Credit markets

On a short fuse
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The crisis in the debt markets

IN TRYING to make sense of the sudden panic that gripped credit markets last week, the most apt comparison is with a previous era of computer-driven financial wizardry, excessive borrowing and unexpected correlations in financial markets. Back in 1998 a large hedge fund, Long-Term Capital Management (LTCM), blew up, putting financial markets around the world under so much strain that the American authorities forced Wall Street to rescue it.

But LTCM's exposures were mostly in government bonds, known as the "long-end" of the market, where maturities stretch from, say, ten to 30 years. The peculiarity of last week's disruption is that it occurred in the shortest and typically most liquid end of the market, where borrowings are anything from overnight to a year, and where activity tends to be so dull that it rarely gets a mention in the financial press.

It is the overnight market where the European Central Bank (ECB), the Federal Reserve and other central banks rode in like the cavalry, trying to ease a crisis of confidence among banks which normally lend to each other daily without batting an eyelid. This week the focus is again on the "short end" and whether liquidity injections by the central banks will be enough to restore banks' faith in each other (and in hedge funds and other counterparties); or whether more radical surgery, such as rate cuts, are needed.

The immediate challenge for central bankers is how to curb the unusual spike in the cost that banks charge to lend to each other, via the London Interbank Offered Rate (LIBOR). This is a fear gauge, and when it increases more than the federal funds rate at which American banks borrow each other's reserve balances from the Fed, it suggests an abnormal unwillingness of banks to lend to each other. According to Lehman Brothers, since 2000 the gap between the federal funds rate and LIBOR has averaged 8 basis points. Last Thursday it soared to 25 basis points. Unlimited central-bank liquidity may help to reduce the gap, but only if banks do not find more reasons to question each other's creditworthiness.

Oddly enough, the recent concerns about banks have arisen more from lack of information than an abundance of horror stories. A few German banks have had direct problems related to investments in assets linked to America's subprime-mortgage market, as have hedge funds belonging to Bear Stearns. Some banks have suspended withdrawals from funds invested in other asset-backed securities. Some hedge funds are in trouble, although Lehman Brothers says that more than two-thirds of those that it tracks have yet to report their returns for July. Clearly there are serious problems, but they hardly look big enough to set off a crisis at the heart of the global financial system.

The trouble is, the banks suspect that even worse problems may be lurking, especially in the asset-backed securities markets where most have invested heavily. This is clear from the performance of the commercial-paper market, another short-term asset class that rarely hits the headlines, where rates suddenly hit six-year highs last week. In recent years, banks have created an abundance of investment funds, known as structured investment vehicles and conduits, which finance themselves through the $2.2 trillion commercial-paper market and invest in asset-backed securities, such as mortgages. Now banks are forcing their counterparties to pay a much higher price to roll the paper over, and it is not clear how quickly central-bank injections of liquidity will ease the squeeze.

The mounting concerns about overnight interbank rates and the commercial-paper market have led many investors to argue that the Fed should cut rates to restore calm. That would follow the script from 1998 when three rate cuts between September and November helped to bring the LTCM crisis to a speedy end.

But the Fed chairman, Ben Bernanke, made clear this month that inflation was more of a concern than disorderly markets. Some fear that even if the Fed did ease monetary policy to restore order, lingering inflation fears would push up long-term rates, compounding America's mortgage mess. This week, the Fed has plenty of data to ponder. There is July's inflation report, and data...
on retail sales, industrial production and the views of America's senior loan officers. They will provide evidence of how the troubles in America’s housing market are spreading. For now, however, the markets are paying more attention to the health of the financial sector than to the economy at large.