Breakdown of Covered Interest Parity: Mystery or Myth?

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Summary

The emergence and persistence of basis spreads in cross-currency basis swaps (CCBSs) since the global financial crisis have become a mystery in international finance, as they violate the long-standing principle of covered interest parity (CIP). We argue that the phenomenon is no mystery but merely a reflection of the different risks involved between money market and CCBS transactions in the post-crisis era. Empirical results based on seven major currency pairs support our hypothesis that the swap dealer behaves as if he tries to align the risks of the transactions in pricing CCBSs, which causes CIP to break down. We also find that the basis spreads are well arbitraged among the currency pairs, which suggests they are fairly priced. Hence, it is a myth that CCBS basis spreads or CIP deviations are evidence of the market not functioning properly.