

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

by

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Discussion by  
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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

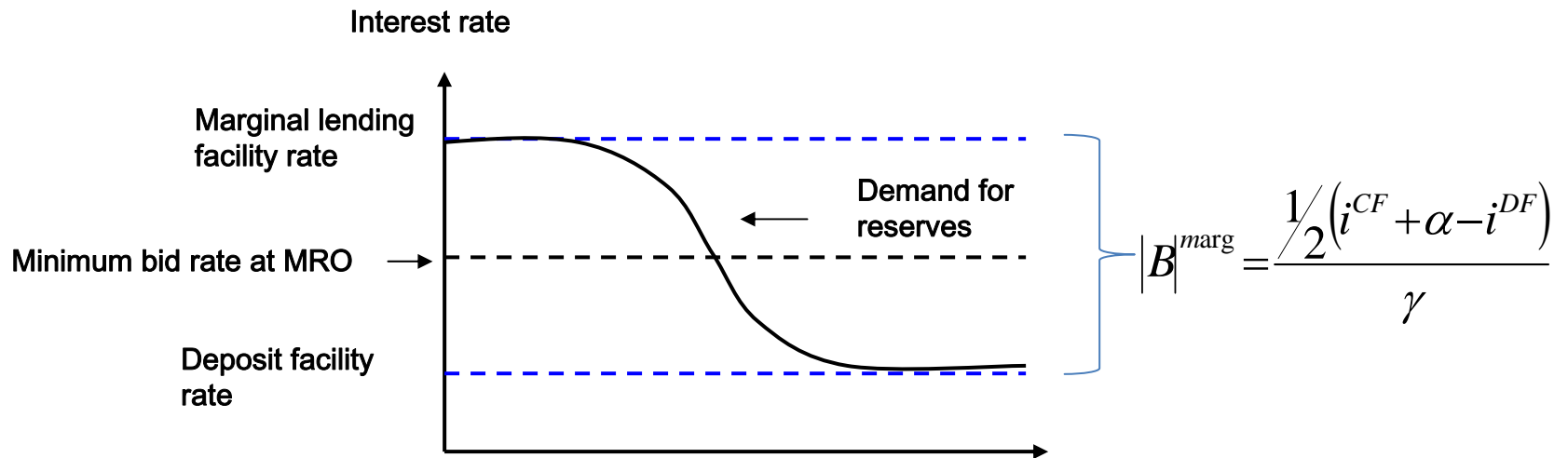
## 3. Policy implications

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

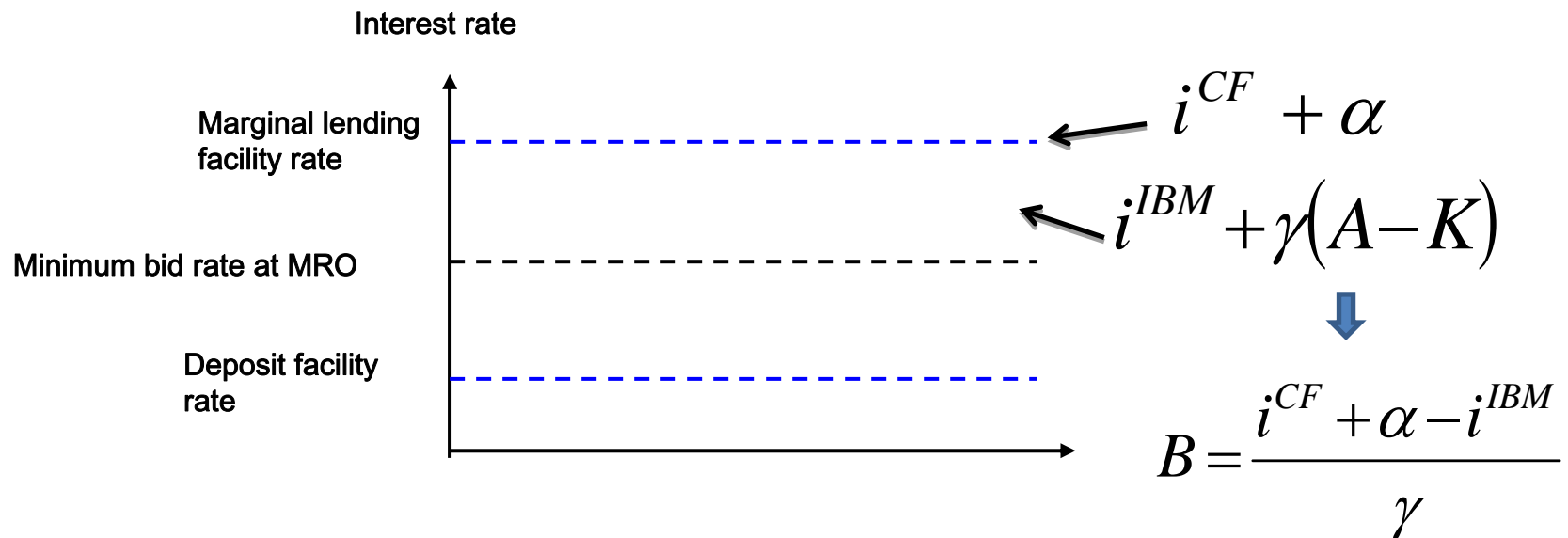


