Thomson Reuters Money Market Forum

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Summary

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- Central banks intervened on a colossal scale in response to the financial crisis, providing unprecedented injections of liquidity.
- Most now argue that the intervention has done its job and now needs to be unwound.
- Central banks seem to agree.
- On the face of it, market pricing would seem to support that conclusion.
- But:
  - market pricing can be very misleading
  - this assumes that it is still a liquidity issue – but what if it's really a question of solvency?
- At its heart this remains a banking crisis, and it is far from over.
- That said, the withdrawal of central bank largesse could hasten its conclusion.

Liquidity injection

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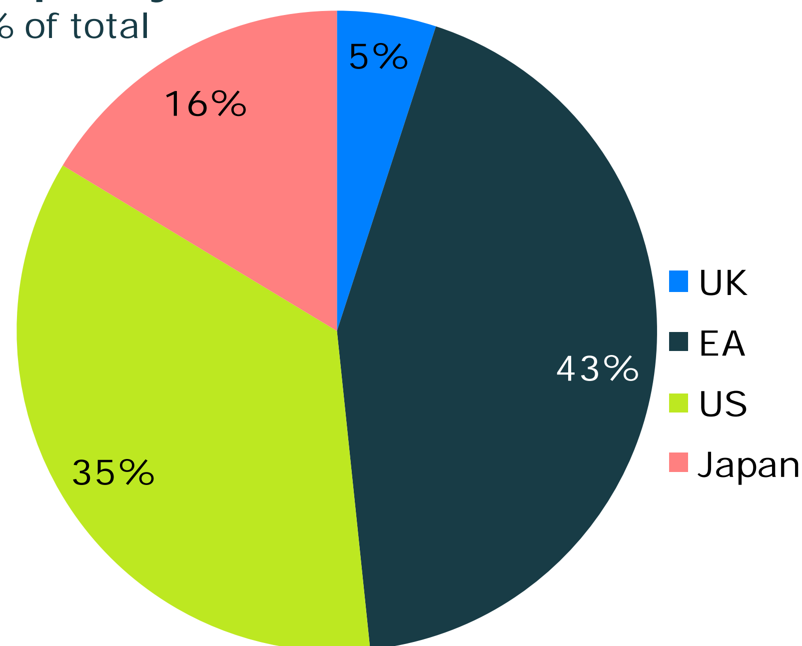

- Since the end of 2007, the big 4 central banks have injected some $4.7trn (roughly 8% of global GDP) into the global economy.
- This is likely an underestimate as it excludes measures by other central banks like PBOC.
- US QE accounts for roughly half of that total injection ($2.3trn), but the Fed has also run down other holdings, leaving the ECB as the biggest single net contributor to global liquidity
- BoJ operations account for a further 16% of the total injection – this will rise to roughly 20% after this month's further injection.

Interbank market becalmed

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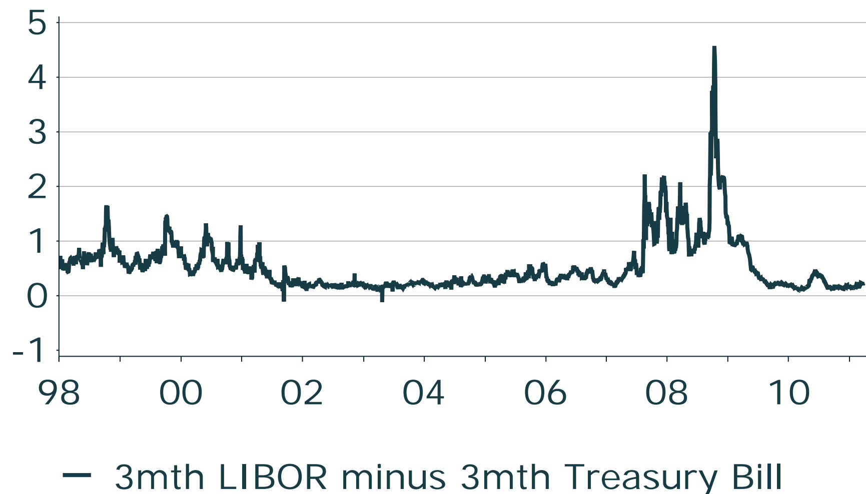
US Interbank Risk

Percentage points



Source: Reuters EcoWin / Fathom

US Interbank Risk

Percentage points

- 2yr swap minus 2yr benchmark UST
- 5yr swap minus 5yr benchmark UST
- 10yr swap minus 10yr benchmark UST

Source: Reuters EcoWin / Fathom

- The interbank market looks to be back to ‘normal’.
- Spreads are back to pre-crisis levels, and in some cases even lower
- The question is: is this due to central bank largesse; or is it a signal that it is time to unwind special measures?

No need for cash

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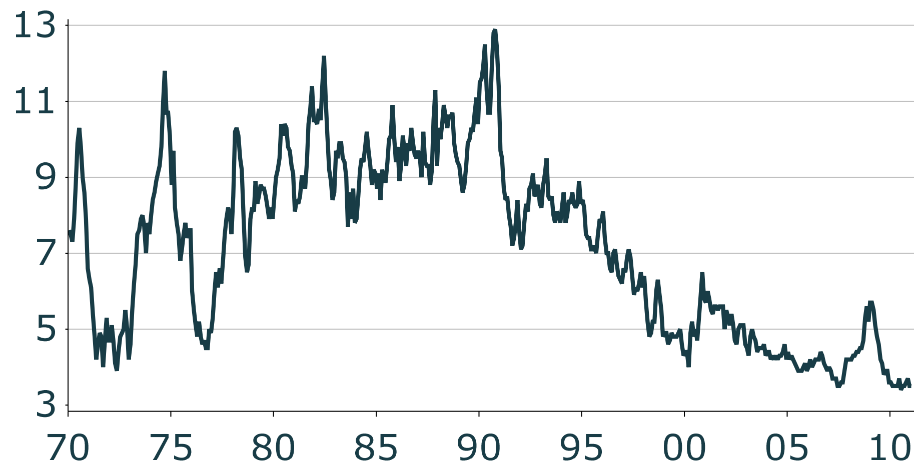

- The demand for cash appears to be at all-time low, and well below the levels seen in the run-up to the crisis even.
- Last week, the so-called fear gauge the VIX fell by more than 42%. That, apparently, was the biggest drop over 7 days in the history of the VIX, which stretches back to January 1990.
- So, if the answer is more liquidity is needed, what was the question?

