CENTRAL BANKS AND LIQUIDITY CRISIS

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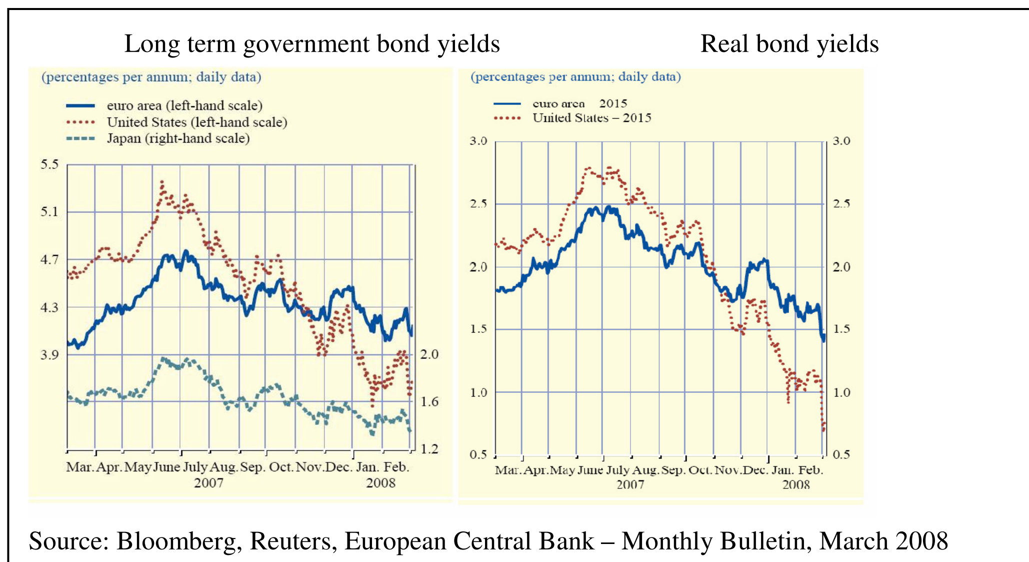
The wake of the US subprime crisis in August 2007 has made market participants to have a hard time understanding how things could change so fast and dangerous for credit market. Every time markets are under pressure, people are supposedly asking this type of questions, but crisis was not fast at all, and the innovative mortgage products, as crisis main cause, were dangerous ever since. The world economy was hanging on by its fingernails from the very beginning of elusive credit risk era. In the '70, it was an oil crisis. In the '80 it was saving & loan crisis turn. Emergent economies and IMF were blamed for financial crisis of the '90. Dot-com bubble of the 2000 was a tech crisis. Summer of 2007 was the moment when liquidity dried up in money markets. Every crisis is eventually a liquidity crisis. The only different thing from one to another is the risk people are aware of.

Keywords: credit crunch, ratio of assets to equity, lender of last resort, price stability, subprime crisis

Credit crunch between European Central Bank and Federal Reserve

At the end of 2007, a weaker than expected incoming data on American economic activity was the sign that subprime nightmare were about to coming true. Later in December and in the beginning of 2008, long-term US government bond yields declined because of the lack of trust from the market participants when they faced the weaker than expected incoming data on economic activity. The facts were not bad only from the housing market and the bad consequences all over the financial market, but from the labor market as well as industrial production. Unexpected weak results were registered also in Europe, and especially because American subprime crisis was an international business. Nevertheless, economic growth changed in a lower gear also in Europe. In the line with this situation, the decline was driven by market participants, no matter which type of bonds they used to invest in.