- Tradeoff stability in short term interest rate/better liquidity management
  - Monetary policy:  $i^{IBM}$  as close as possible to the policy rate (narrow corridor)
  - Financial stability: provide incentive to banks to care about their liquidity management (wide corridor)

- **How to get reserves?**

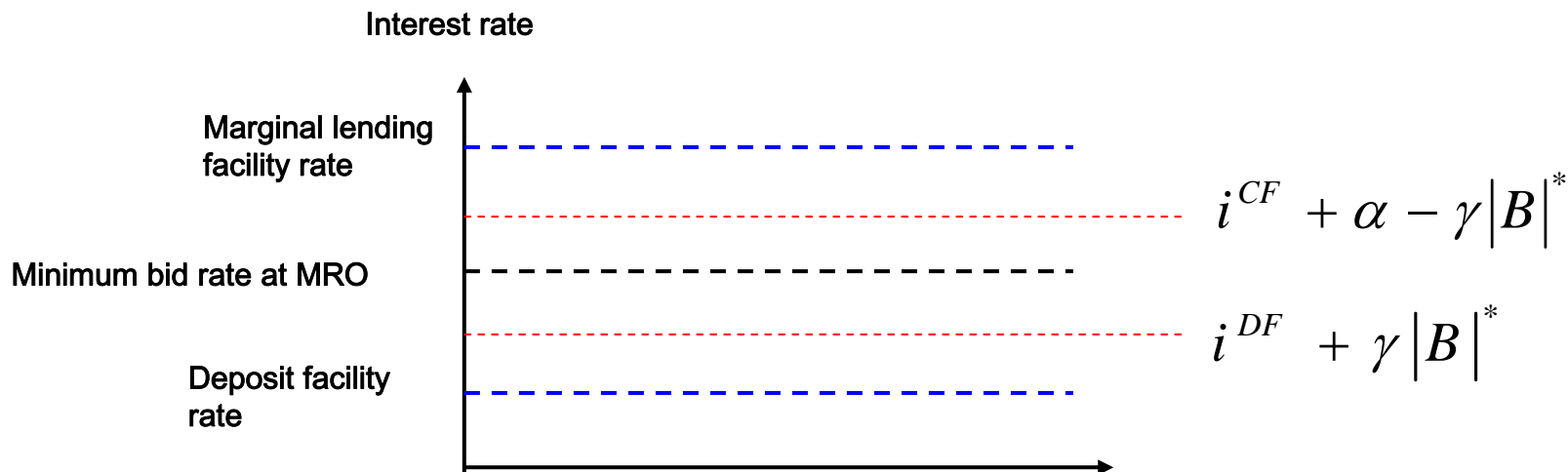
- Step 1: MRO (weekly operations)
- Step 2: marginal lending/deposit facilities or interbank market

