

The role of central banking in the global economic and financial crisis

[Literature](#), [Russian Literature](#)



1. Introduction

It is fair to say that central banks around the world have learned the lessons from previous crises and they attempted to change financial regulations to keep pace with the changing global financial system. The policy response triggered by the recent financial crisis has been rapid and it appears that the global policy response has helped to mitigate the effects of the financial crisis. European Central Bank response to the latest crisis was an example of swift and effective reaction. It combined a mix of standard and non-standard monetary actions.

2. European Central Bank (ECB) – history and mission

The ECB is the central bank for Europe's single currency (the euro) and its main task is to maintain the euro's purchasing power and thus price stability in the euro area. The ECB was created in 1998 to serve as the central bank representing the interests of the countries belonging to the European Union. In less than a decade, the ECB, headquarter in Frankfurt, Germany, has emerged as one of the world's most important financial institutions. The Treaty of Nice (1967) established a three-stage plan to create a single currency and monetary policy for the euro area by creating the European System of Central Banks (ESCB).

The ESCB consists of the ECB as well as the national central banks for each of the member nations. The ECB is successor of the European Monetary Institute (EMI). The EMI was established at the start of the second stage of the EU's Economic and Monetary Union to handle the transitional issues of

states adopting the euro and prepare for the creation of the ECB and European System of Central Banks.

The ECB formally replaced the EMI on 1 June 1998 by virtue of the Treaty on European Union; however it did not exercise its full powers until the introduction of the euro signaling the third stage of EMU. The ESCB officially became law for the countries participating in the ESCB on January 1, 1999 - this date also saw the introduction of the Euro as the official currency for the euro area, replacing the native currencies of each country.

3. European Central Bank monetary policy and role

European Central Bank has one monetary objective - promoting price stability - unlike US Federal Reserve System which is also empowered to promote maximum employment and moderate long term interest rates (Eckes). According to the ECB official website, the basic tasks of ECB are definition and implementation of monetary policy for the euro area; conduct of foreign exchange operations; holding and management of the official foreign reserves of the euro area countries and promotion of the smooth operation of payment systems.

Some of the additional tasks include the issuance of banknotes within the euro area, collecting statistical information, and maintaining working relations with relevant international and European institutions. Although the ECB is governed by European law directly and thus not by corporate law applying to private law companies, its set-up bring to mind a corporation in the sense that the ECB has shareholders and stock capital. Its capital is five

billion euros which is held by the national central banks of the member states as shareholders.

Like most other central banks the European Central Bank relies on open market operations to influence short-term interest rates in order to manage the Euro system's money supply. The ECB also uses public messages and press releases to indicate its position with respect to monetary policy.

To make it possible to measure results, the ECB has adopted the following benchmarks: the ECB's Governing Council defines price stability as " a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2%". In addition, the ECB has adopted the measuring of inflation as a reference as well by stating that " in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2% over the medium term".

4. Central bank response to global financial crisis

The ECB's monetary policy has a primary objective of maintaining price stability in the euro area which defined by keeping euro area HICP inflation below, but close to, 2% over the medium term. This objective has also guided the ECB's policy response throughout the crisis. When confronted with severe downside risks to price stability, the ECB reduced its main policy rates and adopted a range of additional policy measures, often referred to as " non-standard" measures.

These have served as a complement to the changes in interest rates when the channels by which, in normal times, the central bank transmits policy signals to the broader economy were seriously impaired (Preat). These policies were devised in such a way that the ECB's capacity to ensure price stability over the medium term was preserved, thereby contributing to the overall stability of the financial system in the euro area. Following the bankruptcy of Lehman Brothers in 2008, the uncertainty about the financial health of major banks worldwide led to a virtual collapse in activity in many financial market segments since banks built up large liquidity buffers.

This situation meant alarm in view of a high risk of a credit crunch and a high risk of inability for the central bank to steer monetary conditions. The ECB, like other major central banks, quickly reduced its key interest rates to historically low levels, but a key element of its response to retain effectiveness in influencing monetary conditions consisted of its non-standard policy measures. The aim was to continue preserving price stability, contributing to stabilizing the financial situation and limiting the fallout on the real economy. The non-standard measures were adopted in order to support financing conditions and credit flows to the euro area economy in addition to what could be achieved through reductions in key interest rates alone.

The non-standard measures implemented from October 2008 forward were subsequently referred to as Enhanced Credit. These non-standard measures were tailored to the specific, bank-based financial structure of the euro area. The ECB's Enhanced Credit Support comprised five key elements; the first

four elements aimed at supporting bank liquidity in euro and foreign currencies (Fixed rate full allotment, Extension of the maturity of liquidity provision, Extension of collateral eligibility, Currency swap agreements) , the fifth element - Covered bond purchase program -aimed at supporting bank funding in the capital market.

