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Special Commentary

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Coordinated Action by Major Central Banks

This morning, the Federal Reserve, the European Central Bank (ECB), the Bank of Canada, the Bank of England, the Bank of Japan and the Swiss National Bank announced a coordinated action that is designed to improve liquidity in interbank funding markets. As we describe in further detail below, the ultimate aim of the action is to reduce borrowing costs for households and businesses. Specifically, the central banks have agreed to reduce the interest rate that they charge each other for U.S. dollar borrowing by 50 basis points (bps).

Banks have become more cautious about lending to each other.

European banks primarily have euro assets and liabilities. However, because the dollar is an international currency, European banks also make dollar-denominated loans for which they need dollar financing. In "normal" times, European banks can readily access this financing in the interbank funding markets. However, these are not "normal" times. Because of extensive sovereign debt exposure at many European financial institutions, banks have become more cautious about lending to each other. Consequently, dollar LIBOR rates have been rising. For example, the 3-month LIBOR rate has risen about 25 bps since early August. Because essentially every American business borrows at some spread over LIBOR, businesses have experienced a rise in borrowing costs over the past few months at a time when it has been the Fed's intention to reduce borrowing costs.

Today's action is designed to make it cheaper for individual banks to borrow directly from their respective central bank.

In times of financial stress, central banks extend swap lines to each other. The dollar swap lines allow other central banks to borrow dollars from the Federal Reserve, which can supply them in unlimited quantities. Until now the Fed has charged other central banks 100 bps over the overnight interbank swap rate (OIS). Therefore, the cost—for example, of a European bank borrowing dollars directly from the ECB—has been rather expensive. Consequently, many banks have preferred to enter the interbank funding markets, which, as described above, drives up interest rates for everybody else. By reducing the borrowing costs for the swap lines, today's action is designed to make it cheaper for individual banks to borrow directly from their respective central bank. If, as is hoped, the demand for funding in the interbank market declines, LIBOR rates should recede in coming weeks, reducing borrowing costs for non-financial institutions and households.

Today's action is an important signal because it demonstrates that authorities (or at least a subset of them) remain willing to cooperate in order to address strains in financial markets that have been readily apparent over the past few months. Perhaps further policy cooperation will be forthcoming in the weeks ahead. In addition, today's action sends a signal about upcoming ECB policy. We had already looked for the ECB to cut its main policy rate by another 25 bps at its next policy meeting on December 8, and today's announcement reinforces our belief that another rate cut is in the offing. In addition, the ECB may announce further liquidity support next week for the Eurozone's banks in the form of extended maturities for euro financing.

Today's action by the major central banks may help to reduce dollar financing costs for European banks that hold significant amounts of European sovereign debt. It does not, however, "solve" the underlying European sovereign debt crisis. As of this writing, borrowing costs for the Italian government remain north of 7 percent. As we showed in a special report this summer, it becomes extremely difficult for the Italian government to stabilize its debt-to-GDP ratio if borrowing costs rise above 6 percent.[1] In order to "solve" the underlying sovereign debt crisis more needs to be done.

There may a "grand bargain" in the works.

Specifically, we are convinced that the only institution that is large enough to backstop the Italian government is the ECB. However, the ECB, with the backing of the German government, is not willing to provide unlimited support to the Italian government, at least not at this point. However, there may be a "grand bargain" in the works. If peripheral countries agree to surrender budgetary authority to a yet-to-be-determined supra-national European institution and enact structural reforms to liberalize their inflexible labor markets, Germany and other northern European countries may give the green light for the ECB to significantly increase its financial support of Italy, either directly or indirectly (e.g., via loans to the IMF or the European Financial Stability Facility). In that regard, we eagerly await the December 9 European Union summit, at which some of these issues may be discussed.

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In sum, today's announcement by the major central banks is an important step in addressing some of the fallout from the ongoing European sovereign debt crisis. That is, LIBOR rates have been pushed up by concerns about the financial health of European banks that hold significant amounts of European sovereign debt. Today's actions may help to reduce LIBOR rates in coming weeks. However, the underlying sovereign debt crisis will not be entirely solved until European governments make some more painful decisions regarding ECB intervention in sovereign debt markets, budgetary authority among individual governments and labor market reforms. Stay tuned.

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[1] **See "With Greece 'Stabilized" Will the Fire Spread?" (July 27, 2011), which is available upon request.**

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