- 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

$$\gamma \leq \frac{1/2 (i^{CF} + \alpha - i^{DF})}{E(A^a) - D} = \bar{\gamma}$$

b)  $K^a > D$  and  $A_H^a - K \leq |B|^{marg}$

- Bank a expands borrowing over D
- corresponds to  $\bar{\gamma} < \gamma < \bar{\bar{\gamma}}$

c) last case  $A_H^a - K > |B|^{marg}$

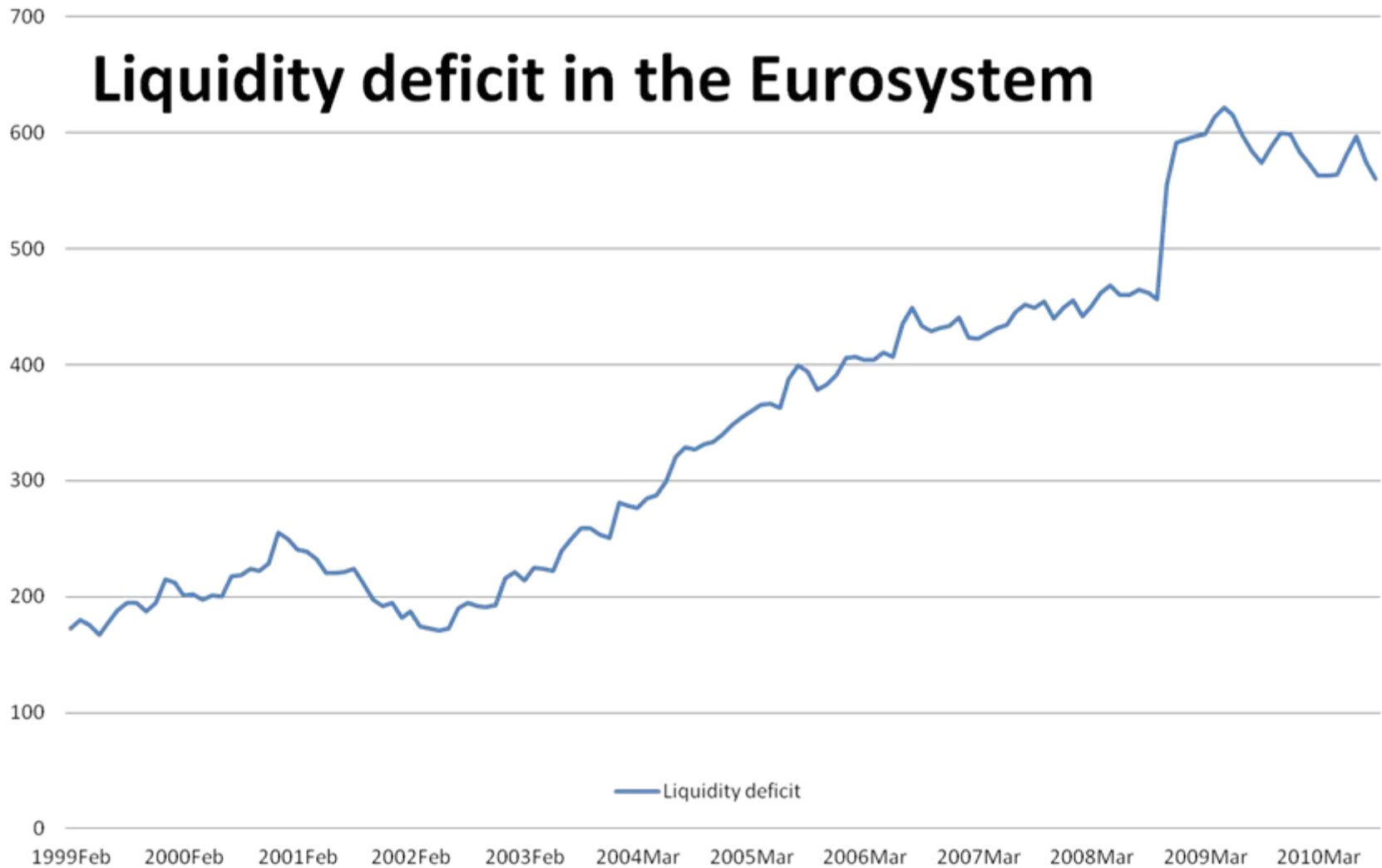
- bank a covers part of its remaining liquidity need at the credit facility
- corresponds to high transaction costs



