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Abstract

The recent financial crisis saw a dramatic and persistent jump in interest rate spreads between overnight federal funds and longer - term interbank loans. The Fed took several actions to reduce these spreads including the creation of the Term Auction Facility (TAF). The effectiveness of these policies depends on the cause of the increased spreads such as counterparty risk, liquidity, or other factors. Using a no-arbitrage pricing framework and various measures of risk, we find robust evidence that increased counterparty risk contributed to the rise in spreads but do not find robust evidence that the TAF had a significant effect on spreads. (JEL E43, E44, E52, G21)

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Additional Materials

Replication Package (302.09 KB)

JEL Classification

E43 Determination of Interest Rates; Term Structure of Interest Rates

E44 Financial Markets and the Macroeconomy

E52 Monetary Policy

G21 Banks; Other Depository Institutions; Micro Finance Institutions; Mortgages