The Levy Economics Institute of Bard College

Policy Note

2008 / 4

A SIMPLE PROPOSAL TO RESOLVE THE DISRUPTION OF COUNTERPARTY RISK IN SHORT-TERM CREDIT MARKETS

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In the middle of September 2008, a year after the subprime crisis broke, Washington announced the imminent collapse of U.S. financial markets, which would bring with it conditions similar to those during the Great Depression. The cause? Lending channels were "clogged" with extraordinary numbers of impaired mortgage-backed securities (MBS) on the balance sheets of financial institutions. The fear was that nonfinancial businesses would be unable to fund productive activities supporting growth and employment. Officials recommended a solution whereby the government would take these questionable assets off the institutions' balance sheets. However, it was far from certain that this action would provide the relief sought.

The major problem threatening the stability of the U.S. financial system is impaired risk assessment caused by the default of many mortgage-backed assets, yet it is not clear that removing them will make it easier to assess counterparty risk in short-term credit markets. But this should be the first objective of policy, since these markets provide the basic liquidity support for institutions operating in the financial markets and, presumably, for the day-to-day operations of businesses and manufacturers.

The new financial architecture, which buttressed the "new consensus" in monetary theory, was to have eliminated the possibility of a 1930s-style business cycle by providing a more rational and efficient distribution of risk through the use of new risk-based capital requirements and new

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risk-specific financial instruments. The proof was the decline in the volatility of real variables, such as growth and employment, as well as the reduction in risk spreads relative to risk-free government securities. It is clear that this system has broken down: instead of risk being transferred to those most able to bear it, it has been transferred to those most willing to bear it in order to receive income. As a result of their failure to meet their commitments to bear this risk, many financial institutions have declared insolvency, merged with other institutions, or been nationalized. This has created a general distrust of counterparties to any financial transaction. As taught by John Maynard Keynes, the only possible way to quell disquietude over the creditworthiness of a counterparty in these circumstances is to hold cash rather than to lend it at interest if the return at maturity is uncertain. This is absolute liquidity preference, in which there is no interest rate that will offset the fear of failure to complete the contract.

Building on the works of Keynes and Irving Fisher, Hyman P. Minsky pointed out that this situation leads to a process of asset liquidation and debt deflation, whereby liabilities increase at a faster rate than the sale of assets to meet those liabilities. This process quickly leads to systemwide insolvency and bankruptcy—the Armageddon envisioned by Treasury Secretary Henry M. Paulson and Fed Chairman Ben Bernanke. The problem is that their solution starts at the wrong end—with the devalued assets resulting from debt deflation, rather than the absolute liquidity preference caused by the failure to assess counterparty risk with confidence.

As Keynes noted, one way to solve the problem is to hold money, and one way to prevent this from completely disrupting asset prices is to meet the (money) demand of the financial institutions. While this response solves the problem of counterparty risk (i.e., a dollar bill or a Treasury bill loaned to the government is riskless), it does not solve the problem of reducing counterparty risk in interbank transactions. The government proposal aims to reduce the risk to all financial institutions by *offering* to take impaired assets off their balance sheets, under the assumption that this offer will reduce the risk of contracts not being met. But there is no reason for this to be the case, as the plan will do nothing to replenish the reduction in bank capital when assets are purchased at market value. Given the difficulties in raising capital under the current (abysmal) conditions, capital can only be increased by reducing the size of balance sheets further; that is, less lending, rather than more.

However, there is a much simpler way to deal with counterparty risk, one that follows the pattern of organized derivative exchanges. The purchaser of a futures contract does not have to assess the risk of completion by the seller, since the exchange acts as an intermediary, monitoring and hedging risk by means of margin payments and position limits. In the interbank market, the Fed could play the same role as the exchange clearinghouse. This could be achieved by enacting the already-approved measure permitting the Fed to pay interest on the gross reserve deposits of member banks. Instead of holding Treasury bills in order to build liquidity, banks could hold deposits with the Fed. It would be the equivalent of the Fed issuing its own interest-bearing notes. Under normal circumstances, banks make loans and then seek to raise the legal reserves required, so the Fed would have those resources to lend to member banks seeking additional balances. The counterparty for both transactions would be the Federal Reserve, so banks would not have to assess the counterparty risk of borrowers. The Fed guarantee would take the place of the Treasury's $700 billion bailout, and existing regulatory supervision would take the place of counterparty risk assessment. This approach has an additional advantage, in that lending in both the Fed funds and private interbank markets is unsecured. The Fed, as counterparty, eliminates the associated risks of interbank lending, thus reducing short-term interest rates and restoring confidence in the interbank market.

In addition, in order to support bank lending to nonfinancial members as well as nonmembers of the federal funds market, the Fed could return to the "real bills" doctrine by lending in full against commercial loans at the Fed rate. This approach would be facilitated by the unification of the federal and discount rates.

A supplement to this proposal would include support of the banks' core deposit base by removing the Federal Deposit Insurance Corporation (FDIC) limit to match the unlimited guarantee recently given to money market funds. Those who argue that this might erode the deposits of money funds should remember that banks usually provide backup credit lines for those funds. Additionally, member banks should be allowed to borrow from the Fed an unlimited amount without collateral, to eliminate the possibility that larger banks could dominate the market for retail deposits at the expense of smaller banks. This provision should not increase the government's risk, since the Fed and other regulators already exercise control over lending exposures and capital ratios.

This proposal should resolve the problem of assessing counterparty risk and restore short-term lending without government funding, asset pricing, or approval of a bailout package. All it requires is Congressional approval to eliminate the cap on member banks' insured deposits, to bring forward the introduction of interest payments on deposits, and to extend FDIC insurance to any unsecured lending of Fed deposits at member banks. Once short-term markets are functioning, the problem of recapitalizing sound banks and reviving unsound banks can be approached (preferably by the FDIC or an agency similar to the Hoover-era Reconstruction Finance Corporation). Moreover, the issue of cascading home foreclosures could be dealt with through an agency modeled after the Home Owners' Loan Corporation of the 1930s. The response does not need to be formulated under threat of the financial system's imminent collapse due to the dislocation of short-term credit markets.

This approach would also clear the way for policy to prevent the decline in employment from rationalizing the financial sector by supporting employment in the manufacturing and service sectors. As emphasized by Minsky, policies should be designed to minimize the creation of additional financial assets and greater financial instability. He would suggest a government employment guarantee program that provides direct income support while increasing the production of useful goods. It would be particularly appropriate to resolve the infrastructure gap in the U.S. economy.

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