Interbank Markets Remain In Crisis

I am beginning to lose faith in optimism as the credit markets – "credit" itself being derived from the Latin word meaning belief – remain unable to reclaim the levels of trust amongst participants once taken for granted. Worse, as we shall see below, a self-healing mechanism may be coming unglued as a consequence of ad hoc central bank practices. Nothing here is encouraging.

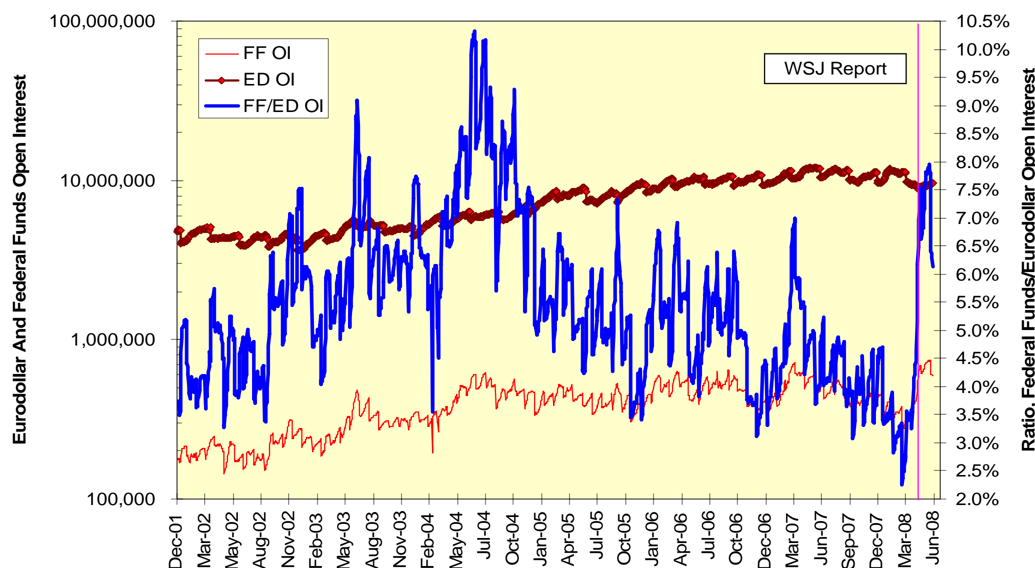
Markets and economies have a sort of organic nature; if you constrict the flow of funds or information in one channel, another mechanism should arise as a sort of work-around. This certainly seemed to be the case in the interbank markets after two different shocks. The first shock was the huge widening of the spread between LIBOR and other short-term interest rates after the onset of the credit crunch last July. This was addressed with some measure of success by the Federal Reserve's yeoman efforts to jam funds into the banking system by accepting all manner of collateral through various lending facilities.

The second crisis was more subtle and is the irregularities in reporting of LIBOR by banks to the British Bankers Association. This first came to light in a mid-April report by *The Wall Street Journal*; the implications of the misfeasance are interbank markets are still bedeviled by banks' mutual distrust and true LIBOR may be higher than stated.

Overnight Index Swaps

The self-healing mechanism referenced above was a shift from LIBOR to overnight index swaps based on the federal funds market in the U.S. This OIS market grew explosively starting beginning several days prior to the *WSJ* report; this raises the intriguing possibility participants in the LIBOR market were front-running the story of their own bad behavior, but we digress.

The shift in the market can be seen in the relative open interest of the Eurodollar and federal funds futures used to price and hedge LIBOR and OIS, respectively. Federal funds' open interest increased from 2.3% of Eurodollars' open interest on March 3, 2008 to 8.0% on May 27. The percentage, which always declines at the start of the month as federal funds futures expire at the end of the previous month, fell more sharply than usual last week as Bernanke and Trichet signaled in succession monetary policy might return to some semblance of sobriety someday. Maybe; for now, we have words and a huge repricing in European short-term interest markets and in the euro/dollar exchange rate, but no action.

