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STABILIZING FINANCIAL MARKETS: THE ROLE OF THE CENTRAL BANK

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Bank of England

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Bank of England says £65bn gilt intervention staved off UK financial ‘spiral’

Central bank worried pension funds would dump £50bn in government bonds into a chaotic market



The Bank of England feared ‘severe disruption of core funding markets and consequent widespread financial instability’ © Maja Smiejkowska/Reuters

Tommy Stubbington in London OCTOBER 6 2022

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The Bank of England has defended last week’s intervention in the UK government debt market, saying it stepped in to prevent a £50bn fire sale of gilts that would have taken Britain to the brink of a financial crisis.

Pandemic interventions were pervasive

Survey of 39 jurisdictions

- 528 interest rate changes
 - 50 adjustments in reserve remunerations rates
 - 143 lending support operations
 - 101 exchange rate policy actions
 - 53 asset purchase operations
- Objectives
 - Restore flow of credit to firms, households and governments
 - Restore functioning of systemically important markets
 - Restore functioning of monetary transmission mechanism

Interventions in private markets

- HKMA (1998)
 - Currency board under attack
 - Purchased HK\$118 billion of equities (8% of market cap)
- Bank of Japan (starting 2010)
 - ETFs and J-REITS
 - Currently holds ¥37 Trillion

Central bank purchases of corporate bonds

Central Bank	Program/Facility	Number of Bonds	Number of Issuers	Date	Approx. Value	Private debt market size
Eurosystem	Corporate Sector Purchase Programme	1,857	407	9 Aug 2022	€344 bn	€9.5 tr
Federal Reserve	Corporate Credit Facility	1,291	550	31 Dec 2020	US\$14 bn	\$22.8 tr
Bank of England	Corporate Bond Purchase Scheme	361	146	5 May 2022	£19 bn	£2.5 tr
Riksbank	Corporate Bond Purchases	327	59	30 Jun 2022	SEK12 bn	SEK5.6 tr
Bank of Canada	Corporate Bond Purchase Program	79	42	22 Mar 2021	CA\$218 mn	CA\$2.8 tr
Total		3,915	1,204			

Sources: [Board of Governors of the Federal Reserve](#), [European Central Bank](#), [Bank of England](#), [Sveriges Riksbank](#), and [Bank of Canada](#).

How central banks use their balance sheets

- **Aggregate demand management**
Goal is to achieve price stability with full use of productive resources
- **Selective credit support**
Steer credit to specific sectors, regions or firms
- **Emergency government financing**
Provide funding directly to the government
- **Lender of last resort (LOLR)**
Lend to solvent financial entities facing immediate liquidity
- **Market maker of last resort (MMLR)**
Address dysfunction in specific financial markets

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Purposes can shift over time

- Fed Treasury purchases
 - March and April 2020 \Rightarrow stabilization
 - From June 2020 \Rightarrow AD stimulus
- Bank of England Asset Purchase Facility
 - Jan 2009 MMLR for corporate bonds
 - Almost immediately began purchasing gilts
- Eurosystem PEPP
 - Aggregate demand management
 - MMLR
 - Government finance (?)

Eurosystem

Tool\Facility	Function					Maximum Size	Peak Use
	AD Mgmt	Credit Support	LOLR	MMLR	Govn't Finance		
Main Refinancing Operations	✓					Unlimited	€337bn
Emergency Liquidity Assistance (ELA)			✓			Unlimited	
Long-term Refinancing Operations	✓					Unlimited	€2,213bn
Targeted Longer-term Refinancing Operations (I,II,III)	✓	✓	✓			Unlimited	
Pandemic Emergency Longer-Term Refinancing		✓	✓			Unlimited	
Outright Monetary Transactions				✓	✓	Unlimited	€0
Securities Market Programme				✓	✓	Unlimited	€209bn
Covered Bond Purchase Programme 1	✓	✓				€60 bn	€60 bn
Covered Bond Purchase Programme 2	✓	✓				€40 bn	€16 bn
Covered Bond Purchase Programme 3	✓	✓				€80 bn per month each	€298 bn
Corporate Sector Purchase Programme	✓	✓					€312bn
Asset-backed Securities Purchase Programme	✓	✓		✓			€32bn
Public Sector Purchase Programme	✓			✓	✓		€2,108bn
Pandemic Emergency Purchase Programme	✓			✓		€1850 bn	€1,718bn
Transmission Protection Instrument				✓	✓	Unlimited	€0
Central Bank Liquidity Swaps			✓			Varies, some unlimited	€3.7bn
Eurosystem Repo Facility for Central Banks (EUREP)			✓				

