DOC. N.º 90

News Front Page
Africa
Americas
Asia-Pacific
Europe
Middle East
South Asia
UK
Business
Market Data
Economy
Companies
Health
Science & Environment
Technology
Entertainment
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Programmes
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Central banks act on credit fears

The Federal Reserve, European Central Bank and central banks from the UK, Canada and Switzerland are to jointly help banks deal with the credit crunch.

Weakness in sub-prime loans have destabilised the financial sector

They have each announced that they will provide billions in loans to banks in order to lower interest rates and ease the availability of credit.

The move was coordinated by the US Federal Reserve, which has already cut interest rates three times this year.

It is a sign that despite rate cuts, banks are nervous about credit risks.

Shares on Wall Street initially reacted positively to the news with all three indexes sharply up by more than 2% at one point.

> **"This news just goes to illustrate again how serious the illiquidity issue in money markets has become"**
> Ian Kernohan, Economist, RLAM

But the gains gradually fizzled out as investors contemplated the possibility that company profits would still slow even if banks' troubles were ironed out.

The Dow Jones Industrial Average closed up 41.13 points, 0.31%, at 13,473, while the broader S&P index rose 0.61% and the technology-heavy Nasdaq ended 0.7% higher at 2,671.14.

World oil prices, which had dipped back at the start of December from their record highs at near $100 a barrel last month, barrelled higher on the hope that the Fed's coordinated steps would be aggressive enough to keep the global economy on track and keep energy demand high.

Recession worry

"This co-ordinated set of actions is a response to pressures in interbank markets, which have increased in recent weeks, reflecting sentiment about the global financial sector," a Bank of England spokesman said.

"The actions demonstrate that central banks are working together to try to forestall any prospective sharp tightening of credit conditions," he added.

BBC Business Editor Robert Peston said the move was without precedent and meant "the stakes are high".

Central banks are worried that if banks are having trouble getting credit, they will raise rates they charge to customers, bringing spending among indebted populations to a standstill.

This could push the US economy into recession, and cut world economic growth.

> **"If they can count on central banks to lend to them, then they too may be prepared to start lending to each other again"**
> BBC Business Editor Robert Peston
>
> **Robert's blog: Should we feel alarmed or elated?**

The move comes after interest rate cuts by both the Fed and the Bank of England had failed to cut the inter-bank interest rates which banks charge each other, which indicated that they were still reluctant to lend money.

"If they can count on central banks to lend to them, then they too may be prepared to start lending to each other again," observed Mr Peston.

Divided opinion

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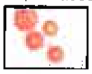
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The move means that central banks will help each other out in providing as much liquidity (cash) as they judge necessary to revive the inter-bank market.

"The Fed in conjunction with these other central banks is providing a ton of liquidity to the markets by year-end," said Greg Salvaggio at Tempus Consulting.

"It will work in the short term as another interest rate cut," he added.

But others warned that the move was also a sign of just how serious the crisis had become.

"This news just goes to illustrate again how serious the illiquidity issue in money markets has become," said Ian Kernohan of RLAM.

"This doesn't change my view that the UK economy will slow next year."

Conditional loans

The banks will still have to provide collateral and meet certain conditions in order to get help from the central banks.

Banks judged to be in sound financial condition will be able to participate.

The central banks have judged that these auctions are necessary because banks are having such difficulties borrowing money from each other.

The banks have been reluctant to trust their fellow financial institutions because of uncertainty about their exposure to US sub-prime loans, which have sunk in value as record mortgage defaults has depleted appetite for those risky investments.

Bank of America and rival bank Wachovia are the latest to warn that heavy write-downs will eat into earnings.


Nobody bid in the Bank of England's last three month auction

As a result, interbank interest rates have risen, making intervention necessary.

No minimum rate

The Bank of England will increase the amount offered in its next auction on 18 December from £2.85bn to £11.35bn, of which £10bn will be offered for three months.

Crucially, it will accept a slightly wider range of assets as collateral for the loans.

The Bank of England held a similar auction for three-month loans in September, but there were no bidders, because banks were worried that the stigma attached to the auction would reduce confidence in them so soon after the run on Northern Rock.

That auction had a punitive minimum rate set at 1% above the Bank of England's base rate, whereas the new auctions do not have a minimum rate.

The Fed said it would conduct two auctions next week where commercial banks will be able to bid for up to $20bn (£9.7bn) at each one, followed by two more auctions in January.

A Federal Reserve spokesman said if the four were successful in boosting liquidity in the stressed banking system, more could follow.

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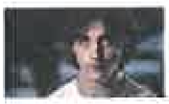
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