Christian Noyer: No moral hazard – the banks are doing their job

Comment by Mr Christian Noyer, Governor of the Bank of France, in the Financial Times, 18 September 2007.

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In recent weeks, Central Banks in Europe and the US have acted repeatedly to provide liquidity to interbank money markets. These interventions have raised some questions. Concerns were expressed that monetary authorities were bailing out speculators, thus creating the same kind of moral hazard that may have led to excesses in the past. There were also concerns as to whether the integrity of monetary policy would be compromised.

These are valid questions. On numerous occasions, in the past, we pointed out the potential dangers that mispricing of credit risk posed for financial stability. We may be now seeing some of the consequences. Excessive risks were taken, and losses will have to be accepted. It is important that monetary and financial authorities take no action that would prevent this process from running its course, let alone be seeing to be condoning past or future excesses.

However, the logic behind recent interventions is different. Put very simply, financial turbulence and uncertainty have suddenly triggered an upward shift in the demand for Central Bank money. Faced with such a shift, whose direction is apparent but amplitude uncertain, the choice, for monetary authorities, is clear: either accommodate, and provide temporary liquidity; or not, in which case, interest rates would have to rise to restore balance in the interbank market.

Standard economic theory dictates that, in such circumstances, exogenous changes in money demand should indeed be accommodated. In a seminal article going back to 1970[1], William Poole showed that, when there is uncertainty about money demand, the optimal response is to stabilize the interest rate, thus letting money supply adjust. Since short-term interest rates are, for all Central Banks, the main policy tool, an increase in interbank rates over and above the official rate would indeed be tantamount to a shift in monetary policy. In contrast, liquidity provision by Central Banks has ensured that the overall policy stance has remained unchanged. A clear distinction has been – and will be – maintained between temporary liquidity provision, on the one hand, and medium term oriented monetary policy, on the other.

Should liquidity be provided at a penalty rate, as some have argued, to avoid moral hazard? The answer is clearly positive if and when liquidity assistance is targeted at specific institutions. But there is no reason, for Central Banks, to significantly depart from prevailing policy rates if their main objective is to respond to an exogenous and general increase in demand for central bank balances.

In the future, monetary policy may have to be adjusted, not for the purpose of easing financial tensions, but according to its own objective and in view of the state of the economy. As regards the euro area, the Governing Council has judged that, in the current uncertain environment, it was appropriate to gather additional information before drawing conclusions for monetary policy, although the overall stance is “still on the accommodative side” and… “the medium-term outlook for price stability remains subject to upside risks”.

Looking further ahead, difficulties in the subprime mortgage markets combined with the generalized securitization of loans will lead to losses whose localization in the financial system remains undetermined. This information problem is currently creating uncertainty and

[1] Optimal Choice of Monetary Policy Instruments in a Simple Stochastic Macro Model ; The Quarterly Journal of Economics Vol. 84, No.2 (May, 1970)

turmoil. However, things should be put in perspective. Available data indicate that, unless the economy unexpectedly deteriorates, those losses will remain small in comparison to total available capital in the financial system and should be easily absorbed. Of course, conditions remain fragile in many segments of the capital markets. Perverse dynamics may always develop. By acting to restore balance and stability in the interbank market, Central banks are just doing their job.