# The Euro Area Interbank Market and Liquidity Management of the Eurosystem in the Financial Crisis

by

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A comment by

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Rome, 30 September 2010

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# The paper

The paper wants to reconcile four empirical facts:

- The strong increase in the demand of ECB funding since late 2008;
- The strong increase in the ECB depo usage;
- The decrease of the volume in the interbank market;
- The soft trading of the Eonia below the MRO rate.

They use a two-stage game between banks and the CB to show that:

- In a low cost env., banks trade in the interbank market, there is no excess funding and CB facilities are not utilized;
- In the high cost env., weak banks want to avoid excessive interbank transactions and so, ex ante, they take more CB liquidity. Ex post, this extra liquidity ends up in the CB depo facility.
- In the ultra high cost env., weak banks are even forced to use the CB marginal lending facility.

# Comment 1 – Just an issue of price?

- After Lehman, the high price in the interbank market forced the ECB to take an intermediation role. So, it was just an issue of price…

- I have a more extreme recollection of those events …

- … it was not an issue of price but of trust…. the market was suffering one of those "*contagious illiquidity*" episode (Akerlof and Moore).

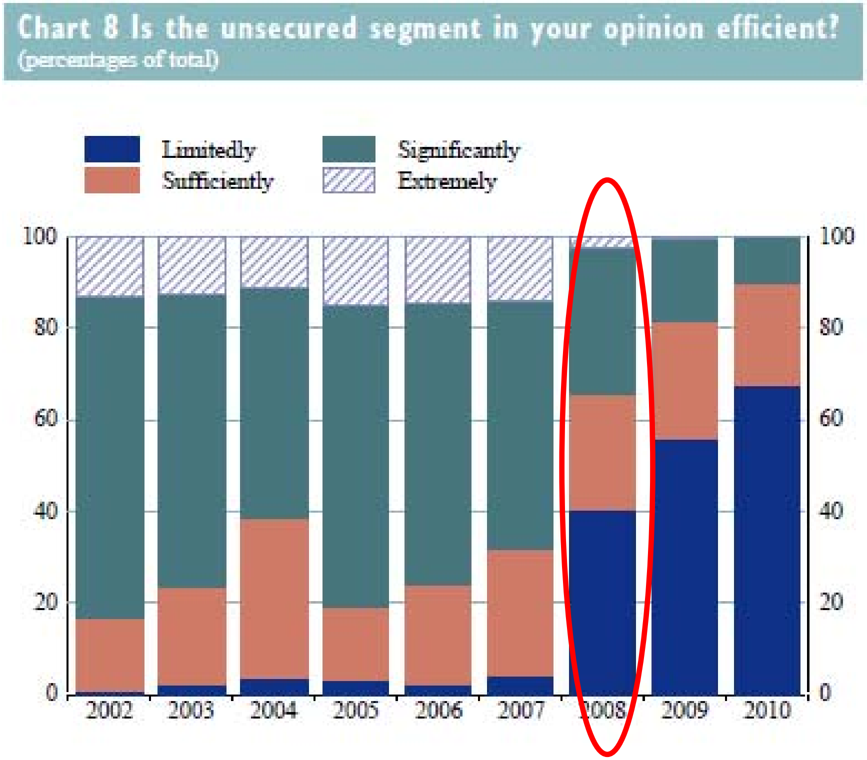
- The unsecured market was frozen; banks were only lending overnight. The LIBOR rates quoted in the market were not rappresentative of the cost of funding (which was much higher!!!).

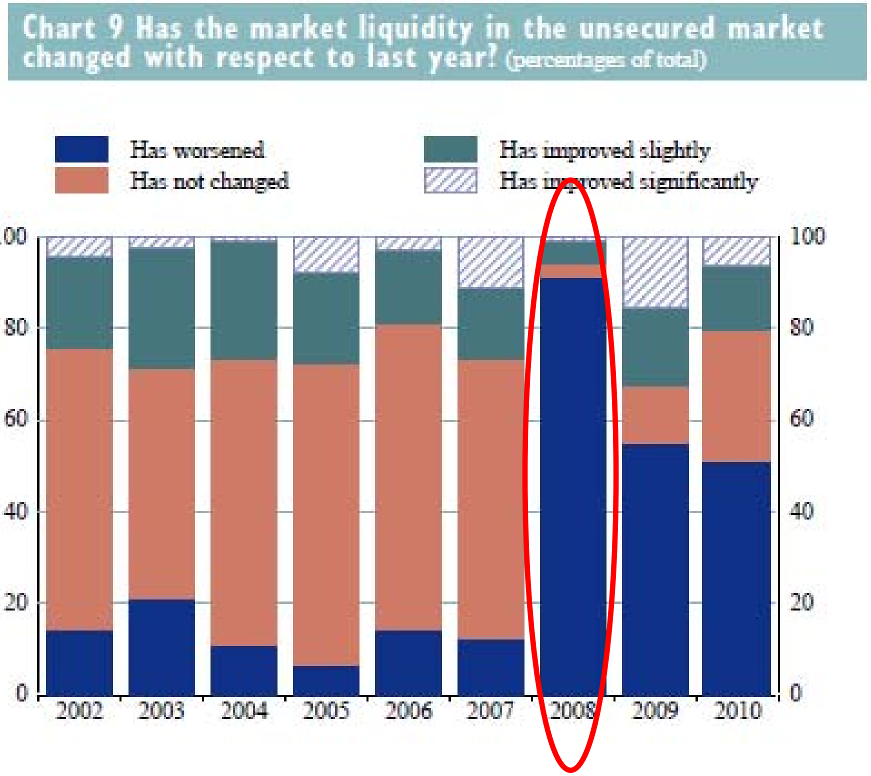
- The possible cost of a liquidity short-fall by a bank was huge.