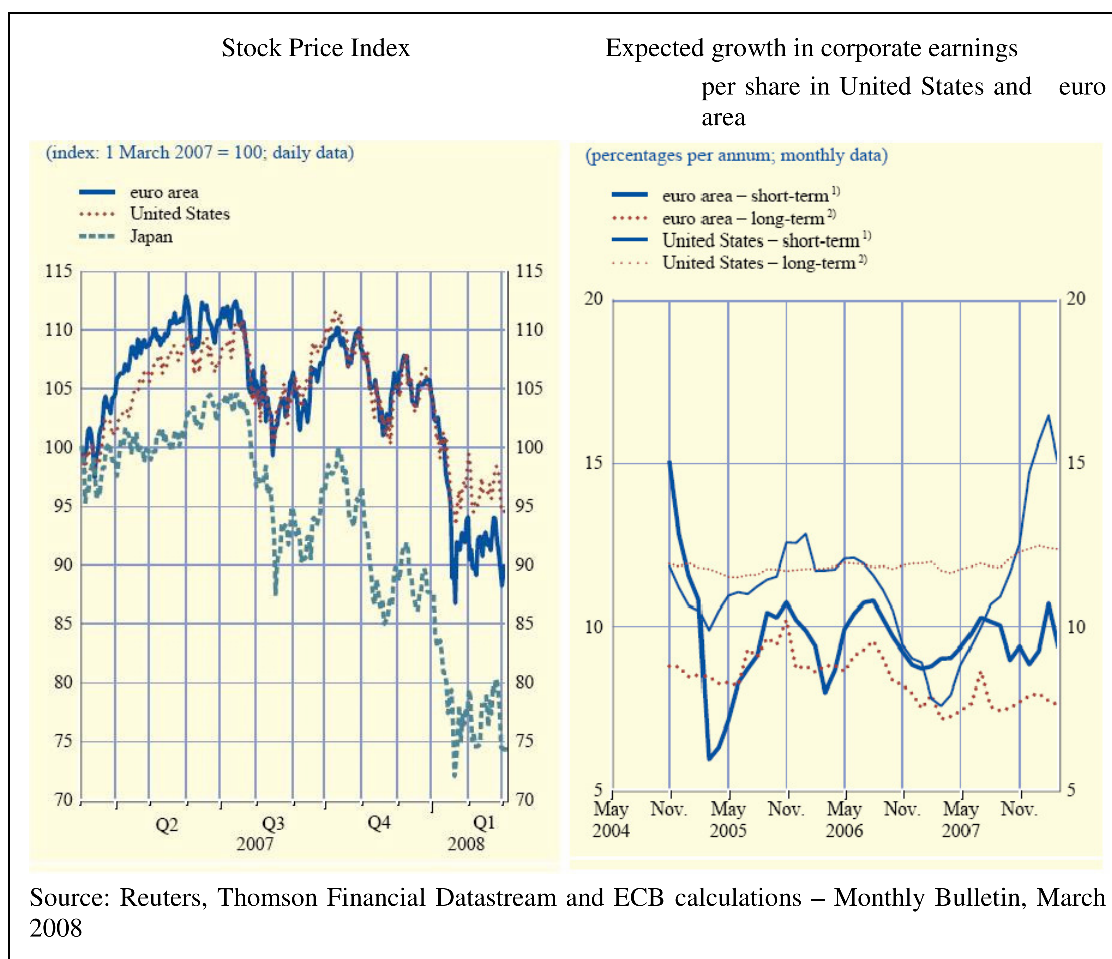


Source: Bloomberg, Reuters, European Central Bank – Monthly Bulletin, March 2008

As we can see, euro area bond yields fluctuated less than US area bond yields. This difference of volatility between euro and US long-term government bonds is driven by the level of exposure of these two major economies. Euro area is eventually considered to be sounder than US economy, because of the financial turmoil and the subprime crisis. Nevertheless, both long term government and real yields marked downturns from summer 2007, the very beginning of the credit crunch.

In Europe, the most important thing is the preservation of price level stability. But printing money to open up a discount window to banks, would have got ECB out of this task and bring a bad predicament. This is why the Govern Council decided on 6 March 2008 to leave the key interest rate unchanged, even meanwhile Federal Reserve were acting to cut the interest rate, a month after another. In Europe the crisis was announced when Northern Rock declared bankruptcy, but the way the scenario played out for European banks was a little different from the one of Wall Street.

The following charts reveal an unreal level for expected growth in short-term corporate earnings in United States. This erroneous calculus was lead into action by subprime crisis, also named as housing market crisis. In fact, it was not a housing market crisis at all, but a classic credit crunch. Some people purely cannot afford to contract a loan, because of their high risk profile, meaning low or variable income. With a low credit score, people could eventually obtain money from friends or relatives, or unknown and dangerous money lenders from the street. Deregulation on the credit market allowed people with low credit scores to obtain money from mortgage institutions, which were acting just like any other commercial bank. Mortgage institutions seemed to be reasonable judging the financial profile of their clients, obvious for higher rates of payment than ones of the banks. Bad credit scores means high risks for credit market. Therefore, someone who wants to borrow money having bad credit score is named a subprime debtor, simply because he cannot belong to the prime category of debtors.