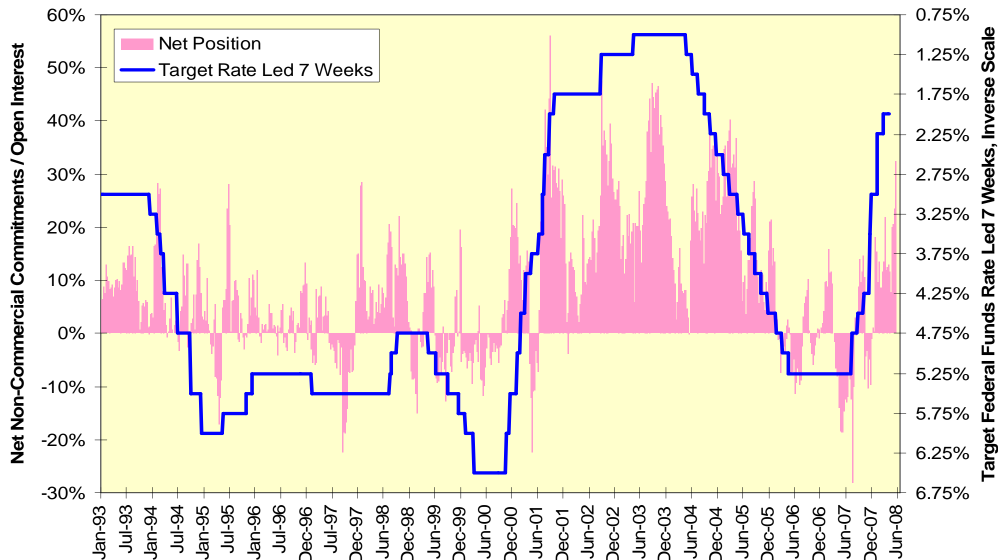


If the markets were using OIS as a substitute for LIBOR, the twin bombs from the central banks were a sudden and violent reminder of what happens when you use a derivative for unintended purposes. It also should serve as a warning to those who use the federal funds futures to assess Federal Reserve rate-setting policy, a topic addressed

here last October and who use the Commodity Futures Trading Commission Commitment of Traders data as a price-forecasting tool, a topic addressed here just two weeks ago.

If you looked at the net non-commercial position in federal funds futures, you might think these trades were making a gigantic bet the Federal Reserve would be cutting rates soon. Hardly; as of last Friday, the futures had a 100% probability the Federal Reserve would do nothing at its June 25, 2008 FOMC meeting. In addition, the non-commercial's track record of forecasting FOMC moves with a seven-week lead time is not as good as urban legends have it to be.

Non-Commercial Commitments Poor Predictor Of Rate Changes

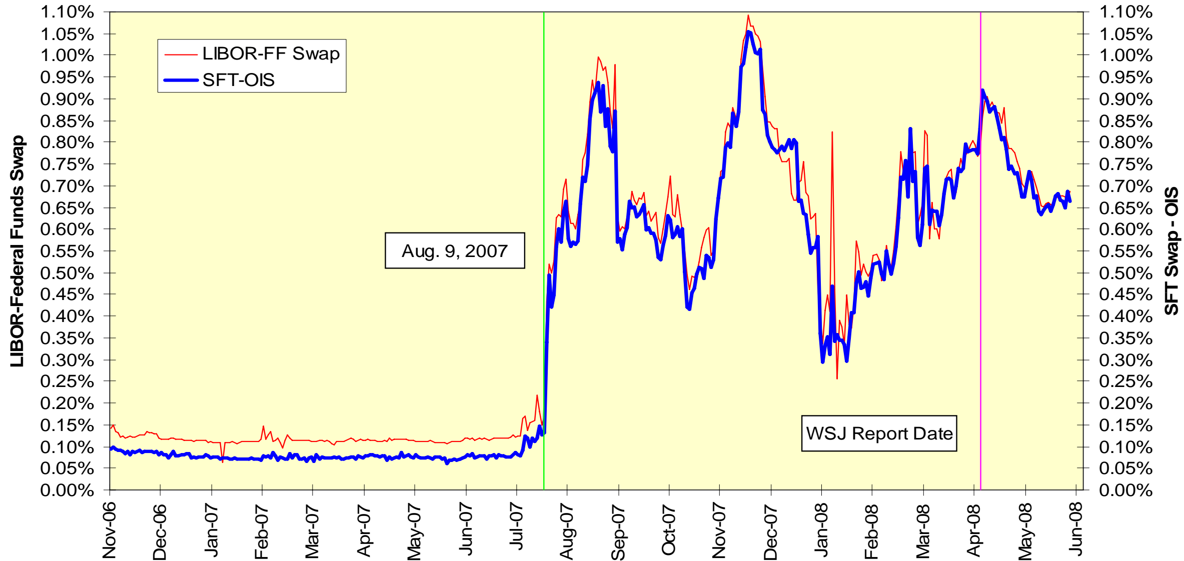


If the FOMC does decide to reverse course, this huge non-commercial position in federal funds futures will have to be unwound quickly and will no doubt distort the expanded OIS market.