- Banks had a huge difficulties funding certain assets (ABS).

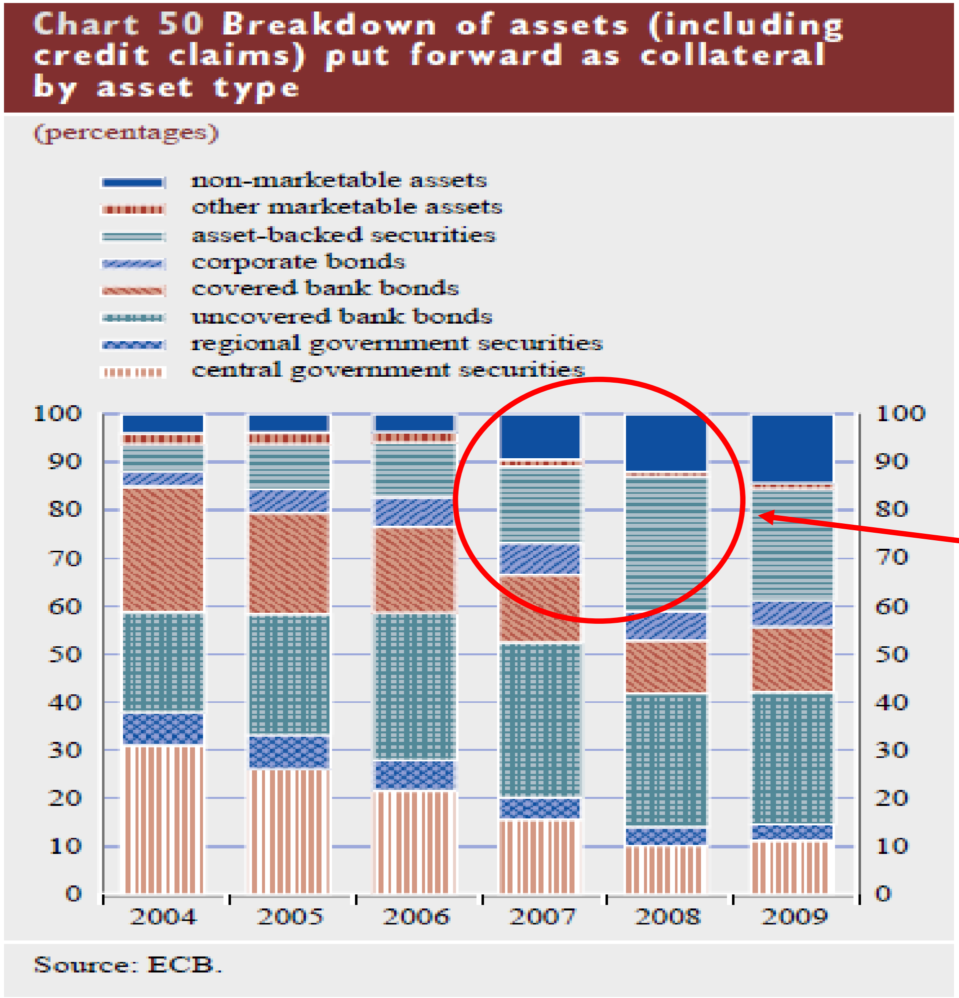
- The unlimited funding policy and the widening of the collateral in Oct 2008 was necessary to stop the domino effect given that banks were willing to exchange only via ECB reserves.