Source: Reuters, Thomson Financial Datastream and ECB calculations – Monthly Bulletin, March 2008

Evolution of stock prices and expected growth in Unites States and euro area

For years, commercial banks did not allow subprime profile clients to borrow money they could not afford to pay back. But eager for easy cheap money, mortgage institutions put the money in the hands of subprime clients, creating an unhappy historical financial precedent. The system was wrong from the very beginning, because the subprime debtors were deceived by greedy brokers and lenders of mortgage institutions, following huge earnings but having any backup plan at all, in case that money would stop flowing. But for the first two years, it has been not any problem at all in collecting the money from the debtors. A subprime debtor had returned as much money as he could in the first two years. One month much more, one month nothing at all, another month just a little, depending on a variable income, the debtor was totally free in its paying decisions. As no dinner is for free, the subprime debtor has finally faced the unseen face of its loan contract. After two years, the mortgage institution asked him for all the money owned by that moment. This meant that the ordinary subprime debtor had not only an average sum of 250 dollars to pay, but a dramatic 800 dollars one. A dangerous huge number of foreclosures menaced the American economy over night, and the mortgage credit mechanism has stopped. The only problem was the great amount of jeopardized mortgage contracts. When the mortgage institutions wanted to execute clients for unpaid rates, the great number of foreclosures made the housing market to crack down. There was to many houses to sell and almost no one to buy them, because the more to come falling prices expectations. But the mortgage contracts were summed in collateral debt obligations (CDOs) listed on the stock market. The most important American investment banks sold the CDOs to hedge funds, retirement funds and the like, for Americans and Europeans too. Especially the last of them, were wondering what in the world could have happened with their money, when the subprime debtors ceased to pay their average 800 dollars monthly rates. The system crushed from California to Wall Street and forward to Europe. In august 2007, two great funds of Bear Stearns, one of the five big investments banks from Wall Street, declared bankruptcy. It was the official beginning of the crisis.

The lender of last resort

During a liquidity crisis, a central bank uses to provide massive amounts of liquidity outside of its normal monetary policy operations. From American subprime debtors, to European retirement funds invested in mortgage backed securities, people of all over the world did not take the credit risk profile into account. When money has stopped flowing, European Central Bank (ECB) along with other central banks as Federal Reserve (Fed), began to pump money in the wounded economies in order to keep money market rates close to the market participants pain. This chief target of central banks has to be seen in the light of the consequences over the future free market evolution. There are some gloomy issues derived from the central banks' intervention:

1. Conflict between objectives
2. Statue of lender of last resort and moral hazard
3. Price stability

The credit crunch is usually a good reason to blame the state acting against the free market. But this crisis is perhaps one of the only that has not burst because of the state. At least this is the leading conclusions of the economists and market participants. Since 2002, the great American investment banks' leverage has raised from 30:1 to 41:1. Leverage effect is measured by market value of the assets as a multiple of tangible equity, also named average ratio of assets to equity. Where did people get all those money from? Or, who permitted them to do that risky business until the point of no return? This paper work is discussing a different issue, and a simple answer will not be enough. But mortgage institutions had in fact too much space maneuver. If a firm portfolio is leveraged at 33 to 1, it takes a mere drop of 3% to wipe out its entire capital.

To save investing banks which declared bankruptcy, Fed injected money, lending 30 billion dollars to J.P. Morgan Chase, helping the bank to buy Bear Stearns. But, according to the fact that Bear Stearns has a debt of more than a trillion, people of all over American economy still do not recognize that there will be they who are about to pay the rest of the damages. In this case, Fed was a lender of last resort. Europe needs also emergency liquidity into its financial system, but European Central Banks is leaded by another mainstream. Europeans are afraid that European Central Bank has become a lender of last resort, even the Govern Council argued that it is far to be true. A lender of last resort provides liquidity to a solvent but illiquid commercial bank, of course at a penalty rate. In fact, in Europe the Central Bank has not such an

authority, but every national central bank. Considering the size of monetary base of about 3.8 trillion euro, The European Central Bank argued that any individual lender of last resort is only small part which could not affect the monetary stability. Indeed, but how about every national central bank? The crisis doesn't hit one single country, after all. If every national central bank agree to allow give more money to endangered market participants helped by European Central Banks ' discount window, then European Central Banks could be the head of the lenders of last resort, even its principal task is only to watch over the interest rate. Since European Central Bank fix the level of interest rate from a national central bank agree to lend the endangered clients, there is a good reason to admit that European Central Bank bring its objectives into a conflict, even is not officially endowed with lender of last resort function.

If Federal Reserve lend money every time a big investment bank declared bankruptcy, then every major commercial or investment bank will consider that anything is possible as long as there is an ultimate financial institution which can fix the problem every time when this occurs. This is nothing else but moral hazard. Along with conflict of interest between its objectives, the European Central Banks has to watch very carefully over the market participants' attitude in waiting its help. The European Central Bank had been aiming at raising interest above the neutral level because the GDP growth was over the expectations in 2007. The 4% European Central Bank' interest rate comparing with 2.23% Fed's interest rate is high enough to avoid both moral hazard and price volatility, if we take into account that in United States the core rate of inflation is 2.3%, with an inflation rate of over 4%. Unfortunately credit crisis seems to be far from its bottom. European Central Bank remains the principal institution Europeans are expecting protection against a world depression from.

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