# José Manuel González-Páramo: Central banks and the financial turmoil

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the Eleventh Annual International Banking Conference "Credit Market Turmoil in 2007-08: Implications for Public Policy", Federal Reserve Bank of Chicago, Chicago, 25 September 2008.

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## 1. Introduction[1]

Ladies and gentlemen,

It is a great pleasure to be here in Chicago on the occasion of the Federal Reserve Bank of Chicago's Eleventh Annual International Banking Conference. Since its inception, this conference series has aimed to gather prominent academics, policy-makers and market participants to discuss issues of major importance for our banking industries, financial systems and economies at large, such as asset price bubbles, systemic financial instability, cross-border banking, or financial globalisation.

Over time, a permanent concern of the organisers has been to focus on the implications for monetary and regulatory policies and, more generally, for public policies of such phenomena. It is fair to say that a great deal of knowledge has accumulated over time thanks to this series of conferences. It is also reasonable to reckon that the foundations of this body of knowledge have been put to the test by the financial market turmoil over the past year.

When the Tenth Annual International Banking Conference took place in September of last year, the market turmoil had already broken out and central banks were already engaged in interventions aiming to minimise the disruptions to money markets and to preserve the implementation of their desired monetary policy stance. While market data on future interest rates suggested that we were in for a rather protracted period of tensions in money and credit markets, it was not obvious at the time that the financial turmoil would turn out to be one of the most challenging events of the last century for our financial systems.

Indeed, the international financial landscape looks today very different compared to one year ago and almost every day new events contribute to re-shape it further. In particular, over the past two weeks adverse events occurred almost on a daily basis and led to increased uncertainty and significant financial market volatility. A large bank failed, while several financial institutions had to be partly or entirely taken over by others. In response to the renewed tensions, public authorities announced a number of measures and initiatives to address problems at both stressed markets and troubled individual institutions. In particular, central banks stepped up their efforts to inject liquidity in global money markets in order to guarantee their smooth functioning.

As I mentioned earlier, one of the main objectives of this series of conferences is to discuss the main lessons for public policies arising from developments in the international banking and financial sector. The continuation of the market turmoil does not allow me to talk to you with the benefit of detachment and the comfort of an ex-post assessment. However, I should like to take advantage of the occasion to share with you some considerations on the ECB's response to the market turmoil drawing on the experience of the past year.

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[1] I am very grateful to Cornelia Holthausen for her valuable contributions.

## 2. The separation between monetary policy formulation and its implementation

Central bankers have, naturally, eyed the developments of the past year of financial turmoil – and, particularly, their recent intensification – with great concern, as they have the potential to influence adversely the ability of central banks to steer monetary policy rates, affect the transmission mechanism of monetary policy and, more generally, may pose a threat to financial stability.

Once the credit concerns that had built up in the sub-prime mortgage market segment started to affect interest rates and traded volumes in the euro area money market, the ECB responded to these highly unusual market events by timely and forcefully adjusting its liquidity policy. I will not deal with the specificities of the ECB's liquidity management over the past year – this will be carried out by the ECB staff in tomorrow's session on "The Experience with Crisis Management" – but I would like to stress one fundamental principle underlying our response to the turmoil: "the separation principle". This principle relates to the dichotomy between the ECB's monetary policy and its liquidity policy or, in other words, between the formulation and implementation of monetary policy.

During the turmoil, the separation principle proved to be very effective. Supported by the flexibility of its operational framework, the ECB was able to react in a flexible and quick manner to a changing market environment, and it allowed the steering of interest rates close to the policy rate by means of temporary quantity adjustments, albeit without increasing the aggregate supply of euro liquidity to the banking sector.

The main objective of the ECB's immediate and lasting responses to tensions in the money market was to keep under to control the very short-term interest rates as the first step in the transmission of monetary policy. Broadly speaking, the ECB's liquidity policy response consisted of three elements: First, it changed the timing of the liquidity provision within the maintenance period (the so-called "front-loading policy"), and thereby allowed banks to build up temporary liquidity buffers. Second, it lengthened the average maturity of its tender operations: before the turmoil, the bulk of liquidity was supplied through one-week operations, and only about 30% was auctioned for three months. As the turmoil unfolded, the ECB gradually increased the share of the three-month operations and moreover introduced a six-month maturity operation. Finally, it participated in the joint coordination effort of an increasing number of central banks around the world within the context of the Term Auction Facility.

