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## Interbank markets hold the key to current crisis

*Lack of interbank lending is one of the factors behind global equity markets' collapse*

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AS the sub-prime crisis in the United States and UK has now turned into a full-fledged global credit and financial crisis, policy makers worldwide are belatedly attempting to take urgent steps to prevent a global financial meltdown. Actions taken so far have included massive infusion of liquidity into their respective financial systems, blanket guarantees on bank deposits to reduce the likelihood of bank runs and recapitalisation of financial institutions, including in some cases partial bank nationalisations.

One of the core concerns, however, remains the persisting credit crunch. To be sure, the US Federal Reserve has tried to alleviate the effects of this on large corporates by effectively establishing a new programme to buy up commercial paper, which is effectively short-term (usually three-month) debt needed by many corporates for their day-to-day operations. While this new liquidity backstop (so-called Commercial Paper Funding Facility or CPFF) is an important step to re-liquify the system, the main concern is the fact that the interbank unsecured lending markets have remained frozen, with banks unwilling to lend each other.

This is partly reflected in the pointed rise in the euro-dollar rates (proxied by the Libor rate). Indeed, while monetary policies in the developed countries have been very accommodative through reductions in the policy interest rate (like the fed funds rate in the US), these policy rates do not have any direct control over the Libor, which is the interest rate that really matters to the financial markets and the economy.

Historically, the fed funds rate and the Libor have moved more or less in tandem (the latter being around 50 basis points higher than the former), creating the illusion of the complete effectiveness of the fed funds rate as a tool of monetary policy. However, in actuality, it is the Libor and not the fed funds rate that matters for adjustable rate mortgages (ARMs), prime rates, credit derivatives, and credit card rates.

During this time of financial stress, the Libor has, however, remained persistently high, reflecting the severe risk aversion and lack of trust in the financial markets due to counterparty risks (if I lend to bank A, will they go bankrupt tomorrow?). Thus, the so-called Libor-fed funds rate (proxied by the Overnight Index Swap or OIS rate) has spiked to over 300-400 basis points in October 2008.

Lending between financial institutions has effectively stalled since the bankruptcy of Lehman Brothers in September, as perceived counterparty risks have skyrocketed.

Another popular proxy for the extent of the credit crisis is the Ted Spread, which is the difference between the three-month Libor rate and the three-month Treasury bill rate. This spread has also spiked as investors have rushed to the safe haven of Treasury bills, thus pushing the interest rates on these assets to historical lows.

While the Ted spread is more often used by analysts than the Libor-OIS spread, caution must be exercised in interpreting the Ted spread as a proxy for the credit crunch. For instance, the Ted spread came down slightly at the end of last week, not due to a decline in the credit crunch fears, per se, but rather because some traders have been forced to sell all assets, including T-bills, to muster cash required.

Conversely, and somewhat controversially, it has been suggested that the Libor rate may be artificially high also because some banks may be engaging in so-called 'predatory behaviour' in the sense that banks with ample capital are not lending to competitors in need of funds without adequate collateral.

Given the global nature of the unsecured interbank markets, short of aggressive coordinated policy actions by all Group of Seven (G-7) countries to guarantee this unsecured lending by global financial institutions, it is very likely that the credit crunch will persist in the near term. The lack of interbank lending, the continuing decline in asset prices and capital values due to the market-to-market accounting conventions, large-scale liquidations by hedge funds and other investors, as well as the expectation of severe economic recession, have all worked in tandem to lead to a collapse in global equity markets, led by the US.

While the equity markets often grab the headlines and are the most obvious sign to the lay person of the extent and the severity of the ongoing financial crisis, it is the credit crunch in the interbank markets that is really the key to stabilising the financial markets.

Conversely, even if policy makers are able to successfully renew the flow of credit, as long as the real estate market remains in doldrums, it is doubtful whether there will be any significant improvement in the equity markets on a sustained basis.

While it would be premature at this time of unfolding crisis and crisis management to start drawing too many detailed lessons, there are a few obvious issues for policy makers to consider:

One, re-examine the effectiveness of the monetary policy instruments available to them, particularly during the times of the financial market turmoil and systemic risks.

Two, reconsider the balance between financial market liberalisation and financial regulations and the type and quality of regulations required, including reducing the incentives to take outsized risks. (Privatisation of profits and socialisation of risks surely is unacceptable!) There is obviously a need for significant regulatory overhaul, though policy makers need to be cognisant of unintended consequences in any type of regulatory initiatives.

### **Boosting transparency**

Three, pay much greater attention to the extent of leverage that the financial institutions, corporates and households are allowed to take.

Four, increase the transparency of the financial market transactions which have become rather opaque due to esoteric derivatives which do not have a clearing house. Currently no one is quite sure who owes what and to whom.

Five, revisit the issue of regional and global financial coordination and what, if any, role the International Monetary Fund in particular should play in future crises. In relation to this, it is imperative that global leaders move from the current outdated G-7 group of industrial nations to at least the G-10 (including China, India and Brazil) as the central focus of future internationally coordinated financial and monetary initiatives.

Six, as the US is likely to experience a prolonged period of lower consumption and investment growth, Asian economies need to refocus attention on stimulating domestic and regional demand if they are to remain regain economic volatility. Asia has for too long been overly dependant on end demand from a cheap-credit-turbo-charged US consumer. It is time to diversify growth strategies.

It is rather odd that, while we have heard constructive ideas from US and European economists, their Asian counterparts have been notably silent on the issue despite the crisis having spread to that region as well. One hopes that Asia will soon find its voice as discussions eventually move from crisis management to reinventing the architecture of the international financial system.

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