. When the ECB accepts now riskier assets the probability to create losses at the expense of the central bank has risen. Even when the financial crisis may be overcome one day and assets may regain value it is not guaranteed that the ECB can sell them with profits. The ECB takes this into account to some extent by applying a uniform haircut add-on between 5 and 10 % and other down payments. Thus there is a certain protection against losses. But what happens when a worst case scenario comes into effect and the ECB will have to sell these assets and looses money?

Then there is a second line of defence. During the past years the ECB has acquired huge surpluses. Out of these a certain amount of losses can be covered. If necessary other assets like gold and currency reserves have to be sold. If all that is not enough, national central banks have to step in and cover the losses from their surpluses. They have to do so according to their share in the ECB-system. These shares were also used when profits of the ECB were distributed among national central banks.

If the reserves of the ECB and the national banks are not high enough – what seems, given the huge amount of assets at the central banking system, to be highly unlikely from a present point of view - the last line of defence is the tax payer. Either public deficits or taxes in member states have to be raised in order to finance the central banking system. That means in the end the member states and their citizens would have to carry the burden. But that would also be the case if central banks would not act in the described manner. Then a severe economic crisis would unfold. The result would be shrinking wealth and high unemployment. Then at last, the tax payer would have to step in and take over the losses produced by a badly managed financial market system.

Even if losses can be avoided several problems remain. By easing the collateral lending requirements, the ECB more and more transforms from a lender of last resorts to a bad bank that owns “toxic assets”. It becomes a “buyer of last resort “. This involves an incentive problem since it could encourage banks to engage in risky investments. And it could lead to the perception that a central bank in possession of many bad assets could start to print money in order to be able to buy all the more of them to stabilise financial markets. That is clearly forbidden by the Maastricht treaty but even the mere impression that it could happen, would incite inflationary expectations triggering a price wage spiral. Therefore it would be preferable if national governments would play the part of a buyer of last resort, if necessary. In this case the negative influence on the central bank is very limited. That could help to prevent destabilising expectations.

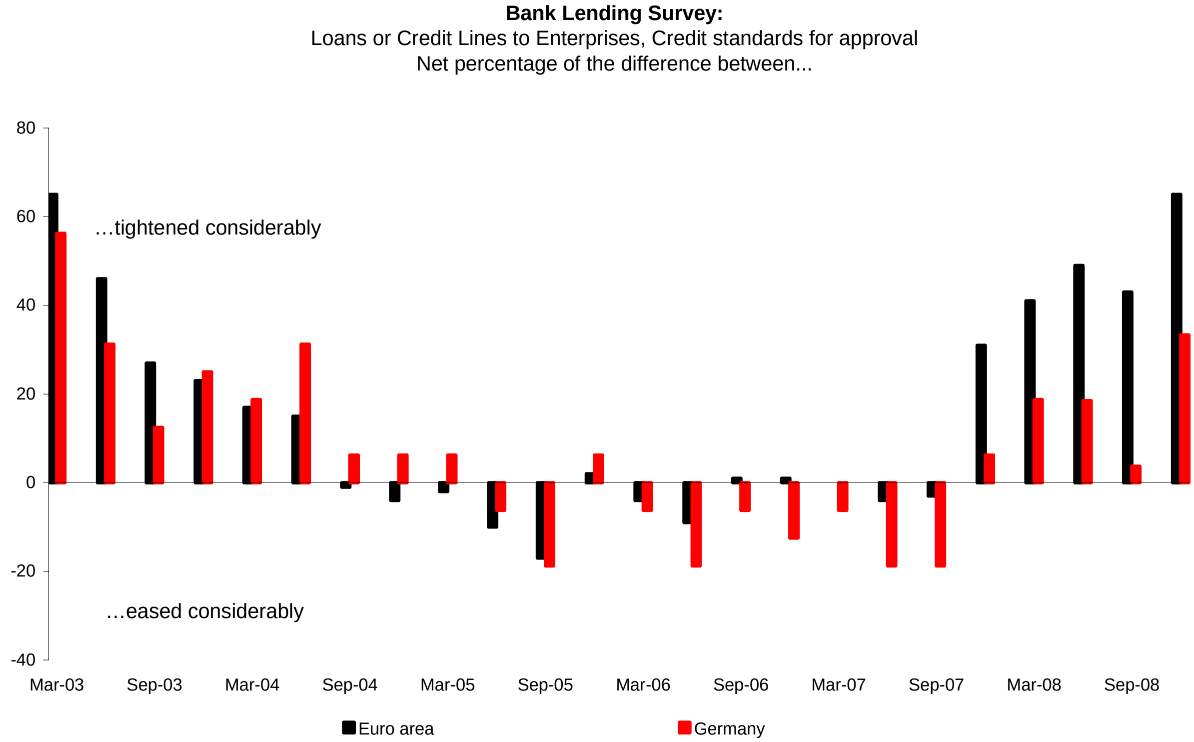
Inflation is anyway a major argument against a lenient stance towards collaterals. There are fears that liquidity in the banking system gets so high that there are looming dangers of inflation. But these would only materialise when banks start to lend money to business firms in a large extent to finance investments in the real economy. Then the economy may get overheated and inflation occurs. As long as the money stays in the financial spheres this danger does not occur. Furthermore it is very easy to withdraw liquidity fast as soon as an economy starts to accelerate. The ECB just has to sell the assets she has bought during the crisis.