# The ECB Money Market survey: in 2008 unsecured market was impaired



# The ECB collateral composition: increase in ABS



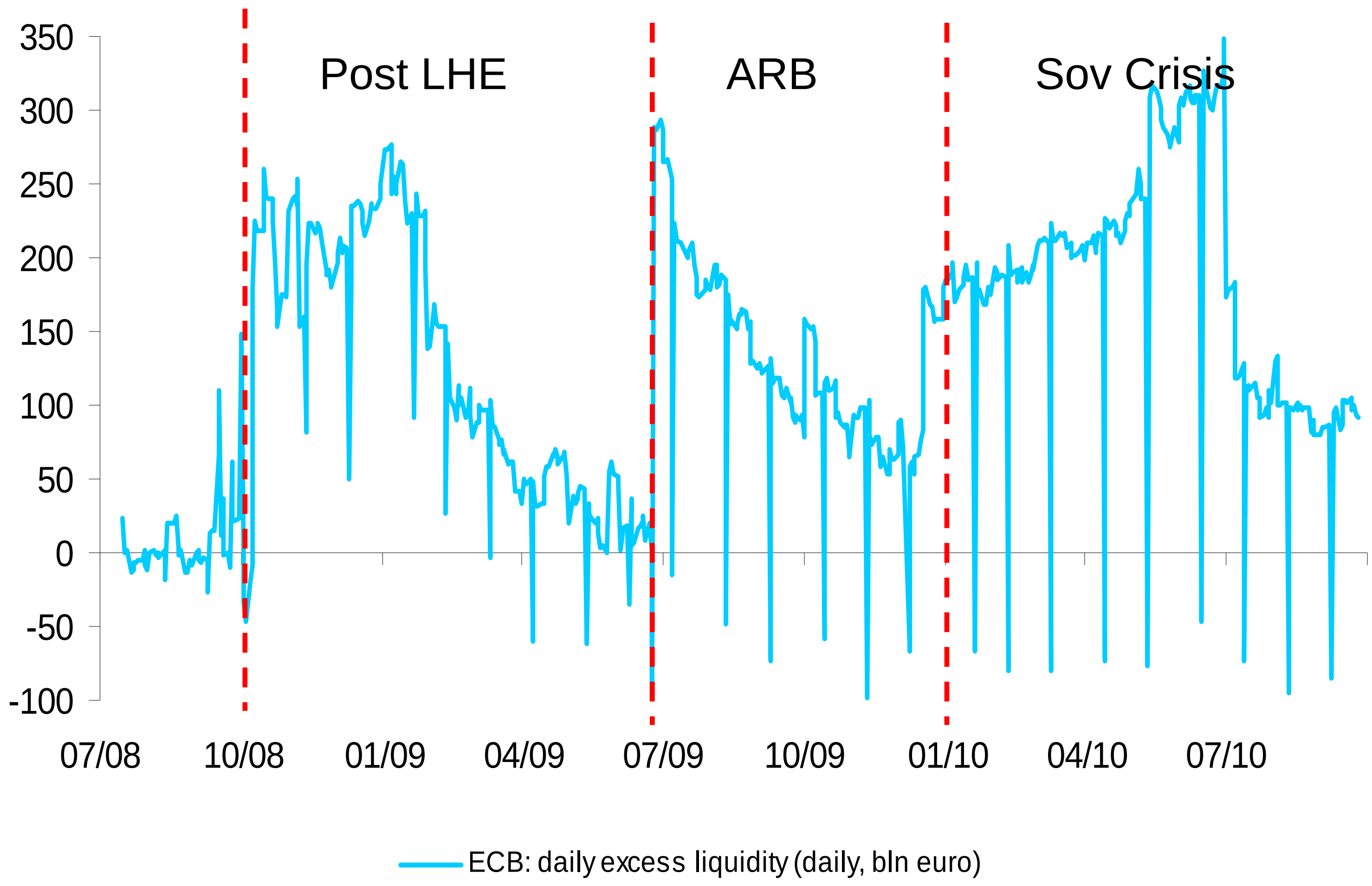
# Comment 2 – In “normal times” liquidity surplus cannot persist.

- The liquidity game is a repeated one.

- All banks do have a structural liquidity deficit versus the CB (reserve requirements and autonomous components).

- Banks with surplus of liquidity will reduce their liquidity demand to the CB and this will foster the adjustment of the liquidity excess (in the model this is not possible because surplus banks has zero need of CB funding).

