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19 June 2008

Outline of paper to be presented at the Financial Markets Regulation Conference Manchester, 1-2 July 2008

CENTRAL BANKS, MONEY MARKET LIQUIDITY AND INTERNATIONAL BANKS UNDER STRESS

One of the functions of financial intermediation is to liquify illiquid investments. As Keynes put it so well in a famous passage of the General Theory:

> "Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of 'liquid' securities. It forgets that there is no such thing as liquidity of investment for the community as a whole … Capital markets provide liquidity to make investments which are 'fixed' for the community more 'liquid' for the individual".

It is quite natural that financial innovation has steadily pushed this "liquification" function further in the decades that have followed Keynes's remarks.

Indeed, the main strategy of major banks over the past 10 to 20 years has been to shift from keeping loans on their own balance sheets to providing liquidity to various capital market structures. This helped to widen the scope of capital markets as an increasing range of debts were securitised. Precisely because of the liquidity support facilities provided by major banks, these markets became ever more liquid.

Given this strategy, it had been clear for many years that impossible-to-predict shocks could put bank funding markets under exceptional strain. This could happen even if no major individual bank faced a solvency crisis. It has also been known that in circumstances of stress central banks could be called on to provide emergency liquidity not only to specific firms, but also to interbank markets, doing so on exceptional terms.

In response to the crisis that broke in August 2007, central bank banks widened radically the terms on which they provided liquidity (in terms of collateral, counterparties, maturity of operations and currency composition). The efficacy of these measures has been reviewed by a recent Study Group at the BIS, which produced several policy recommendations.

There will be other instances in the future that whole banking systems face liquidity crises the precise nature of which is hard to foretell. In many cases, it is only central banks that will be able to deal with such crises. So the toolkit available for central bank liquidity operations and how it is used, will influence the shape of future crises.