

Watching Key Spread

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Former Federal Reserve Chairman Alan Greenspan says financial markets will return to normal when an arcane interest-rate spread narrows back to its level prior to the credit crisis.

The spread Greenspan focuses on is the one between the three-month London Interbank Offered Rate (LIBOR) and the overnight index swap rate (OIS).

LIBOR is the rate at which international banks lend dollars to each other.

The OIS measures traders' expectations for the federal funds rate, which is set by the Fed and charged on overnight interbank loans.

As of July 13, three-month LIBOR was 69 basis points higher than the OIS rate, meaning the spread was 69 basis points. That's down from a high of 90 basis points in April, but well above the average of 19 basis points over the past five years.

In Greenspan's eyes, financial markets will return to normal when the spread shrinks to 25 basis points.

At the magic 25-basis-point level, Greenspan says, "we will learn this crisis has come to an end."

In an interview with Bloomberg, Greenspan says the spread is unlikely to shrink to 25 basis points soon because, he says, "risk was very heavily underpriced".

Still, Greenspan noted in his speech that financial markets have shown a "pronounced turnaround" since March.

"The worst is over in the financial crisis or will be very soon," he says. In addition, "There is a reduced possibility of a large, intense recession."

That's partly because of the positive impact of the Bush administration's tax rebate, Greenspan maintains. "There is a sense it is buoying the retail market," he says, pointing out that the U.S. economy is demonstrating "remarkable resilience."

Retail sales rose 1 percent in May, twice as much as economists had forecast. In February, Greenspan said the chance of a recession stood at "50 percent or better." More recently, he said the economy was on the "brink of recession."

The U.S. economy grew at an annualized rate of 0.9 percent in the first quarter, which means the six months through June 30 produced the weakest economic expansion in five years – but expansion nonetheless.

The housing slump continues to put "major downward pressure" on the economy, Greenspan says. Financial institutions around the world have suffered \$391 billion in write-downs and losses thanks to bad debt stemming from the meltdown of the subprime mortgage market.

Housing still constitutes a "critical problem," he says. And financial markets may not completely rebound until home prices stabilize. That might happen "by the end of the year," Greenspan predicts.

Greenspan says rising inflation will test the Fed's independence during the next few years. Fed officials will have to exert "increasing pressure" on money supply to quell inflation. "As a result, you will see interest rates rising," Greenspan predicts.