On the other hand, with ample liquidity the danger of another bubble in the financial markets remains. But again, also in this case the ECB could immediately sell the assets and withdraw liquidity. However, to address this problem more fundamentally, proper new regulations have to be put in place. Among them should also be new tools for monetary policy. Interest rate policy is a too rough instrument to prevent bubbles since it affects the whole economy. Therefore manufacturing would be also adversely affected, if a financial market problem arises. This is suboptimal. Preferable would be specific minimum reserve requirements for financial investments. By those, these specific problems could be tackled in an appropriate manner.

In sum the most serious problem with expanding the collateral framework is the incentive problem. All other problems are also existent, but can be tackled with an appropriate reaction of the ECB rsp. of governments.

3. How to deal with a financial market crisis

The present crisis on financial markets is not the first one in recent times. In 2000 /2001 the dot com bubble burst. Then also all major economies faced a severe economic downturn since the crash on stock markets worsened lending conditions significantly. That brought investment to a halt. The same happens now albeit the root of the crisis is not an overvalued stock market this time.



Looking at the lending survey one realises that lending conditions in the Euro area have become worse and worse since the end of 2007. In Germany the most important economy the process started a bit later but the tendency is the same. These results indicate that a financial market crisis sooner or later spills over to the real economy triggering severe downturns on a global scale. Therefore it is of utmost importance to have rules in place how to deal with those sorts of crisis. The lengthy discussions usually taking place reasoning on question like whether this sort of crisis will be confined to the economy of its origin or to financial markets are completely unnecessary. All these questions have been settled by facts. Financial markets are global markets and they affect the real economy. Hence a wait and see attitude shown by some European governments and the ECB in the early stage of the present and past crisis is completely inappropriate.

Instead, what is needed is a fast reaction of economic policy. The speed of a reaction can be enhanced if rules on what is to do are in place. This applies also to the ECB. In order to avoid incentive problems with the lenient collateral procedure the ECB and governments as well should return to their pre-crisis behaviour as soon as the crisis is over. But as soon as the next crisis occurs – something that cannot be excluded - certain reactions that have proven useful during present and past adverse situation should be in place very fast. Among them is the expansion of the collateral framework and a fast decline of interest rates as the Fed has shown.

The decisive question is when is there a crisis and when not. There were several symptoms that could be observed ahead of the unfolding crisis. One is the significant decline of share prices. They dived very fast during the past crisis and a bit slower during the present one. The other indicator is the risk premium of uncollateralized lending among banks that were rising dramatically in relation to its past record even before Lehman Brothers went down. But research in this field has to on. But it seems necessary to define a set of reliable criteria that determine a financial market crisis situation. One could define a threshold value for these criteria. If that threshold is surpassed the crisis procedures should be applied. These rules should be established at best at a global level but at least by a decision of ECOFIN, the European parliament and the ECB council. Then a faster, clearer and more appropriate reaction than during the present and past crisis should be possible.