Title

- **Liquidity and interbank markets in financial crises.**

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Interbank markets in the southkorean crisis 1997-98

- the main activity of merchant banks was to discount commercial paper. They were using to this aim the proceeds from the sale of bills. They used to sell those bills to the commercial banks who had a lot of commercial paper in their trust accounts. Originally the trust accounts of banks were not allowed to buy commercial paper, but from 1993 onwards this prohibition was lifted and thus the banks eagerly invested in commercial paper, first discounted by merchant banks (see Cho, 2001).Merchant banks were intermediaries with very short time horizons who profited form difference in discounts, they had also no liquid reserves.

The crisis

- What happened in the first months of the 1997-98 crisis is the following. Commercial banks do not discount the commercial paper any more, merchant banks are closed, financial firms either go bankrupt or try to get short term credit from banks.

Financial fragility

- The expansion of the market for commercial paper has made the financial system more fragile for it has increased the web of reciprocal debts within the financial sector and between the financial sector and the non financial sector, thus increasing the correlation of default risks (see Lejionhufvud 1998). In case of distress the recalling of loans or the refusal of rolling over existing loans by one part of the financial system to the others could start a series of loan recalling and thus spreading the initial disturbance to the whole system. This was very likely in a dichotomized financial system in which only one part, the banks, had the right to refinanced by the central bank. The danger of a dichotomised banking system for systemic risk has already be recognized in Goodhart (1993).

Monetary policy

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Monetary policy in the two crises

- Monetary policy in Korea was rstrictive during the financial crisis thus favouring the spreading to other markets of the inital disturbance. The reson was that the Imf imposed a tight monetary policy as condition for granting an emergency loan.
- In the U.S.A.during the current crisis monetary policy has been very accomodating in the attempt to stop the spreading of the crisis to other markets.

Both policies however have failed

- In South Korea the policy adopted was the wrong one, in the United States was the best possible, given the circumstances.
- The results however are bad for both policies.

Minsky on central banking

- We read the condcut of monetary policy by the central bank in the usa during the recent financial crisis in the light of Minsky’s thoughts on the art of central banking and on its theory of structural instability of the financial system.

Minsky

- The central bank has to maintain orderly conditions in all markets in order for financial markets to be efficient. To maintain orderly conditions in financial markets means to protect those, who hold positions in these markets. If secondary markets must be developed to generate liquidity while the system is working smoothly and to ensure protection when the system is working badly, then **the dealers, who operate in those markets, must have access to the refinancing by the central bank.** The only warrant, which is accepted for sure, it that by the Central Bank. **If the central bank could stabilize certain private assets, these assets would become sources of liquidity at certain warranted prices.**

SECURITIZATION

- In a paper on securitization Minsky (2008) warned that securizitation might make the central bank not able to control the supply of money. In fact the financial institutions, which work in the securitization process do not hold any reserves and no capital. The danger that they pose to financial stability are also stressed in a sentence: *"**Securitization lowers the weight of that part of the financing structure that the central bank is committed to protect**"*

Minsky on rating agencies

- He writes with a terrible foresight that **in a securitized world the revising of the risk class of securities by rating agencies may cause a rush to sell the underlying assets, which in turn will start the debt deflation process.** This is actually what has happened in the first months of the crisis at the end of 2007. He warns also that the market for securitized assets will be a thin market if the price and quality of securities deteriorate.

The structure of financial system

- Minsky also warned that the **diffusion of a crisis would depend on the structure of the financial system.**
- This means that the amounts of losses that may derive from an initial shock are greater the more layered the financial system is and the greater the ratio of assets, whose value depends on the functioning of the system, to external assets.
- The field of instability, according to Minsky, is bigger the more layered is the financial structure. In this case even a small event can cause a disastrous depression.
- This aspect is more structural than macroeconomic, and hints at how **the diffusion of the crisis is affected by the network of financial sector linkages.**

Monetary policy in the U.S.A. now

- As Minsky correctly pointed out, in a system where securitization plays a big role, the central bank is committed to protect only a part of the financial system. **If, however, the linkages among different parts of the financial system are high, then its protection to one part of the system may not be sufficient to rescue the whole system in an emergency situation.** Here structural problems matter.

The central bank as market maker of last resort

- In this situation the central bank has completely changed its role in the interbank market and instead of simply netting out transactions among banks or acting as lender of last resort to the banking system, has become, as Buiter and Sibert (2008) correctly pointed out, a **market maker of last resort.**

Instability of the units and instability of the system

- Minsky tries to envisage a relation, which is not linear, between the instability of the units and the instability of the system. In the current crisis, both the presence of a very high number of Ponzi units in the financial system (see Kregel 2008a) and the complexity of economic structure would indicate that potential losses may be very big.

Bernanke on the FED’s monetary policy

- Bernanke (2009) argues that the reason why the central bank has switched from conventional monetary policy to these other measures **is that the federal funds rate has virtually approached its lower bound, which is zero.** He seems therefore to believe that monetary policy has been useful until now. Only now that has reached the lower possible bound it has stopped helping the economy. From the behavior of spreads and haircuts it does not seem that the easing of monetary policy has been successful in normalizing money markets while the current policy seems to have addressed the question of liquidity with better, though unusual, tools.

Learning process?

- **The possibility to avoid the propagation of the crisis depends on the timing of the interventions. The learning process by the central bank has been too slow in this respect.**
- **The successful part of central bank intervention has been the direct interventions into the markets, which however has started too late to avoid the spreading of the crisis.**

Direct intervention into the markets to support assets' prices

- **The successful part of the intervention by the central bank has been the direct interventions into the markets through various ad hoc designed facilities, which however has started too late to avoid the spreading of the crisis.**