The Real Libor Scandal… "With the Complicity of the Bank of England"

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According to news reports, UK banks fixed the London interbank borrowing rate (Libor) with the complicity of the Bank of England (UK central bank) at a low rate in order to obtain a cheap borrowing cost. The way this scandal is playing out is that the banks benefitted from borrowing at these low rates. Whereas this is true, it also strikes us as simplistic and as a diversion from the deeper, darker scandal.

Banks are not the only beneficiaries of lower Libor rates. Debtors (and investors) whose floating or variable rate loans are pegged in some way to Libor also benefit. One could argue that by fixing the rate low, the banks were cheating themselves out of interest income, because the effect of the low Libor rate is to lower the interest rate on customer loans, such as variable rate mortgages that banks possess in their portfolios. But the banks did not fix the Libor rate with their customers in mind. Instead, the fixed Libor rate enabled them to improve their balance sheets, as well as help to perpetuate the regime of low interest rates. The last thing the banks want is a rise in interest rates that would drive down the values of their holdings and reveal large losses masked by rigged interest rates.

Indicative of greater deceit and a larger scandal than simply borrowing from one another at lower rates, banks gained far more from the rise in the prices, or higher evaluations of floating rate financial instruments (such as CDOs), that resulted from lower Libor rates. As prices of debt instruments all tend to move in the same direction, and in the opposite direction from interest rates (low interest rates mean high bond prices, and vice versa), the effect of lower Libor rates is to prop up the prices of bonds, asset-backed financial instruments, and other "securities." The end result is that the banks' balance sheets look healthier than they really are.

On the losing side of the scandal are purchasers of interest rate swaps, savers who receive less interest on their accounts, and ultimately all bond holders when the bond bubble pops and prices collapse.

We think we can conclude that Libor rates were manipulated lower as a means to bolster the prices of bonds and asset-backed securities. In the UK, as in the US, the interest rate on government bonds is less than the rate of inflation. The UK inflation rate is about 2.8%, and the interest rate on 20-year government bonds is 2.5%. Also, in the UK, as in the US, the government debt to GDP ratio is rising. Currently the ratio in the UK is about double its average during the 1980-2011 period.

The question is, why do investors purchase long term bonds, which pay less than the rate of inflation, from governments whose debt is rising as a share of GDP? One might think that investors would understand that they are losing money and sell the bonds, thus lowering their price and raising the interest rate.

Why isn't this happening?

PCR's June 5 column, "Collapse at Hand," explained that despite the negative interest rate, investors were making capital gains from their Treasury bond holdings, because the prices were rising as interest rates were pushed lower.

What was pushing the interest rates lower?

The answer is even clearer now. First, as PCR noted, Wall Street has been selling huge amounts of interest rate swaps, essentially a way of shorting interest rates and driving them down. Thus, causing bond prices to rise.

Secondly, fixing Libor at lower rates has the same effect. Lower UK interest rates on government bonds drive up their prices.

In other words, we would argue that the bailed-out banks in the US and UK are returning the favor that they received from the bailouts and from the Fed and Bank of England's low rate policy by rigging government bond prices, thus propping up a government bond market that would otherwise, one would think, be driven down by the abundance of new debt and monetization of this debt, or some part of it.

How long can the government bond bubble be sustained? How negative can interest rates be driven?

Can a declining economy offset the impact on inflation of debt creation and its monetization, with the result that inflation falls to zero, thus making the low interest rates on government bonds positive?

According to his public statements, zero inflation is not the goal of the Federal Reserve chairman. He believes that some inflation is a spur to economic growth, and he has said that his target is 2% inflation. At current bond prices, that means a continuation of negative interest rates.

The latest news completes the picture of banks and central banks manipulating interest rates in order to prop up the prices of bonds and other debt instruments. We have learned that the Fed has been aware of Libor manipulation (and thus apparently supportive of it) since 2008. Thus, the circle of complicity is closed. The motives of the Fed, Bank of England, US and UK banks are aligned, their policies mutually reinforcing and beneficial. The Libor fixing is another indication of this collusion.

Unless bond prices can continue to rise as new debt is issued, the era of rigged bond prices might be drawing to an end. It would seem to be only a matter of time before the bond bubble bursts.

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