Markets, Heal Thyself. One More Time

In the midst of all this, the important thing to remember is the *WSJ* report did not create the credit crisis; it occurred within the range of a dislocation in the interbank market that began in August 2007. On August 9, 2007, the ECB injected €94.8 billion into the banking system to restore liquidity. The spread between LIBOR and federal funds, whether measured by the spread between the LIBOR set-for-tomorrow swap and OIS or by a straight swap between LIBOR and federal funds, kept expanding into early September. Both measures retreated, hit a new high in early December, retreated again and then rose going into the *WSJ* report date.

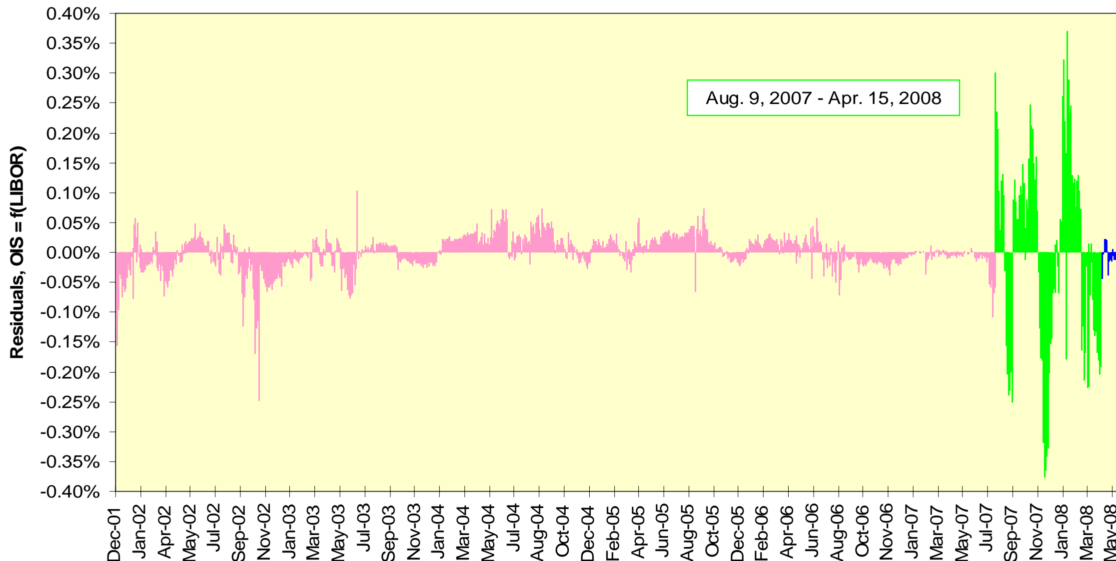
Swap Markets At Mid-Point Of Credit Crunch Range



Incredibly, the expansion of the OIS market after mid-April led to a lowering, not a widening, of the spreads. Restated, the markets were well on their way toward healing themselves before last week's central bank pronouncements.

A second way of looking at this healing process now at risk of interruption is to compare the relationship between OIS and LIBOR over three periods, those before August 9, 2007 and after April 15, 2008 and the period in-between. If we plot the residuals, or unexplained portion of the relationship, over these three periods, it is easy to see how much the post-WSJ period resembles the pre-credit crunch period…and how different the August 2007-April 2008 period was. If we lock the OIS market the way the LIBOR market got locked, we could return to that distorted relationship and crisis period quite quickly.

Credit Crunch Mattered; *WSJ* Report Did Not



If the interbank markets, whether LIBOR or OIS lock and plunge us into a new phase of the credit crisis, future economic historians will puzzle whether the efforts by the central banks to save us from ourselves accomplished anything other than creating the worst global inflation since the 1970s. Most traders learn eventually and the hard way their first loss is their best loss. Central banks went for the trade-out-of-it strategy. I cannot speak for anyone but myself, but that strategy never worked for me; did it ever work for you?