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Abstract

This paper investigates the effectiveness of one of the Fed's unconventional monetary policy tools, the term auction facility (TAF). At issue is whether the TAF reduced the spread between LIBOR rates and equivalent-term Treasury rates by reducing the liquidity premium embedded in LIBOR rates. This paper suggests that rather than reducing the liquidity premium in LIBOR rates, the announcement of the TAF increased the risk premium in financial and other bond rates because market participants interpreted the announcement by the Fed and other central banks as a sign that the financial crisis was worse than previously thought. Evidence is presented that supports this hypothesis.

Keywords: term auction facility, liquidity premium, counterparty risk, libor rate

JEL Classification: E52, E58, G14

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