Provision and Pricing of Liquidity Insurance

Introduction to a Special Issue of the International Journal of Central Banking

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The evaporation of liquidity has been at the center of the financial crisis that erupted in August 2007 and intensified following the collapse of a number of financial institutions in October 2008. Banks and other financial institutions with funding needs faced increasingly serious problems in drawing funds from the interbank money market, triggering central banks to intervene as lenders of last resort. At the same time, market liquidity dried up in a number of markets such as the one for asset-backed securities, making it more difficult for financial institutions to off-load the more complex assets on their balance sheet. Again, in a number of cases central banks stepped in to become market makers of last resort. The drying up of both funding and market liquidity and their interaction played an important role in the propagation of the crisis.

This volume of the *International Journal of Central Banking* (IJCB) deals with some of the key aspects of the provision and pricing of liquidity insurance. It contains the papers, discussions, and commentaries that were presented at the inaugural Financial Stability Conference organized by the IJCB and held at the Federal Reserve Bank of New York on June 11, 2009. The purpose of the IJCB conferences is to stimulate research on issues of topical importance for central banking and provide a forum for interaction between central bank researchers, academics, and policymakers. In addition to the contributions published in this volume, the conference also contained a policy panel, in which Nigel Jenkinson (Bank of England), Martin Helwig (Max Planck Institute), and Eli Remolona (Bank for International Settlements) debated the need for adjusting the global regulatory framework in order to ensure stronger liquidity buffers. In addition, Ben Bernanke (Chairman of the Federal Reserve Board) gave the dinner speech, discussing the response of the Federal Reserve to the financial crisis through the lens of the central bank's balance sheet and addressing how the growth of the Federal Reserve's balance sheet could be reversed in case the need for an exit from the credit-easing policies was needed.

The first paper, “Interbank Lending, Credit-Risk Premia, and Collateral” by Florian Heider and Marie Hoerova (European Central Bank), provides a model that illustrates how tensions in the unsecured interbank market and the market secured by risky collateral affect repo rates in the market for safe collateral. The scarcity of safe collateral exacerbates the volatility of repo rates. The model generates empirical predictions that are in line with developments during the 2007–09 financial crisis. This paper is discussed by Ernst-Ludwig von Thadden (University of Mannheim). The second paper, “Liquidity, Moral Hazard, and Interbank Market Collapse” by Enisse Kharroubi and Edouard Vidon (Banque de France), discusses the incentives of banks to provide liquidity in a model where banks face moral hazard when confronted with liquidity shocks and those shocks are private information. The paper shows how the collapse of the interbank market for liquidity can occur in equilibrium and that the likelihood of such an equilibrium is higher when the individual probability of the liquidity shock is lower. The paper is discussed by Tano Santos (Columbia University).

The third paper, “Credit, Asset Prices, and Financial Stress” by Miroslav Misina and Greg Tkacz (Bank of Canada), asks whether some combination of measures of credit and asset prices can help predict periods of financial stress in Canada. They find that at the two-year horizon, credit and real-estate prices emerge as important predictors of financial stress, confirming some of the general findings in the early-warning literature. The paper is discussed by Stijn Claessens (International Monetary Fund). In their commentary, “Prices and Quantities in the Monetary Policy Transmission Mechanism,” Tobias Adrian (Federal Reserve Bank of New York) and Hyun Song Shin (Princeton University) argue in favor of a revaluation of credit quantities and factors affecting the supply of credit in the conduct of monetary policy. They emphasize and illustrate fluctuations in leverage and the associated changes in haircuts in collateralized credit markets and argue that central banks’ interest rate and liquidity management policies should take into account leverage in the pursuit of price and financial stability.

The fourth paper, “Strategic Trading in Multiple Assets and the Effects on Market Volatility” by Chenghuan Sean Chu, Andreas Lehnert, and Wayne Passmore (Federal Reserve Board), studies equilibrium price dynamics in an environment where some distressed firms are forced to sell assets and others specialize in strategic trading around such fire sales. The model is used to conduct a welfare analysis of extending government guarantees to less liquid securities and allows one to consider the optimal exit strategy for a government that accumulates assets on its balance sheet. The paper is discussed by Bruce Carlin (UCLA). In his commentary, "When Everyone Runs for the Exit," Lasse Pedersen (New York University) analyzes the dangers of rushing for the exit in financial markets. He analyzes why people crowd into trades, why they run, what determines the risk, whether to trade when the dust settles, and how much to pay for assets in light of this risk.