Monetary Policy, Illiquid Collateral and Bank Lending during the European Sovereign Debt Crisis

Jean Barthélémy, Vincent Bignon, Benoît Nguyen *

Key question

During the last financial crisis, the central banks have been very active in fulfilling their lender of last resort function. What is the role played by money issuance procedures in stabilizing the recessionary impact of financial crises? Such procedures vary widely across central banks. The Eurosystem (European Central Bank and national central banks of the euro area) departs from the Bank of England and the US Federal reserve bank by injecting money through secured loans to banks. This article assesses the role of a specific feature of the collateral framework of the Eurosystem that allows banks to pledge illiquid assets –that are non-marketable– as guarantee for their refinancing operations. The article analyses whether, during the sovereign debt crisis, against the backdrop of dysfunctioning interbank market and sluggish securitization market, money injections against non-marketable assets have contributed to cope with the wholesale funding drain and then sustain bank lending.

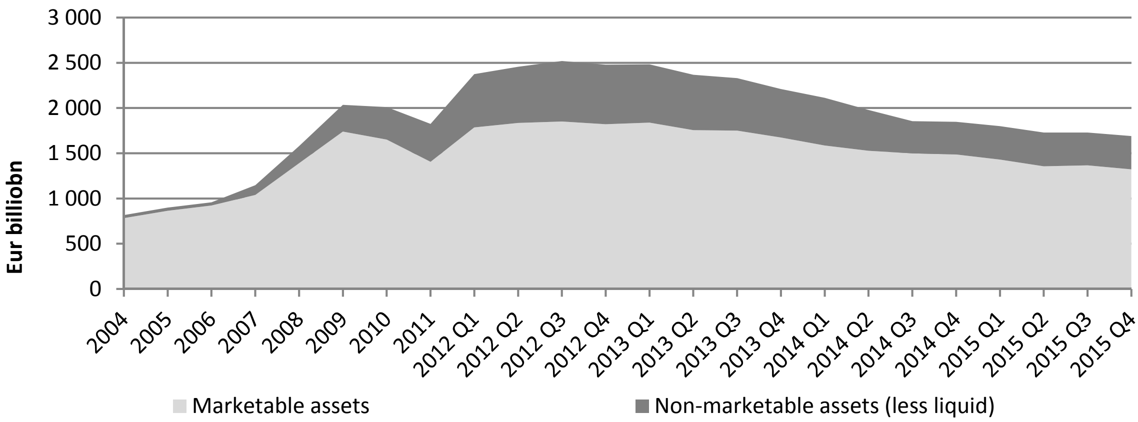
Methodology

Using original individual monthly data on central bank refinancing operations, collateral pledged with the Eurosystem, and balance sheets of the 177 largest banks in the euro area from Jan 2011-Dec 2014, a measure of wholesale funding stress is built. Then, panel regressions models measuring the role of illiquid collateral in sustaining bank lending are estimated. They control for bank capital ratio, for the business model of banks and for time-varying demand for loans by including bank and time-country fixed effects.

Main results

- The illiquid collateral represented up to 27% of the total collateral pledged with the Eurosystem in 2012, *i.e.* €670 billion.
- More than 40% of the banks sample coped with a run during the summer 2011.
- A one standard deviation increase (a 2 percent point increase) in the share of illiquid assets pledged was associated with a 1.1 % increase in bank lending to the economy.

Collateral pledged with the Eurosystem [(1)]



(1) After valuation and haircut – Sources: Eurosystem database; authors' computations.

Main message

The article contributes to revisit the optimal management of financial crises by central banks. It highlights that the collateral framework of central bank may play an important role in stabilizing bank lending in times of wholesale funding distresses of banks. It shows that the acceptance of illiquid assets as collateral for refinancing operations at the central bank is associated with a significantly higher bank lending to the economy.

* Economie et Statistique / Economics and Statistics n° 494-495-496, 2017. https://insee.fr/en/statistiques/3135076