CENTRE FOR EUROPEAN POLICY STUDIES
Thinking ahead for Europe since 1983

A Concerted Approach to Re-start the Interbank Market

CEPS Commentary/10 October (updated 12 October) 2008

Daniel Gros and Stefano Micossi

One of the key points underlined at the recent G-7 summit in Washington was the necessity to re-start the interbank market, which has become dysfunctional almost everywhere.

How to revive the interbank market? The crisis has now become so acute that banks refuse to lend short even if they have the funding. In the eurozone, banks prefer to deposit surplus funds at the ECB's low-yielding deposit facility rather than to on-lend to other banks. The ECB has de facto become the clearinghouse for the collateralised interbank market in the euro area. However, the normal, unsecured, interbank market remains frozen.

This issue needs to be tackled, but no country can achieve it on its own since the bulk of the interbank market is cross-country. What is needed is a coordinated approach, as proposed by the UK – but taken at the euro area level.

However, one key aspect of the British proposal needs to be changed.

Experience has shown that under present circumstances any additional funds pumped into banks are hoarded rather than being on-lent in the interbank market. The reasoning behind the refusal by banks to lend to other banks is the fear that, even if their counterpart appears to be safe, in a world in which other banks do not lend even to safe banks, even safe banks can very quickly become illiquid. This negative feedback loop must be broken.

Therefore we propose that each participating government guarantees its own banks' reimbursement of interbank loans, including cross-border loans if they are to a bank from another country that participates in this scheme. Thus, this guarantee scheme would apply to the asset side of banks' balance sheets. This is an important difference from the current thinking to guarantee the liabilities of banks. Guaranteeing their liabilities makes funding easier, but it offers no guarantee that credit will actually increase.

The guarantee for interbank lending proposed here would presumably be valid for a limited time and government could charge appropriate fees. But given the current levels of the cost of protection against counterparty default in the banking system, this fee could be substantial enough to provide a comfortable insurance premium for the protection of taxpayers without choking off the market.

The objection of (national) finance ministers will of course be that this exposes them to a risk that originates potentially in another jurisdiction. In reality, this risk will be quite limited because all governments have already announced that they will not let any large

Daniel Gros is Director of the Centre for European Policy Studies. Stefano Micossi is Director of Assonime, a business association and think-tank in Rome.

bank fail. Hence, most governments have implicitly already guaranteed the liabilities of their own large banks, thus implicitly providing protection also to cross-border interbank lending.

Moreover, losses from housing-related activities seem relatively minor in Europe (except Spain and Ireland). This implies that the key issue in Europe is not how to make up for massive losses, but how to resolve a coordination problem that has led to the disappearance of the vital interbank market.

Financial markets expect concrete action from today’s euro area summit meeting in Paris. This proposal to re-start the interbank market should be part of any wider package.

See also related CEPS Commentaries on the global financial crisis:

Daniel Gros, “What next for Europe’s Financial Markets?”, 14 October 2008

“A Concerted Approach to Re-start the Interbank Market”, Daniel Gros, 10 October (updated 12 October) 2008

“Nationalizing banks to jumpstart the banking system”, Paul De Grauwe, 10 October 2008

“Credit Rating Agencies: Scapegoat or free-riders?”, Karel Lannoo, 10 October 2008

“The cost of ‘non-Europe'?”, Daniel Gros and Stefano Micossi, 7 October 2008

“Europe’s banking crisis: A call to action”, Open Letter by ten leading economists, 3 October 2008

“Crisis Management Tools for the Euro Area”, Daniel Gros and Stefano Micossi, 30 September 2008

“‘No recourse' and ‘put options': Estimating the ‘fair value' of US mortgage assets”, Daniel Gros, 23 September 2008

“The beginning of the endgame…”, Daniel Gros and Stefano Micossi, 18 September 2008

“The twin shocks hitting the eurozone”, Paul De Grauwe, 16 September 2008

“The crisis, one year on”, Karel Lannoo, 8 August 2008

“Cherished myths have fallen victim to economic reality”, Paul De Grauwe; 24 July 2008

“It's high time to create a truly European System of Financial Supervisors”, Karel Lannoo, 27 June 2008

“The US Housing Bust and Soaring Oil Prices: What next for the world economy?”, Daniel Gros and Cecilia Frale, 5 June 2008