Three steps to calm the storm

Joint post by Willem H. Buiter and Anne C. Sibert. This post appeared first as a Comment in the *Financial Times*, Thursday, September 6, 2007.

Should the Bank of England do more to calm the money markets? During the current turmoil, it has been more hands-off than the European Central Bank, which has injected liquidity on a massive scale, and the Federal Reserve, which has injected liquidity on a modest scale and cut its discount rate by 50 basis points. The Bank is criticised by the City and some commentators for this "passive" policy stance. Would a more activist stance be appropriate?

Should the Bank have cut its policy rate? Neither the Fed nor the ECB has yet done so. The policy rate is not appropriate for addressing credit and liquidity crises. The Bank should cut Bank rate only if necessary to achieve its inflation target and, subject to that, to support the real economy. While Bank rate may well have peaked, there is no case for a cut now.

Should the Bank have cut its discount rate - the rate on overnight borrowing from its standing (collateralised) lending facility? We think not. It would be a bonus to those already willing and able to borrow at the discount window, but would do nothing to boost banks' ability and willingness to access that window. The problem is that the Bank's definition of eligible collateral at the discount window and in open market operations is too restrictive. Also, stigma continues to attach to discount window borrowing.

Should the Bank have injected additional liquidity to keep interbank rates closer to its policy rate, using short-term repos (repurchase agreements) at the policy rate, longer-term repos at market rates or outright purchases? We believe the main problem is that eligible counterparties (banks, building societies and certain securities dealers) do not have eligible assets to offer as collateral or sell outright.

The gap between overnight money market rates and policy rates is not significantly higher in the UK than in the US or the eurozone. On September 4, the overnight gap was 36 basis points in the UK, 26 in the US and 44 in the eurozone. A wider gap opens up at longer horizons: at one month, the UK gap is 93 basis points, compared with 55 for the US (putting the market rate above the discount rate) and 47 for the eurozone. At three months the gap is 105 basis points for the UK (putting the market rate above the discount rate), 45 for the US and 75 for the eurozone.

We believe there are three features of the UK discount window regime and one related feature of the open market regime in need of an urgent fix.

First, the Bank should help to de-stigmatise discount window borrowing. Even the quality press calls this the "emergency facility". It is no such thing. Every party uttering the words "emergency facility" should be corrected by the Bank.

Second, like the Fed, the Bank should extend the term of its discount window loans from overnight to at least 30 days. Third, the Bank accepts as collateral at its discount window or in open-market purchases only instruments issued by European Economic Area central governments, central banks and major international institutions rated at least Aa3 (and, exceptionally, US Treasury bonds). This is too restrictive. The ECB accepts marketable and non-marketable securities rated at least A-, including securities issued or guaranteed by private entities. The Fed has been quite restrictive, but the Federal Reserve Act allows it to lend, in a crisis, to any institution,organisation or individual and against any collateral.

Faced with financial turmoil, the rule of thumb should be: if it can be valued, it is eligible as collateral at the Bank's standing lending facility. If securities become illiquid in turbulent markets (for example, debt backed by impaired mortgages), the Bank may have to act as market maker of last resort and establish a price itself. To avoid moral hazard, an appropriate "haircut" (discount) should be applied to the instrument's fair value. Longer term, the Bank should extend its set of eligible discount window counterparties to all institutions subject to a Bank-approved prudential regulatory regime.

What the Bank did on September 5 was mainly 'mood music' for the markets. The substance is that the reserve target ceiling has been raised a little. Eligible banks can hold a slightly larger amount of reserves at the Bank without incurring a 100 basis points cost; banks were also given an extra week to choose their reserve targets. This addresses none of our concerns.