Press Points for Chapter 3: ***Market Interventions During the Financial Crisis: How Effective and How to Disengage?***

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Key points

- **While it is too early for a comprehensive assessment of the long-term effectiveness of crisis interventions, the empirical analysis in this chapter indicates that crisis intervention announcements have been effective in calming distressed financial markets.**
- **As measured by their short-term goal of calming markets, announcements of liquidity support were most effective during the early phases of the crisis, while bank recapitalization and asset purchases by the authorities were most effective in later stages.**
- **As regards long-term effectiveness, our initial conclusions are that the market prices of some financial instruments have started to stabilize and that debt issuance is picking up in response to the public sector's unprecedented crisis measures.**
- **Disengagement from crisis interventions should be guided by the return of lasting confidence in the health of financial institutions and markets. Clear communication about unwinding—not only when to start, but how the entire process is designed is important for retaining market stability and managing expectations.**

This chapter assesses the extent to which interventions announced and undertaken by the authorities of major advanced economies during the current financial crisis have been effective in calming distressed markets and restoring financial stability. Together with a preliminary examination of the longer-term impact of these interventions on their intended target markets, the chapter also discusses disengagement from these crisis interventions by touching upon issues of timing, sequencing, and market distortions.

The chapter addresses three main questions:

How effective were the announcements of crisis interventions in calming markets?

Receding stress in the banking sector and some return to self-sufficiency in the most impaired debt markets are promising signs that the most sweeping public sector interventions in the financial sector since the Great Depression have helped rein in concerns about

systemic risk. Policy responses to the crisis were rapid and, to some extent, effective in calming financial markets and restoring market functioning.

The analysis was based on an event study of policy announcement in 13 advanced economies over a two-year period (June 2007 to June 2009). The conclusions of this event study are that in an environment of high market uncertainty and counterparty risks, such as that in the early phase of the crisis when concerns were primarily about funding liquidity, liquidity support was most effective in calming financial markets.

As the crisis evolved from one of liquidity to one of solvency, announcements of bank recapitalization and asset purchases by the authorities were most effective as these measures helped alleviate credit risk.

What is the longer-term effectiveness of crisis interventions?

Although it is too early for a comprehensive assessment of long-term effectiveness, there are several aspects one can usefully evaluate in the interim. The chapter examined longer-term effectiveness by looking at volumes of issuance and general price movements of the financial instruments that the authorities have attempted to influence. While tying the specific policy interventions to longer-term effectiveness is very difficult due to intervening events and other confounding factors, the initial conclusions are that some market prices are stabilizing and debt issuance is picking up.

When and how should the public sector disengage from crisis measures?

In general, disengagement of crisis interventions in the financial system by central banks and governments should be guided by the return of lasting confidence in the health of financial institutions and markets. Since economic and financial conditions differ across countries, there is not a common template for when and in what order the public sector should unwind the facilities put in place during the crisis.

That said, some general principles do apply.

1. The strategy for the timing and the manner of unwinding crisis measures should include managing market expectations and having a clear communication on both when to start and on how to execute the unwinding strategies.

2. It is important to plan on averting arbitrage opportunities either across sectors or across national borders. For example, it is preferable, where possible, for countries to coordinate the unwinding of government guarantees on bank debt issuance.

3. For government financial sector measures, priority should be given to exiting from support programs that have a significant distortionary impact on financial markets and involve large contingent liabilities for the government. Still, the timing and modalities of these decisions would need to be balanced against the condition of financial markets and, specifically, how illiquid or fragile they may still be.