Accepted Manuscript

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Andrea Eross, Andrew Urquhart, Simon Wolfe

PII: S1042-4431(16)30061-0
DOI: http://dx.doi.org/10.1016/j.intfin.2016.07.005
Reference: INTFIN 884

To appear in: *Journal of International Financial Markets, Institutions & Money*

Received Date: 2 February 2016
Accepted Date: 5 July 2016

Please cite this article as: A. Eross, A. Urquhart, S. Wolfe, Liquidity risk contagion in the Interbank Market, *Journal of International Financial Markets, Institutions & Money* (2016), doi: http://dx.doi.org/10.1016/j.intfin.2016.07.005

Liquidity risk contagion in the Interbank Market

Andrea Eross: a.eross@hw.ac.uk[1]
Andrew Urquhart: a.j.urquhart@soton.ac.uk[2]
Simon Wolfe: ssjw@soton.ac.uk[2]

Abstract

This paper studies liquidity risk contagion within the interbank market by assessing the long-run relationship of short-term interest rate spreads from January 2002 to December 2015. In particular, we model the interaction between the LIBOR-OIS spread, euro fixed-float OIS swap rate and the three-month US-German bond spread and discover strong evidence of structural innovations affecting the interbank market. We find that when the short-term interbank market is affected by a liquidity shock, the LIBOR-OIS spread is a leader in moving back to equilibrium, while the euro-dollar currency swap rate and the US-German bond spreads are followers. Moreover, we find long-run cointegrating relationships and bi-directional causality between the spreads. However, structural breaks identified as prospective financial crises affect the long-run relationships and liquidity shocks drive interbank rates and spread fluctuations. Therefore, liquidity shocks propagating within the interbank market can forecast benchmark interest movements, and ultimately this has significant implications for policy-makers and market players alike.

Keywords: Contagion, Financial Crises, Interbank Market, Liquidity shocks, Structural breaks

JEL classification: C32, G15

1. Introduction

This paper studies liquidity risk contagion within the short-term interbank market in times of financial market turmoil. During the early stages of

[1]Heriot-Watt University, Accountancy, Finance and Economics
[2]University of Southampton, Southampton Business School