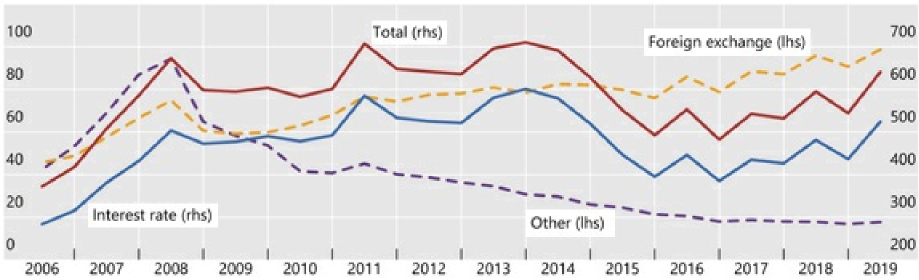
It’s all or nothing for big banks in new speculative frenzy

The latest Bank for International Settlements (BIS) statistics on global derivatives trading, issued on 8 November, reveal a 20 per cent increase in notional values over the 6 months ending 30 June 2019. From US$544 trillion at the end of 2018, total over the counter (OTC) derivatives reached US$640 trillion at the end of June. The gross market value of OTC derivatives, a much lower figure that banks assess their derivatives are worth for accounting purposes, rose by 25 per cent for the same period. A significant increase in exchange-traded derivatives was also reported. Derivatives growth had stalled after the 2008 global financial crisis as contracts such as credit default swaps collapsed, but growth resumed in 2016. The bulk of derivatives today take the form of interest rate swaps, which will spell trouble for derivatives contracts when interest rates eventually rise—in addition to the impact it will have on the bloated corporate debt bubble. According to estimates by *Executive Intelligence Review* magazine, the expansion of derivatives brings total global financial aggregates (derivatives, debt, stock market valuations, etc.) to around US$1.8 quadrillion, and is set to reach US$2 quadrillion by year’s end.



Outstanding notional amounts of OTC derivatives, USD trillions. Source: BIS

Given post-global financial crisis reserve requirements, opening the spigot on speculation has been a little trickier than usual. From an assessment of what is known of the overnight lending “repo” market freeze which began on 16 September, it appears that major banks deliberately held back liquidity which would normally flow through to the broader banking system, forcing the US Federal Reserve to make its extraordinary intervention. The Fed is injecting overnight and fortnightly loans at a rate of nearly US$700 billion per week, has made its third rate cut this year, launched a new quantitative easing program (claiming it was not QE), and is considering other “technical things” it can do to increase liquidity, including “daylight overdrafts”, or in other words, provision of “intraday liquidity” to the banks.

According to a 10 November Econimica blog post, however, the new Fed QE is “flowing straight into assets, like monetary heroin”, rather than benefiting commercial banking. Contrary to the Fed’s claim that it was simply buying securities from Wall Street banks to boost excess reserves on hand at the Fed, allowing banks to again lend into the repo market, the Fed’s own data shows that bank reserves on deposit are lower than they were at the start of 2019, and slightly lower than they were in August, before the repo squeeze. So the money has flowed straight into speculation in stocks, bonds, debt securitisations, market indices, interest rate derivatives, and so forth. EIR Economics Editor Paul Gallagher’s conclusion: “Based on these [Fed] data, this is essentially a rate of quantitative easing of US$1.5 trillion/year or more, far more than any previous ‘QE’ program by the Bank of Japan, Bank of England, European Central Bank, or the Fed. And the claim that it is ‘building up excess bank reserves, not going into the economy’—used since Ben Bernanke to assure that QE would never cause hyperinflation—does not apply.”

In testimony before a US Congressional Committee on 14 November, Fed Chairman Jerome Powell revealed that the Fed’s reserve requirement was based on surveying the banks on what they felt was needed, but admitted that when liquidity dried up in early September, “banks had much more liquidity than they said they needed and yet it didn’t flow into the repo market”. He said the Fed was doing “a lot of forensic work” to understand why the liquidity issues occurred! While other Wall Street banks have rallied since the Fed’s injections, Deutsche Bank (declared most systemically contagious by the IMF), Goldman Sachs, and Lincoln Financial have not. Wallstreetonparade.com reports this as confirmation of the hypothesis that the repo crisis was caused by big banks quarantining each other to avoid contamination. Deutsche Bank, for instance, holds some €25 billion of “Level 3” assets—impossible-tovalue illiquid and complex OTC derivatives, distressed debt and other contracts.

Whether banks are already breaching their self-determined reserve ratios, with the full knowledge of the Fed, is an open question. According to analysis by Pam Martens and Russ Martens at wallstreetonparade.com on 14 November, it appears the Fed “is letting JPMorgan Chase call the shots on the amount of cash reserves it has to hold at the Fed in order to remain viable during a financial panic”. It has reduced the cash reserves it holds at the Fed by US$145 billion over the year ending 30 September 2019 and now holds 63 per cent in the form of far less liquid securities, according to a St Louis Fed study. At the same time, the bank reduced its lending portfolio and increased its trading assets and off-balance-sheet exposure significantly, raising its risk profile. And as previously reported, JPMorgan Chase is pushing for the removal of cash reserves altogether. ("Is Fed's super-QE directed by JPMorgan?", *AAS*, 6 Nov. 2019.)

JPMorgan Chase recently shifted US$130 billion into bonds, which require less capital to be held against them than loans, freeing up more dollars for gambling. The world's biggest banks are desperate to maximise profits because despite some cosmetic reforms since the last crisis, they are closer to collapse than ever. Essentially, the repo operation is cover for a mammoth government-backed injection of money into speculative markets, required to keep the players in the game.

As Wall Street On Parade concluded: "If the USA is going to weather an economic downturn, it needs commercial banks that are willing and able to lend to businesses and consumers, not shrink their loan portfolios and move further into a trading casino mindset. The only workable solution to restore the safety and soundness of US commercial banks is to permanently separate them from the trading houses and investment banks on Wall Street. That means restoring the *Glass-Steagall Act* that protected the US financial system successfully for 66 years until its repeal under the Bill Clinton administration in 1999."

Australian Alert Service, 20 November 2019
