Applied Economics

2019, Vol. 51, No. 3, 278-287

Liquidity and credit risks in the UK's financial crisis: how quantitative easing changed the relationship

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Summary

This article investigates the relationship between credit and liquidity risk components in the UK interbank spread during the recent financial crisis and sheds light on the transmission mechanism of the quantitative easing (QE) carried out by the Bank of England (BoE) on short-term interest rates. Specifically, the authors find that prior to the bank's intervention counterparty risk was a major factor in the widening of the spread and also caused a rise in liquidity risk. However, this relationship was reversed during the period when QE was implemented. Using the accumulated value of asset purchases as a proxy for the central bank's liquidity provisions, the authors provide evidence that the QE operations were successful in reducing liquidity premia and ultimately, and indirectly, credit risk. The authors also find evidence that suggests liquidity schemes provided by other central banks and international market sentiment contributed to the reduction of interbank spread.

Recommended Citation:

Wong, Woon, Iris Biefang-Frisancho Mariscal, and Peter Howell. 2019. "Liquidity and credit risks in the UK's financial crisis: how 'quantitative easing' changed the relationship." Applied Economics, Vol. 51, No. 3, 278-287. 2019. https://doi.org/10.1080/00036846.2018.1494814.