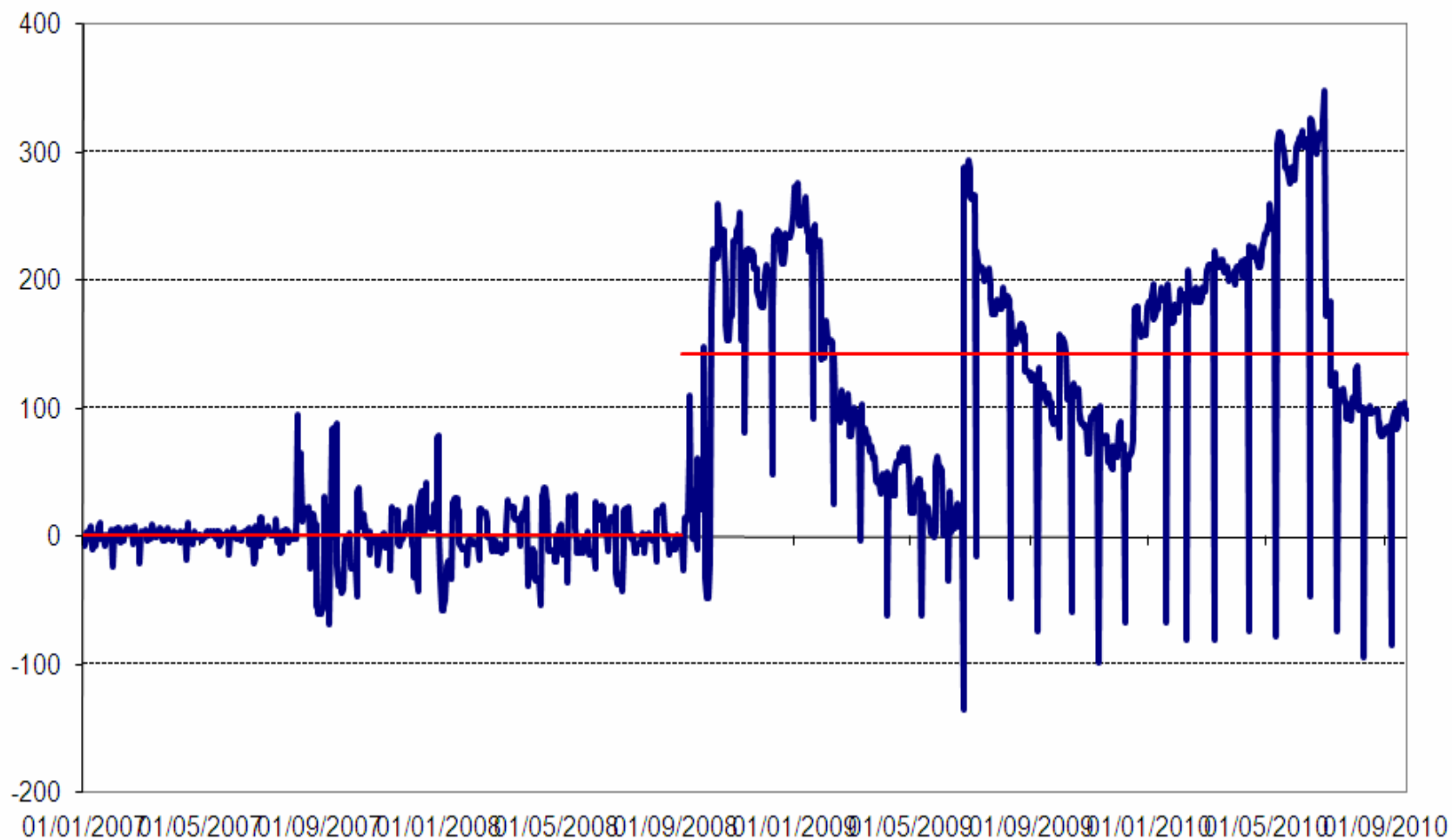
## 2. Discussion

- 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