More specifically, in collaboration with the Federal Reserve, the ECB offered US dollar liquidity to European banks at various maturities in order to satisfy the exceptional demand for those funds. I believe that all of these actions proved to be effective in easing the tensions at the short-term end of the global money markets and in maintaining control of short-term interest rates in the euro area. I am sure that global money and funding markets will continue to benefit from our very close cooperation in the times to come. Still, term interest rates in the money market continue to be strongly influenced by credit concerns and, not surprisingly, have proved to be only marginally sensitive to changes in liquidity policy.

As a result, the transmission of monetary policy for the economy at large is affected by the ongoing turmoil. I will now turn to this very question.

## 3. The impact of the turmoil on the monetary transmission mechanism

During the current turmoil, the role of banks in the transmission mechanism of monetary policy has been brought to the forefront. In Europe, as you know, universal banks continue to be important players in the financial landscape. This is why they also play a crucial role for the transmission of monetary policy, as upheld by several theories, notably the bank lending

channel, and supportive empirical findings.[2] According to this theory, the pass-through of changes in monetary policy interest rates to the real sector of the economy is influenced by banks' ability to provide credit to firms. This applies, in particular, to banks with less liquid balance sheets, often the smaller banks.[3] With a bank lending channel, the effects of monetary tightening on the supply of credit becomes more pronounced.

The European banking sector has undergone a phase of some structural changes over the past years. In particular, as in other parts of the world, the European market for structured financial products, such as asset-backed securities or Collateralized Debt Obligations, has grown rapidly over the last decade. For instance, the quarterly issuance of euro-denominated asset-backed securities increased from just under €20 billion at the beginning of the present decade to above €150 billion in the second quarter of this year.[4] These developments potentially influence banks' ability to grant credit.[5]

Such changes are important for the conduct of monetary policy because, first, they affect monetary analysis (one of the pillars of the ECB's monetary policy strategy), and second, because they are likely to affect the monetary transmission mechanism. On the one hand, increased securitisation is expected to weaken the effects of the bank lending channel by dampening the effect of monetary tightening on the supply of credit. Indeed, some evidence points to the fact that the supply of loans is positively affected by securitisation.[6] On the other hand, a more developed and efficient financial system can contribute to a more effective and smooth transmission of monetary policy.[7]

At the root of the problems that led to the current financial turmoil is precisely this growing segment of the financial industry. As valuations of asset-backed securities and other assets declined rapidly, and, in fact, the whole securitisation model was shaken, the outstanding amount of structured products decreased significantly. Obviously, this affects bank credit: according to the latest bank lending survey conducted in the euro area, more than 80% of banks judged that difficulties in raising funds via securitisation have had a negative impact on bank lending.[8]

Overall, the financial turmoil may have affected the efficient working of the banking sector and might have an impact on the supply of credit to the non-financial sector. In light of the fact that bank lending remains strong (the annual rate of growth of loans to non-financial corporations in August 2008 was a still robust 12.6 per cent), it is too early to quantify the extent to which the turmoil may influence the provision of loans. Needless to say, the Eurosystem, and undoubtedly other central banks, will continue to closely monitor the situation.

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[2] See Bernanke, B. and M. Gertler (1995): "Inside the black box: the credit channel of monetary policy transmission", Journal of Economic Perspectives 9, pp. 27-48. For the euro area, see contributions collected in Angeloni, I., A. Kashyap and B. Mojon (eds.), 2003: "Monetary policy transmission in the euro area", Cambridge University Press.

[3] Kashyap, A. and J. Stein (2000): "What do a million observations on banks say about the transmission of monetary policy?", American Economic Review 90(3) , pp. 407-28.

[4] European Securitisation Forum (2008): "ESF securitisation data report – Q2:2008".

[5] European Central Bank (2008b): "The role of banks in the monetary transmission mechanism", ECB Monthly Bulletin, August 2008, pp. 85-98.