While these measures clearly differ in their specific design and scope, they all follow the same guiding principle: a clear focus on the ultimate objective of price stability, supported by the intermediate target of ensuring depth and liquidity in dysfunctional market segments to restore the proper functioning of the monetary policy transmission mechanism. To that effect, they serve as complements to the standard monetary policy tools and can be unwound should upward pressures on price stability materialize. Due to strong and timely action by central banks and governments worldwide signs of stabilization in financial markets were visible.

The improvement in market conditions continued until the outbreak of the European sovereign debt crisis in May 2010, when government bond markets in some countries threatened to seize up. In early 2010 the euro area sovereign debt crisis began with acute market expectations about a possible Greek sovereign default, with a risk of impact on Ireland, Portugal and even Spain and Italy. In May 2010 some secondary markets for government bonds began to dry up completely; large-scale sale offers faced virtually no buy orders and yields reached levels that would have quickly become unsustainable for any sovereign. Given the central role played by

sovereign debt in financial markets such malfunctioning threatened both financial stability and the transmission of monetary policy.

Even if the initial problems were focused on the Greek government debt market, contagion and spillover effects quickly spread to other so called peripheral country sovereigns and to other market segments. In May 2010 the Euro system launched its Securities Markets Program, which entailed the outright purchase of debt instruments. By re-introducing some liquidity into the secondary market, these purchases have helped to re-establish more meaningful pricing of debt instruments of the sovereign markets most adversely affected by the crisis, thereby allowing market participants to recognize losses and unwind positions. Through such mechanisms, market functioning in other market segments has been able to resume and the transmission of monetary policy has been restored.

The second half of 2011 was characterized by a renewed intensification of turbulence in sovereign debt markets, which quickly spilled over to the banking system. As a consequence, the access of euro area banks to market-based funding came under strain, as reflected, for instance, in a substantial surge of euro area money market spreads since July 2011. In the ECB bank lending survey more than half of all participating euro area banks reported deterioration in wholesale funding conditions. Without effective remedies, these developments could have severely undermined bank lending to firms and households and triggered broad-based selling of assets.

The LTROs were aimed at alleviating these adverse funding conditions. Banks were able to satisfy their additional liquidity needs, in the context of a net liquidity injection of around €520 billion – taking into account the shifting of liquidity out of other operations. Moreover, the LTROs provided banks with a more certain medium-term funding situation owing to the longer maturity of the new operations.

The ECB has taken an active role in mitigating the financial and economic crisis in the euro area, which has been fully consistent with its mandate. Reductions in the main policy rates have served to counteract acute downside risks to price stability. Non-standard measures have addressed impairments to monetary transmission channels, thereby complementing changes in policy rates when highly dysfunctional and perturbed market conditions impeded their effectiveness (Preate). To preserve ECB primary objective to ensure price stability, these non-standard measures were temporary.

5. Conclusion

The combination of standard and non-standard measures deployed by the ECB and other central banks has been effective in preventing a full-blown financial collapse. However, the exceptional nature and the risks associated with non-standard measures imply that these measures must be phased out as soon as circumstances permit. The financial market crises that started in 2007 have called for exceptional actions on the part of global financial policy-makers. Central banks, in particular, have faced unprecedented

challenges. The ECB, for its part, has demonstrated its capacity to react swiftly and effectively to these events.

During the initial period of turmoil the ECB was quick to adjust the provision of liquidity to the banking sector. Moreover, it did not hesitate to reduce interest rates to historically low levels and to implement a broad set of non-standard measures. The purpose of these non-standard measures was to support the transmission mechanism of monetary policy in a context of dysfunctional markets. Overall, the ECB's response helped to sustain financial intermediation in the euro area by safeguarding the refinancing of solvent banks and restoring confidence among financial market participants.

In turn, this success in preserving the viability of the banking system and important segments of the financial markets has been instrumental in maintaining the availability of credit for households and companies at accessible rates and, ultimately, in maintaining price stability. Looking ahead, the ECB plans to continue to closely monitor economic and financial developments. The non-standard monetary policy measures that were taken by the ECB in response to acute financial market tensions, and that are temporary in nature, will be gradually phased out in line with improvements in financial markets and economic activity.

According to Rinkus, as globalization has continued on its historic rise and sovereign wealth funds are actively involved in the liquidity of the global economy, it has become increasingly important to have government central

banks and other government agencies develop a more connected and closer working relationship.

References

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