

# Central banks coordinate actions amid fears of a global financial breakdown

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In a series of coordinated and parallel actions, the US Federal Reserve Board, the European Central Bank, the Bank of England, the Swiss National Bank and the Bank of Canada on Wednesday moved to inject tens of billions of dollars into near-frozen credit markets.

The *Financial Times* of London characterized the central banks' announcements as "unprecedented and coordinated moves to prevent a meltdown in the world's banking system." No similar joint action has occurred since the September 11 terrorist attacks on New York and Washington shook global markets, and Wednesday's measures go considerably beyond those taken six years ago.

The Federal Reserve Board announced that it and its counterparts in Europe and Canada were taking the extraordinary action "to address elevated pressures in short-term funding markets."

The announcement came one day after the Fed cut short-term interest rates by a quarter point, its third consecutive rate cut since the credit crisis erupted last August. The US stock market reacted with a panicky sell-off, driving all major indexes down by more than 2 percent. The frenzy on Wall street reflected fears that the US central bank was not doing enough to bail out major banks and financial institutions facing massive losses in assets linked to subprime home loans.

The US housing and credit crisis has engulfed European financial institutions as well, with some of the biggest European banks announcing similar losses.

Last week the central banks of Britain and Canada cut their key interest rates, and the European Central Bank scuttled plans to raise its benchmark rate, but these traditional means for lowering borrowing costs have done little to encourage banks to lend to one another and to other businesses.

Key interest rates for three-month and six-month

loans between international banks have remained sharply elevated for two related reasons: banks are hoarding cash in anticipation of further multi-billion-dollar write-offs of collapsing mortgage-backed assets, and they are reluctant to lend to other banks that may be similarly exposed and unable to repay the loans.

The result is a virtual collapse of confidence in the global banking system—a situation that has the potential of plunging the US and world economy into a deep and protracted recession.

The coordinated actions of the Fed and the other central banks were intended, in the first instance, to restore confidence among world bankers by assuring them that the state institutions would supply a ready and perhaps unlimited flow of cheap credit.

The Fed said it would create a new "term auction facility" through which it would lend \$40 billion to banks over the next eight days, with two further auctions to be held in January. The US central bank added that it would consider additional auctions and might make such dispersals of cheap credit a permanent part of its operations.

The loans will be at rates far below the rate charged on direct loans from the Fed to banks from its so-called "discount window." That rate stands at 4.75 percent, following a quarter point cut announced Tuesday.

At the same time, banks will be able to secure the auction loans with the same broad spectrum of collateral that banks pledge for discount window loans. These include illiquid assets, such as subprime-backed "collateralized debt obligations" whose market value has plummeted as a result of the US housing slump and soaring foreclosure rate. The market for these speculative investments has dried up and banks can unload them only for a fraction of their nominal book value.

US banks have been reluctant to borrow from the Fed's discount window because such loans currently carry an interest rate half a percentage point above the benchmark federal funds rate and there has long been a stigma attached to applying for them. Financial markets traditionally view going to the discount window as a sign that a bank is in dire straits.

One of the purposes of the Fed auctions is to remove any such stigma, while making cheap credit available to a broader array of banks. Moreover, in announcing the auctions, the Fed stressed that banks which participated would not be identified.

To allay nervousness about the motives behind the Fed's extraordinary action, a "senior Fed official" said in a background briefing for reporters that it was "not about particular financial institutions with particular problems."

The Fed also announced that it would carry out foreign-exchange swaps with the European Central Bank, for \$20 billion, and the Swiss National Bank, for \$4 billion. This will enable these central banks to make dollar loans to banks within their respective jurisdictions, making it easier for European banks to obtain dollar-denominated loans. It is hoped that this will result in a lowering of interest rates for inter-bank dollar-denominated loans outside the US, the principal such rate being the London Interbank Offered Rate, or Libor, which has risen to well above 5 percent as a result of the credit crunch.

The European Central Bank said it would conduct two dollar-denominated auctions, starting next week, for European banks that are starved for dollars. The Bank of England announced it would increase the size of its scheduled auction next Tuesday from 2.85 billion pounds to 11.35 billion pounds. It also shelved its collateral rules, saying it would accept mortgage-backed securities and dollar-denominated securities for the first time.

European stock exchanges, which had been falling sharply on Wednesday, reversed course and registered gains after the central banks made their announcements. The markets in New York opened with a 200-plus point rally, but gave up most of their gains in the course of the day and closed only modestly higher.

Taken as a whole, the central banks' measures are a barometer of the seriousness, depth and global scope of the financial crisis. Martin Wolf, the business columnist

for the *Financial Times*, wrote on Wednesday: "The central bank helicopters are planning a coordinated drop of liquidity on troubled market waters. The money to be dropped is not that large. But if this does not work, more will surely follow. The helicopters will fly again and again."

"One point is clear: central banks must be pretty worried to take such a joint action."

He went on to warn that the emergency measures might fail because the basic problem in the financial markets was not a lack of liquidity, but rather a question of insolvency. Suggesting that major bank failures were on the agenda, he wrote that "there is good reason to believe that a good part of the stress is caused by worries over solvency, indeed by the reality of threatened insolvency in at least some cases."



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