Federal Reserve

Tool\Facility	Function					Maximum Size	Peak Use
	AD Mgmt	Credit Support	LOLR	MMLR	Govn't Finance		
U.S. Treasury Security Purchases	✓	✓		✓		Unlimited	+\$3.5tr
Mortgage-backed Securities Purchases	✓	✓		✓		Unlimited	+\$1.3tr
Discount Window and Discount Rate			✓			Unlimited	\$50.8bn
Overnight Reverse Repo	✓					Unlimited	\$2.3tr
Standing Repo	✓					Unlimited	\$275bn
Term Deposits	✓					Unlimited	\$0
Commercial Paper Funding		✓		✓		Unlimited	\$4.2bn
Primary Dealer Credit			✓			Unlimited	\$33.4bn
Money Market Mutual Fund Liquidity			✓			Unlimited	\$53.2bn
Primary Market Corporate Credit		✓		✓		\$850 bn	\$14.1bn
Secondary Market Corporate Credit		✓		✓			
Term Asset-Backed Securities Loan		✓		✓		\$100 bn	\$4.1 bn
Paycheck Protection Program		✓				\$953 bn	\$88.4 bn
Municipal Liquidity		✓		✓		\$500 bn	\$6.4 bn
Main Street Lending Programs		✓	✓			\$600 bn	\$16.5 bn
Central Bank Liquidity Swaps			✓				\$446.1 bn
Foreign & Int Monetary Auth Repo			✓			\$3.6tr	\$1.4 bn

Why central banks intervene in markets

- Rationale

- Markets malfunction, become illiquid and may disappear

- Causes

- Concern over quality of the counterparties
- Concern over quality of securities

- Outcomes

- Private-sector market makers withdraw
- Typical market participants vanish

How central banks intervene in markets

- Operational objectives:
 - Ensure market liquidity
 - Ensure funding liquidity
- Options for intervention to catalyze market making:
 - **Enhanced lender of last resort:**
Collateralized lending so private agents can purchase and hold securities
 - **Market Maker of last resort:**
Directly purchase and hold securities

Enhanced Lender of Last Resort (LOLR)

- *Differs* from the Traditional LOLR
 - Wider range of acceptable collateral
 - Wider range of counterparties
- *Similar* to the Traditional LOLR
 - Counterparties regulated and supervised entities to assure solvency
 - Collateral faces haircuts related to quality

