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policy brief

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Unblocking Credit Markets by Reducing Counterparty Risk

By Ronald McKinnon

The U.S. Treasury's \$700 billion Troubled Asset Relief Program (TARP), announced on September 19, was cobbled together in great haste. Its ostensible primary mission is (1) to buy difficult-to-value mortgages still held by banks and (2) to buy even more difficult-to-value mortgage and other asset-backed securities sliced into various risk tranches and distributed widely throughout both the U.S. and European financial systems. Mission impossible! More subtle approaches are required to quash the counterparty risk that plagues the financial markets.

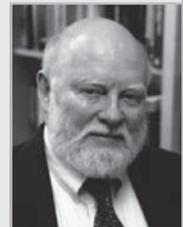
The United States would be better to follow the Euro-

pean lead providing public funds to recapitalize banks, insurance companies, and a few other key players in the credit markets; although these are de-capitalized now, they have a chance of being solvent once the current crisis is over. The U.S. Treasury now realizes this. As announced on October 27, \$125 billion of TARP money will be used to recapitalize seven more banks. This is a necessary condition for reducing the severe *counterparty risk*, which has caused the key interbank and commercial bill markets in the United States and Europe to seize up.

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About The Author

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His fields of interest are international economics and development finance. McKinnon has written over 100 articles and several books, which include: *Money and Capital in Economic Development* (1973); *Money in International Exchange: The Convertible-Currency System* (1979); *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*, 1993; *The Rules of the Game: International Money and Exchange Rates*, 1996; *Dollar and Yen: Resolving Economic Conflict Between the United States and Japan (with Kenichi Ohno)*, 1997; and *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue*, in 2005.

His books have been translated into many European and Asian languages, and he has been a consultant to central banks and finance ministries the world over-including international agencies such as the World Bank and International Monetary Fund.

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(Partial public ownership of the banks can also be a lever for introducing more permanent and much-needed regulatory reforms, a story for another time.)

Although recapitalizing banks is necessary in the long run, this step is not sufficient to quash counterparty risk in the near term. Uncertainty about the adequacy and permanence of the recapitalization process is so great that additional, more direct institutional measures are needed. I propose that central banks act as broker-dealers in the huge interbank markets to borrow and lend at different terms to maturity¹.

A New “Market Maker” Window for Central Banks

Traditionally, in mature industrial economies, the central bank’s (CB’s) role is one of controlling some short-term interest rates — bank rate, federal funds rate — to target macroeconomic variables such as the exchange rate in the 19th century (Bagehot 1879) or domestic inflation

in recent decades by the Taylor rule (Taylor 1993). In crises, the CB may also lend to distressed bank borrowers through its discount window, though traditionally at a penalty rate.

In the current crisis, the Fed has — very unwisely as we shall see — driven the federal funds rate toward zero. The Fed has also lent massively both through its discount window and by holding auctions to buy less-than-prime securities from private banks. These serve to pump short-term liquidity, perhaps in excess, into the system but don’t directly deal with counterparty risk in transacting between private banks. What is the evidence? Insofar as there is interbank trading in London, the LIBOR remains two percentage points or more higher than the federal funds target rate of 1 percent. Also, traders complain that U.S. Treasury bonds, the prime and now the only acceptable collateral in interbank lending, are still in short supply. The flight

to safety, by both traders in the interbank markets and foreign central banks holding dollar exchange reserves, depresses the yield on short-term Treasury bonds (less than one month) to less than 0.5 percent.

Government officials now complain that commercial bank lending to nonfinancial firms, despite extensive bank recapitalization, is inadequate. Thus, on October 27, the Fed itself started buying commercial bills directly from the private sector. But this new strategy is fraught with moral hazard. Many of the new sellers of commercial bills to the Fed — Morgan Stanley, UBS, and the finance arms of General Electric and General Motors — are themselves financial firms in some distress. And no doubt many more distressed borrowers with political clout will soon appear.

Instead, a resumption of normal private bank credit to large and small industrial firms is needed to prevent a sharp decline in domestic output. But a necessary lubricant is parallel borrowing

¹ This proposal is similar to that put forward by Jan Kregel (2008), but the details are quite different.



and lending free of counterparty risk in the interbank market. Counterparty risk naturally rises with the term to maturity of the interbank loan. Even if bank A was fairly sure that bank B could repay a collateralized overnight loan, a three-month or six-month loan would carry a higher probability that bank B would default. Thus interbank transacting has seized up more at longer terms to maturity. However, it is active interbank transacting at these longer terms to maturity that facilitates normal commercial lending of three to six months or more for vital working capital to the non-bank business sector — or even for fixed-term lending to households.

