Financial Stress and Equilibrium Dynamics in Term Interbank Funding Markets*

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Abstract

Interbank funding markets are central to the functioning of the financial system and the transmission of monetary policy. Libor-OIS spreads have been widely-used indicators of conditions in these markets. We construct models that incorporate the long-run equilibrium relationship between term Libor and OIS rates and their regime-dependent dynamics. We find strong evidence for three regimes in the interbank funding market that resemble different pricing of risk and equilibrium outcomes. We provide point and interval estimates for stress thresholds that may serve as benchmarks for policy makers and market participants in assessing funding conditions. We provide evidence of asymmetric adjustment of rates toward long-run equilibrium, and shed light on the role of different policy measures in the adjustment process.

Keywords: Interbank markets, Libor-OIS spread, credit risk, liquidity risk, cointegration, threshold models, GARCH, DCC

JEL Classification: C32, E44, E52, G01, G21

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