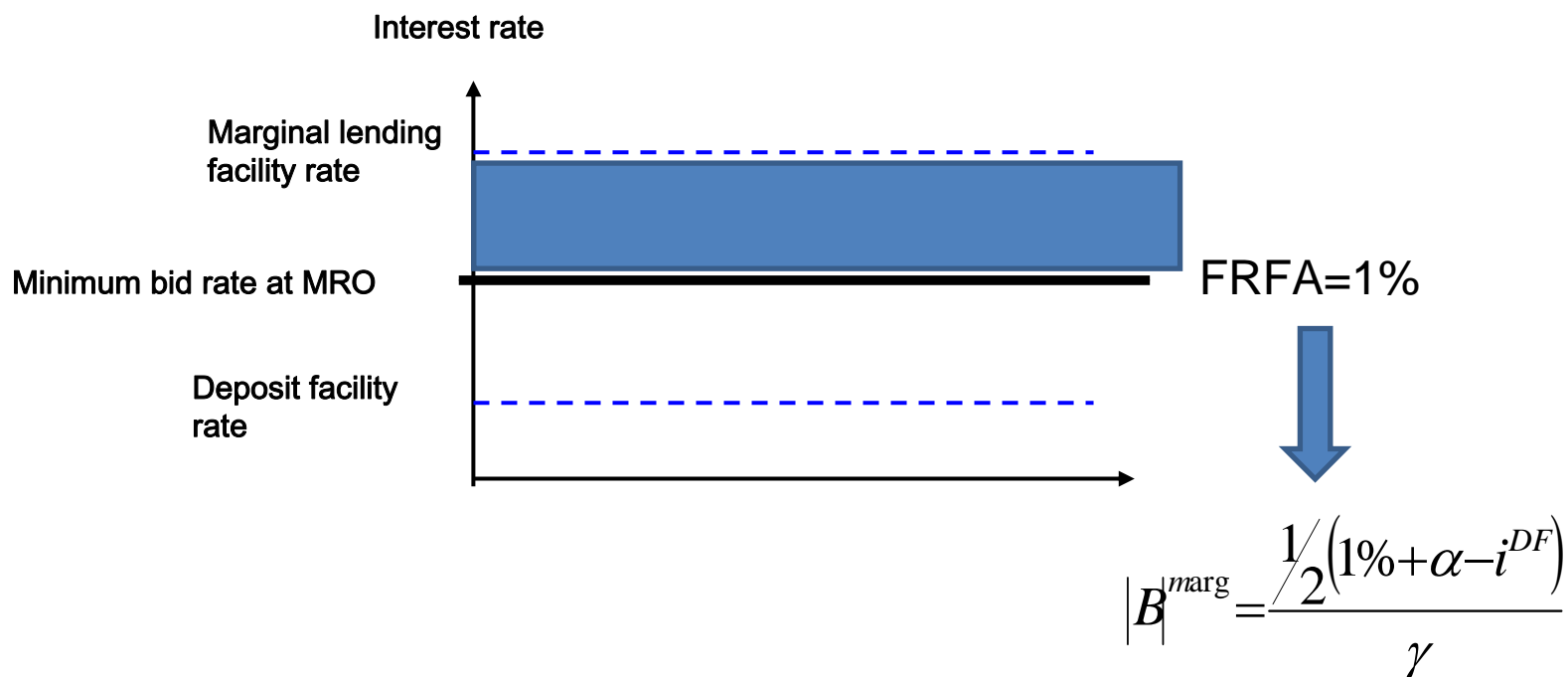
# Liquidity deficit in the Eurosystem