What should central banks do? The recent TARP bill carried with it a little-known provision that allows the Fed to pay interest on commercial bank reserves held with it. The ECB already pays interest on required commercial bank reserves but only recently introduced a rule that allows it to pay interest on excess reserves. These two central

banks are now sufficiently well equipped to act as broker-dealers in their respective interbank markets — but with one further change in their mind-sets. Traditionally, commercial bank reserves with the CB have been treated as short-term sight deposits withdrawable on demand, which makes sense if the commercial bank in question has an unexpected liquidity squeeze. However, to more or less replicate conditions in the pre-crisis interbank market, each central bank would continue to accept sight deposits while, in addition, accept interest-bearing-term deposits for 30, 60, 90 days up to a year.

On the asset side of the CB's balance sheet, it would lend to credit-worthy commercial banks at similar terms to maturity. Like the mythical Walrasian auctioneer, the CB would determine interest rates to just balance the flow of funds at each term — with a small bid-ask spread. The yield curve would slope upward in the normal way — although in today's stressed environment

the slope might initially be quite steep — with long rates as much as three percentage points higher than short rates, as in today's Treasury bond markets. But now counterparty risk would have been eliminated because commercial banks, as either borrowers or depositors, deal only with the CB — which is assuming all the default risk.

Let us call this new facility the market maker (MM) window.

Rehabilitating the Real Bills Doctrine

For this new MM window for lending to commercial banks at market interest rates, the CB would have to develop its own rules for acceptable collateral. But, unlike the current stressed state of the private interbank markets where only U.S. Treasuries are acceptable as prime collateral, the CB should accept a broader range of high-quality private credit instruments. Indeed, the CB could well adopt a modern version of the old “real bills” doctrine: Only documentary evidence of new, high-quality commercial bank lending to

the nonfinancial sector for industry and trade would qualify for a loan through this new MM window.

By overcoming the appalling reluctance of commercial banks to lend to nonbanks despite huge injections of public capital, this new MM window would indeed grease the wheels of industry. Because interest rates would be set high enough to balance the flow of funds at every term to maturity, the project would be self-financing without the inordinate public subsidies characteristic of recent financial bailouts.

Eliminating the “Shortage” of Treasury Bonds

In the current crisis, the upsurge in counterparty risk is largely due to the distribution of opaque mortgage-backed securities throughout the financial system. The resulting flight to safety, both by private financial actors and by foreign central banks holding official exchange reserves, has resulted in a huge new demand for “safe” U.S. Treasuries. Despite high U.S. fiscal defi-

cits that continually increase the supply of Treasuries, the new safe-haven demand has been so great that interest rates on Treasuries have been driven to very low levels, particularly at short term: less than 0.5 percent on those with maturities of three months or less. An important part of this surge in demand is because only short-term Treasuries are acceptable collateral in interbank transacting. And traders have complained about absolute shortages of Treasuries.

Both the Fed and the ECB have recognized this shortage and have engaged in elaborate operations of swapping government bonds for less secure private instruments. Beginning last March 12, the Fed began a \$200 billion swap of Treasuries out of its own portfolio, which has since had to be replenished by the Treasury. Nevertheless, the amounts proved insufficient to overcome the shortage of collateral in private interbank markets, in part because foreign central banks became such big buyers of Treasuries.

Now consider what would happen if our MM window were suddenly opened. Then deposits at the central bank, a government agency, would be virtually as good as holding Treasury bonds at different terms to maturity. The demand for short-term Treasuries would fall sharply so that their yield would rise — as more money was funneled into lending to the private sector. Now the slope of the yield curve would be more normal, i.e., less steep. We would get a new equilibrium where foreign central banks were the main holders of Treasuries, while domestic banks held surplus funds at interest with the Fed, or with the ECB in euro transacting.

The Perils of Near-Zero Interest Rates: A Concluding Note

The genesis of the current crisis is a seizing up of the credit markets because of the counterparty risk arising out of the collapse of the U.S. housing bubble. It has spread

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into credit markets, such as the interbank market, not so directly associated with housing. The Pavlov response of the Fed has been, among other more constructive moves, to keep cutting the federal funds rate so it approaches zero — now only 1 percent. But this ultra low federal funds rate makes it harder to restore normality to the flow of funds in the frozen private credit markets.

First, the mutual distrust in the credit markets would exist at any moderate level of interest rates — and is not relaxed by cutting them. Second, the ultra low U.S. federal funds rate means that our hypothetical MM window would work less well in attracting surplus cash from

liquid banks. If short-term deposit rates at the Fed must be less than the Fed funds rate of 1 percent (to prevent round tripping), then banks with liquid cash won't bother depositing with the MM facility because the yield is so derisory.

In contrast, the ECB with its target lending rate of 3.25 percent and the Bank of England with a target rate of 3 percent are in better shape to introduce MM windows that could offer attractive deposit rates that are slightly less than these target loan rates.

In summary, in the presence of counterparty risk, letting interest rates fall toward zero is counterproductive in unblocking interbank transacting — and in restarting normal

commercial lending to the nonbank sector — as Japan has found to its sorrow over the last 15 years.

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