# Comment 3 – There is not a single story



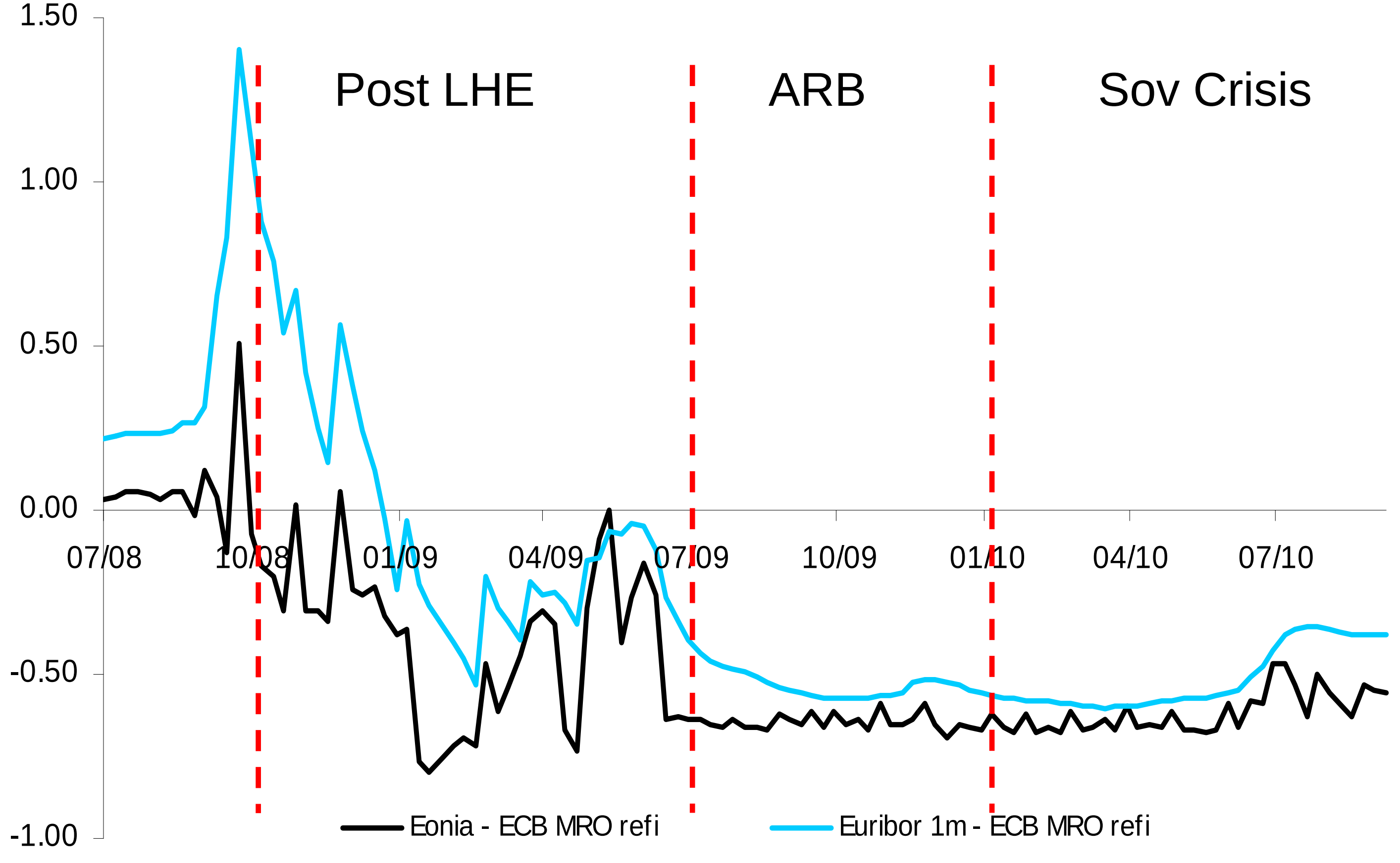
# Comment 3 – There is not a single story

- Post LHE – Severe adverse selection in market. The ECB actions and the Government guaranties helped and there were some signs of normalization in April/May 2009.

- ARB – The liquidity operations was used to indicate that rates will be on hold for long time. The first 1y repo created a large arbitrage opportunity in the market. Banks were stuffed with reserves that they could not unload.

- Sovereign Crisis – Despite the low rates, banks had a renewed preference for ECB funding due to the difficulties in the repo markets of certain countries.

# Comment 3 – There is not a single story




Large excess of reserves also in period of low rates.

# Comment 3 – There is not a single story

- The policy conclusions of the paper (return to fixed allotment and tighter collateral rules) need to be taken with a bit of caution.

- At the moment, there is a too large share of ECB funding that it is borrowed to “certain” bank in “certain” countries.

  While those banks have a much lower amount of reserves.

- Solving this anomaly (i.e., recapitalization of “certain” banks) is necessary for the normalization of the ECB operational framework.

# Many Thanks