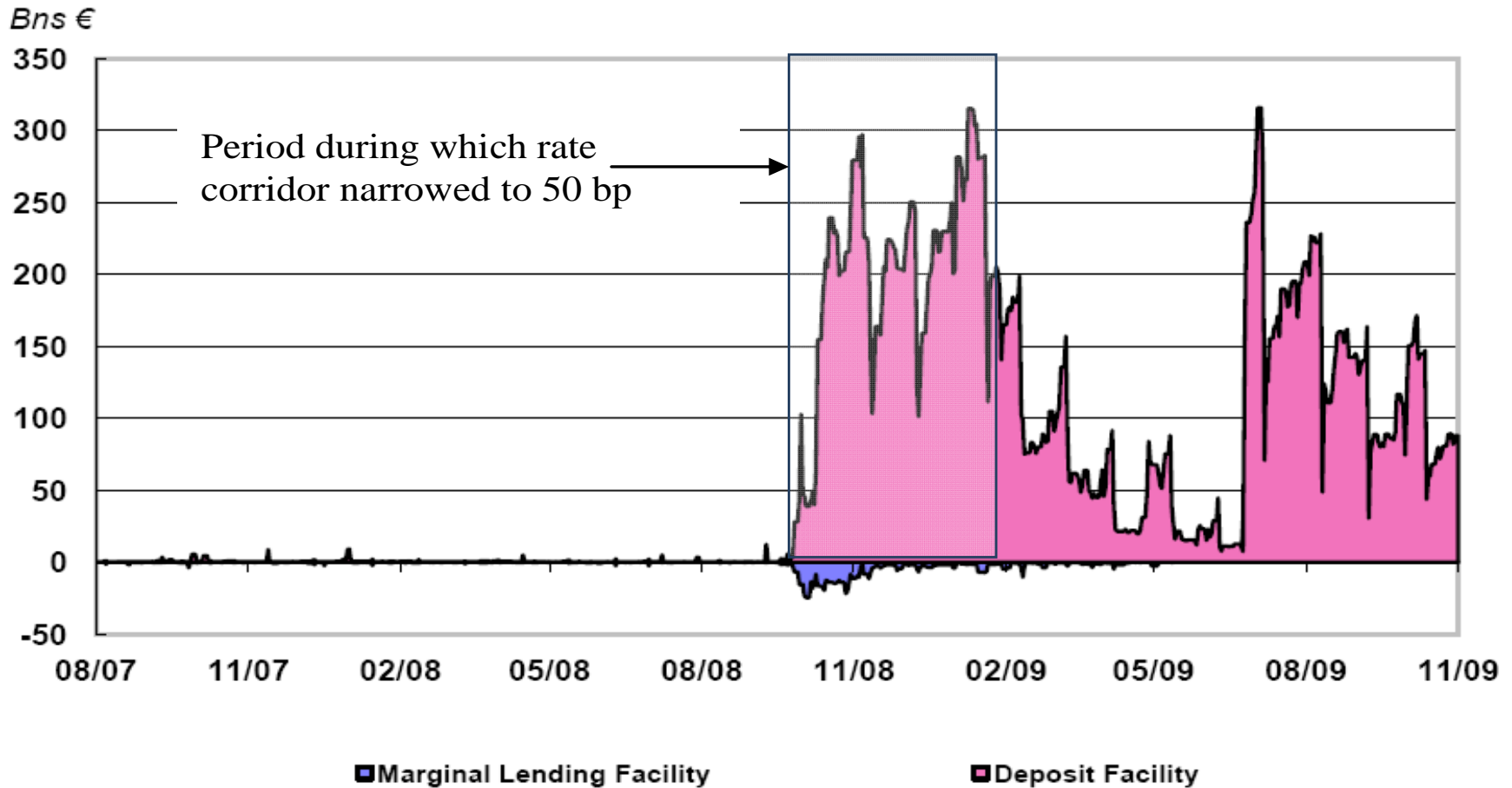
## Monetary and Financial Institutions' excess reserves (EUR billions)