[6] See, for instance, Altunbas, Y., L. Gambacorta and D. Marquéz (2007): "Securitisation and the bank lending channel", ECB Working Paper No. 838, and ECB (2008a).

[7] See, for instance, Gropp, R., C. Kok Sørensen and J. Lichtenberger (2007): "The dynamics of bank spreads and financial structure", ECB Working Paper No. 714.

[8] European Central Bank (2008c): "The euro area bank lending survey", January 2008.

## 4. The role of uncertainty

One of the most relevant features of the current turmoil has been the high degree of asymmetric information and the enormous increase in general uncertainty in the financial sector. I would like to distinguish between the two in the following way:[9]

Uncertainty owes mainly to imperfect information in relation to credit valuations. Uncertainty generally increased during the summer of 2007, because market participants realised that the current practices used for valuations – often based almost solely on ratings – were no longer valid. With this type of uncertainty, market participants have difficulty in modelling the expected occurrence of defaults. Credit spreads can widen, also at the short end.[10] Another typical effect is the flight-to-quality phenomenon: as in previous episodes of high uncertainty, during the turmoil savers have shunned equity and credit risk products in favour of government bonds and commodities as well as cash and bank deposits. As a result, bank deposits increased significantly.

The term asymmetric information, on the other hand, applies to an adverse selection problem, notably in the interbank market, where market players can no longer distinguish solvent from insolvent borrowers. Such a "lemon's problem" induces banks to demand high risk premia of their creditors and lead to a general increase in interbank market rates. Moreover, it can lead to the rationing of credit provision. Indeed, during the turmoil, a general tightening of credit standards has occurred and has been intense and wide-spread. Counterparty credit risk and uncertainty about the development of entire segments of the financial market – notably of more complex instruments such as collateralised debt obligations and other related products – were important elements in the development of the turmoil.

Central banks have to deal with this increase in uncertainty on several accounts. First, monetary policy needs to take into account the heightened uncertainty: central banks need to refine their monetary and financial analysis, and monitor extremely closely the developments in the financial system and their impact on the pass-through of policy rates to the economy.

Second, and to turn to the beginning of my remarks, liquidity management has become more active. Counterparty credit risk as well as uncertainty about the development of own liquidity needs have led banks to hoard liquidity and impaired the normal functioning of money markets. As a consequence, the liquidity provided to the market does not circulate as smoothly as it does in normal times. Moreover, the nervousness of market players sometimes implies stronger than anticipated interest rate reactions.

## 5. Conclusion

I would like to conclude by saying that monetary policy implementation has certainly become a more challenging task as a result of the current financial turmoil. At the same time, the flexibility of the ECB's operational framework has very much helped us in coping with the turmoil. The ECB has been able to maintain control over the short end of the money market, though – not surprisingly – our influence on longer maturities, where prices are driven mainly by credit concerns, remained limited.

At the ECB we believe that the separation principle, i.e. the separation of liquidity policy measures from any considerations about the monetary policy stance, has served us well.

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[9] On this subject, see Cassola, N., M. Drehmann, P. Hartmann, M. lo Duca, and M. Scheicher (2008): "A Research perspective on the propagation of the credit market turmoil", ECB Research Bulletin No. 7, June 2008.

[10] This has been modelled formally by Duffie and Lando (2001): "Term structure of credit spreads with incomplete accounting information", Econometrica 69, pp. 633-664.

Indeed, the liquidity policy aided the transmission of monetary policy even in the turbulent times experienced over the past year, while monetary policy was left free to focus on its overriding objective of ensuring price stability. I strongly believe that especially at times of high uncertainty and rising inflationary pressures like the present, a stable and predictable central bank policy and the firm anchoring of inflationary expectations are of particular importance.

There is no doubt that these are very challenging times for our economies. Some scientists argue that wildfires can be in the long run beneficial to wildlife as over time barren burned areas are covered by healthier new growth. Without pushing too far the analogy, let’s hope that the equivalent applies to the weakest segments of our financial systems. This will very much depend on the ability of all concerned parties – both public and private – to draw the right lessons and thoroughly implement them.

Bearing this in mind, I look forward to the second day of this conference, during which the regulatory implications of the ongoing events shall be discussed. I wish you all a pleasant evening.