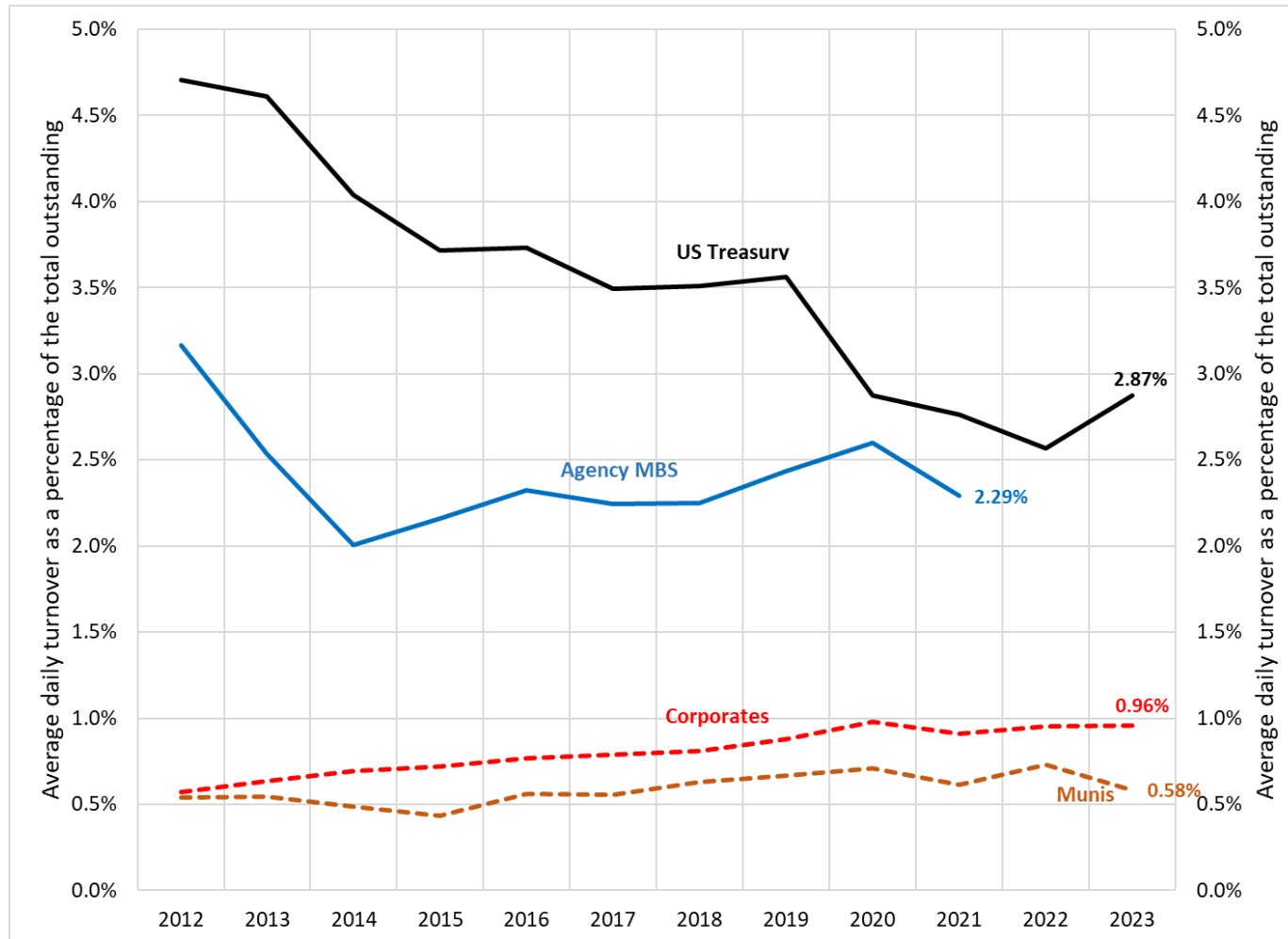
Market Maker of Last Resort (MMLR)

- Purchases directly in illiquid systemically important markets
- Price offered are
 - Above the disorderly market price (if there is one)
 - (Well) below the fundamental value of the security
(the CB's estimate of what the market price would be in an orderly market)
- Requirements for MMLR
 - Ongoing capacity for pricing securities (CBs do this as part of their collateral frameworks)
 - Mechanism for sterilization (transactions do not change the monetary base)
- Differs from enhanced LOLR
 - No requirement of counterparty solvency
 - Only need confidence that transaction will settle (delivery vs payment)

Choosing: LOLR or MMLR?

- Prefer LOLR so private agents determine prices
- May need MMLR if
 - private-sector market makers withdraw
 - typical buy-side participants disappear
 - quality of the security itself comes into question
 - not possible to establish the solvency of potential borrowers
 - complex counterparty arrangements \Rightarrow difficult to identify who needs funds
 - setting up the appropriate lending facility takes too much time

Most bonds NEVER trade!



Source: SIFMA

US bond market:

Enormous number of distinct issues:

Treasurys: 400+

Agency MBS: 25,000+

Corporates: 14,000+

Municipal Bonds: 1.5 million+

Note:

US Treasury market liquidity ↓↓

Challenges to central bank intervention

- Which markets qualify? **Those that are systemic (need a framework)**
- Standing, ad hoc, or dormant facilities? **You will always bail them out**
- Who can borrow? **Solvent, regulated entities, not just banks**
- Who can sell? **Anyone that can deliver**
- How can we mitigate moral hazard? **Penalty terms (?)**
- How swiftly should unwind? **As quickly as you can**

Desirable attributes of a framework for market stabilization

1. Be transparent and clear about objectives, instruments, and terms
2. Support only markets deemed essential
3. Create permanent facilities that may be dormant
4. Specify counterparties in advance
5. Do not act, react; set a price and be a quantity taker
6. Offer pricing that is unattractive in normal times
7. Only intervene when market and/or funding liquidity is severely impaired
8. Credible announcements may reduce scale of required interventions
9. Be clear about the roles of overlapping and competing authorities
10. Exit quickly

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