- The authors do not fully account for the implications of the Fixed Rate Full Allotment and the provision of liquidity at 1 year



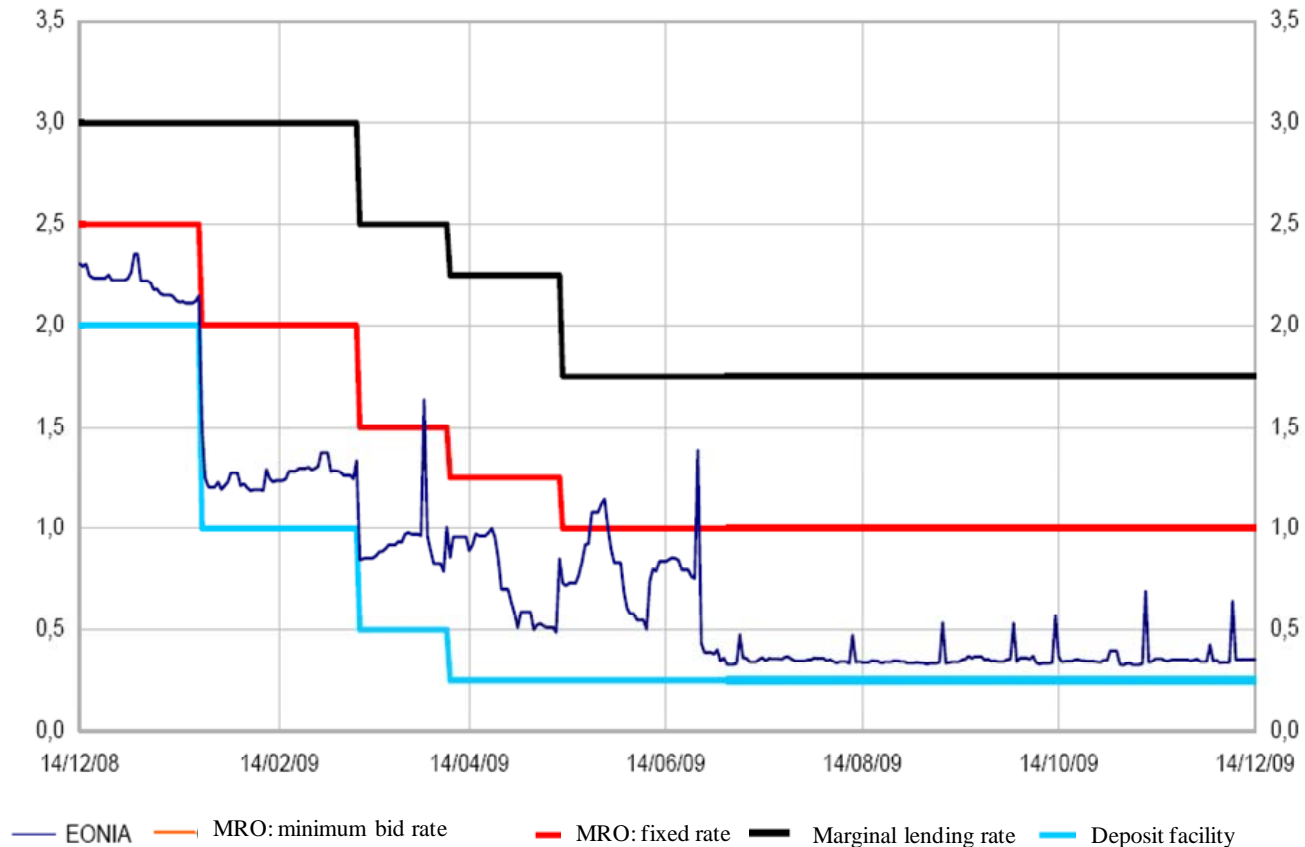
Does the model explain the full period or only the period from 8 October 2008 to 31 January 2009?



- 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

**Eurosystem and EONIA refi rates**



# 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