Will US Fed succeed in forestalling year-end financial crunch?

18 Dec.—Between 13 December and 14 January US$2.93 trillion will be poured into Wall Street banks in an attempt to prevent an end of year liquidity crisis. Injected via various short-term repo market loans, the intervention is designed "to ensure that the supply of reserves remains ample and to mitigate the risk of money market pressures around year end", announced the New York Federal Reserve on 12 December.

The shortage of liquidity in “repurchase agreement” overnight lending markets which began on 16 September has not been resolved by the extraordinary Fed interventions which have been extended and increased in volume several times. By its own figures, the Fed pumping has not added bank reserves to the system. The nearly $350 billion injection, measured by the increase in the Fed’s balance sheet since August, has gone down a speculative hole. The Fed has not yet provided a sufficient reason why the crunch occurred in the first place. If it was just end of (US) financial year issues, why has it continued?

In addition to daily and two-weekly repo injections, the Fed will offer a new longer-maturity repo "that spans years end", of at least $50 billion. Between 31 December and 2 January overnight repo loans will be increased from 120 to 150 billion, along with an additional $75 billion repo offer over the three days.

Credit Suisse analyst Zoltan Poszar has warned in a note to clients the “Fed will be doing ‘QE4’ by year-end” if his analysis of funding stresses is right, according to CNBC on 10 December. While the Fed already announced a new quantitative easing program on 11 October, in all but name, Poszar is foreshadowing an official, full-blown intervention, including a "shift from buying bills to buying what’s on sale—coupons".

Pozsar was a mid-level official at the Treasury and then at the New York Fed for years; he is given some credit for having developed the repo market, and people he trained are in charge of monitoring it. He had forecast on 13 August that the Fed would soon face a liquidity shortage in the repo market. Pozsar’s analysis is complex, but he essentially says that he anticipates a very serious year-end shortage of repo liquidity needed by both banks and hedge funds for foreign exchange (FX) transactions (FX swaps)—which are a form of speculative derivatives transactions.

“FX swaps could end up as the orphaned asset class, and that may force banks in some parts of the world to the edge of the proverbial abyss” in the coming weeks, said Pozsar. FOREX transactions require a lot of liquidity, especially in times of stress.

BIS warning

“Central banks are acting as if a global financial crisis is just around the corner”, proclaimed a 9 December Zero Hedge article which reported highlights from the latest Flows and Liquidity blog of Bank of America economist Michael Hartnett. The 53 interest rate cuts by central banks around the world this year “represents the fastest pace of central bank cuts since the financial crisis. Central banks have injected $400 billion in liquidity since last Christmas, while the dovish ECB and now Fed … are set to boost central bank balance sheets by another $600 billion in 2020.”

Meanwhile the “central bank of central banks”, the Bank for International Settlements (BIS) is warning —in not quite so many words—that the very structure of the repo market itself is a ticking time bomb. In a section of its December Quarterly Review, "September stress in dollar repo markets: passing or structural?" the BIS revealed that just four big banks dominate interbank lending. (It doesn’t name them, but they are likely among the largest US banks, JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley.) “US repo markets currently rely heavily on four banks as marginal lenders”, said the report.

Due to more than 10 years of ultra-low and negative interest rates and QE, however, those banks have shifted from cash reserves—the excess of which get leant out into the repo market—into speculation in Treasuries. They now hold 50 per cent of Treasuries in the market. Treasuries take 1-2 days to settle, preventing banks from readily lending into the repo market. “As the composition of their liquid assets became more skewed towards US Treasuries, their ability to supply funding at short notice in repo markets was diminished”, reported the BIS.

Add to the equation the fact that hedge funds have increased derivatives speculation and therefore are demanding more cash in the form of repos, as noted by BIS. What the BIS did not mention is that there has been a spate of mass withdrawals and hedge fund failures in recent months. Investors withdrew almost $77 billion through the end of the third quarter—more than double last year's withdrawals. A number of highly leveraged hedge funds have frozen withdrawals or gone into liquidation.

The BIS warned that "sustained disruption" of the repo market "could quickly ripple through the financial system", stressing that this was one of "the most damaging aspects of the GFC".

With its extraordinary end of 2019 repo actions the Fed has essentially established a new permanent bailout facility, the legality of which is dubious, to save too-big-to-fail banks in a new crisis which will dwarf that of 2008.
