The Euro Area Interbank Market and the Liquidity Management of the Euro System in the Financial crisis

by

Achim Hauck and Ulrike Neyer

Discussion by

Laurent Clerc

(Banque de France)

The views presented in this discussion are those of the author and not necessarily those of the Banque de France.
Outline

1. Overview of the paper

2. Discussion

3. Policy implications

Christian Bordes and Laurent Clerc: “The art of central banking of the ECB and the separation principle”, WP 290, August 2010

http://www.banque-france.fr/gb/publications/ner/1-290.htm
1. Overview

• The paper is about the functioning of the Eurosystem monetary policy operational framework

• Main characteristic: it is a symmetric interest rate corridor system
• Tradeoff stability in short term interest rate/better liquidity management
  
  – Monetary policy: $i_{\text{IBM}}$ as close as possible to the policy rate (narrow corridor)
  
  – Financial stability: provide incentive to banks to care about their liquidity management (wide corridor)
• **How to get reserves?**
  – Step 1: MRO (weekly operations)
  – Step 2: marginal lending/deposit facilities or interbank market

• The model is solved backward (step2)
• **Equilibrium (step 2)**
  - Bank a is in surplus: no transaction on the interbank market ($i^{DF}$ prevails)
  - Bank a has a deficit but this deficit is below bank’s b surplus: then downward pressure on $i^{BM}$
  - Bank a has a deficit which exceeds bank’s b surplus: upward pressure on $i^{BM}$
  - Bank a’s deficit = bank b’s surplus: the market is close to the minimum bid rate
• **Step 1: Open market operations**

\( K^b = 0 \), virtually by construction as bank b in surplus

– 3 regimes

\( a) K^a = D \): market rate near MRO rate

- Bank a borrows in the interbank market
- For bank b to lend in the market, expected marginal return must exceed \( i^{DF} \)
- Condition met only if

\[
\gamma \leq \frac{1}{2} \left( i^{CF} + \alpha - i^{DF} \right) \\
E(A^a) - D = \bar{\gamma}
\]

\( b) K^a > D \) and \( A^a_H - K \leq B^\text{marg} \)

- Bank a expands borrowing over D
- corresponds to \( \bar{\gamma} < \gamma < \bar{\gamma} \)
c) last case \[ A^a_H - K > |B|^{\text{marg}} \]
- bank a covers part of its remaining liquidity need at the credit facility
- corresponds to high transaction costs
2. Discussion

• 2 preliminary comments

- For the reader, should better distinguish liquidity deficit and excess reserves

- Should present the functioning of the operational framework in normal time and then in crisis period
Liquidity deficit in the Eurosystem
• The authors do not fully account for the implications of the Fixed Rate Full Allotment and the provision of liquidity at 1 year.
Does the model explain the full period or only the period from 8 October 2008 to 31 January 2009?
• 1-year Long Term Refinancing Operation means that bank b can insure against future unexpected liquidity shocks = precautionary saving ($K^b \neq 0$)

• Bank a does not borrow anymore at the marginal lending facility, nor on the interbank market

• 2-tier market (separating equilibrium):
  – “peer monitoring” à la Rochet - Tirole
  – bank a only rely only on ECB’s refinancing operations
  – Bank b parks all its excess reserve at the deposit facility (can still borrow in the interbank market)
• Consequently, the separation principle collapses
3. Policy implications

• Situation might be more tricky than the one describe in the paper
• CB cannot reactivate the market by increasing the intermediation cost or collateral requirement: Bank a has become a “persistent bank”
• When 1 year LTROs will mature, excess reserves will vanish and bank b will need to bid at the MRO and $i^{BM}$ will rise
• As long as the problem of persistent banks is not solved, difficult to exit from the FRFA