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Abstract

The financial crisis of 2007–09 is widely viewed as the worst financial disruption since the Great Depression of 1929–33 with several remarkable characteristics. One of the prominent features of the recent financial crisis was the illiquidity of the normally well-functioning interbank markets. The interbank markets play a key role in the financial system and thus their smooth operation is in great interest of the policy makers. As the crisis prolonged banks became literally unwilling to lend to each other and as a consequence, some financial intermediaries began to have trouble finding short-term financing, which was crucial for them to continue their daily business and central banks were forced to inject massive liquidity.

The purpose of this thesis is to analyze the underlying reasons behind the illiquidity of the interbank markets during the recent crisis. The methodology used in this study is twofold. First, a literature review is conducted to understand the structures which provided for the crisis and why the crisis was prolonged. Second, an empirical analysis on the unsecured interbank market in the euro area is conducted to solve the underlying reason behind the rise of the risk premium. The analysis develops a measure of counterparty risk using CDS spreads of 20 Euribor panel banks and treating liquidity premium as the residual component.

In the theoretical part of this thesis liquidity provision through maturity mismatch was identified as the major macroeconomic function of the banking system and also the source of its fragility. The optimal amount of liquid assets retained by banks was acknowledged to be dependent on the uncertainty faced by the banks. The historical overview showed that the transformation of the banking industry was a major contributing factor in causing the recent crisis to be so severe and to spread to markets that were not directly linked to the subprime market. From the empirical study it could be concluded that both liquidity hoarding and counterparty risk contributed to the increased risk premium but their relative importance changed during the crisis. The findings of this thesis suggest that it is not only important to consider the level of the risk premium in the interbank market but also the decomposition of the premium and the behavior of the components around major events

Key words	Liquidity, interbank markets, financial crises, banking theory
Further information	