QE –whatever you want it to be

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- QE leads to yields going up/down [delete as appropriate].
- According to Janet Yellen, the Fed's QE programme has boosted core inflation by 1pp and created 3 million jobs relative to the counterfactual. Hence without it, the US would be in deflation and the unemployment rate would be above 12%.
- We have some doubts....

Is risk like matter?

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- Risk may follow Newton's Law – in a closed system, it cannot be destroyed, it is a constant
- Since 07 has anything actually been resolved? Or have we merely shunted the problem from one balance sheet to another?
- Are government balance sheets the last link in the bubble super-cycle?

Last refuge of the bubble scoundrel

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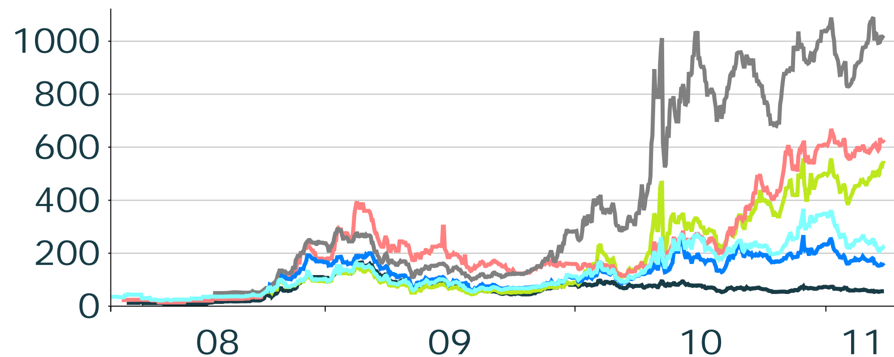

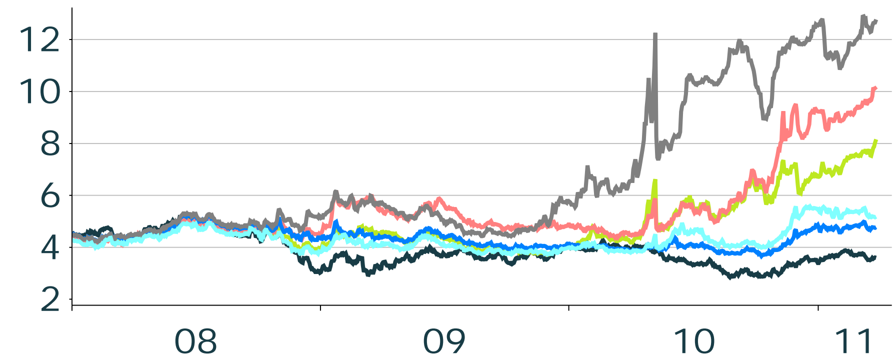

- On the face of it, it would seem hard to argue that peripheral European sovereign debt problems are merely an extension of the US subprime crisis that erupted in 07, but not as hard as you might think
- It is not a sovereign crisis – it was, and it remains a banking crisis.
- It is not a liquidity crisis but one of solvency.

Sins of the banker

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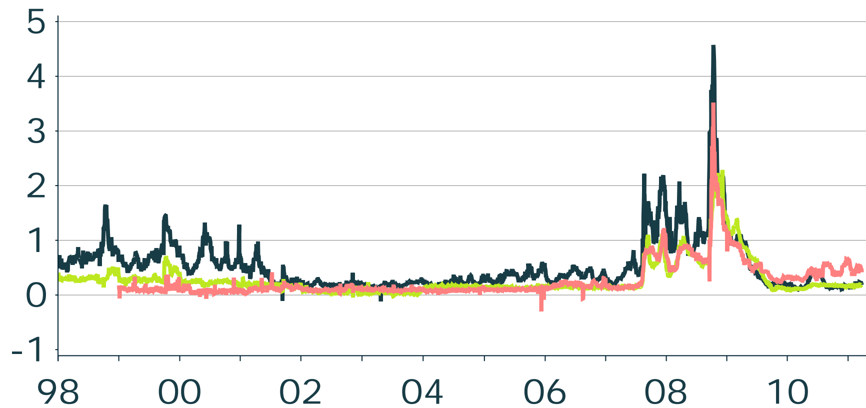
Interbank Spreads
Percentage points



Source: Reuters EcoWin / Fathom

EA Relative to US Bank Equity
Index, 1 Jan 1999 = 100

Source: Reuters EcoWin / Fathom

- The question should not be how much do Greece, Portugal, Ireland etc owe?
- It should be who lent them the money in the first place?

When you owe the bank a €1 trn...

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% of GDP	France	Germany	Greece	Ireland	Italy	Portugal	Spain	UK
France	-	6.1%	0.6%	8.5%	1.6%	3.6%	1.9%	11.7%
Germany	10.0%	-	1.8%	15.0%	12.5%	1.7%	2.8%	7.8%
Greece	2.1%	1.1%	-	3.7%	0.3%	4.5%	0.1%	0.5%
Ireland	2.0%	4.3%	0.1%	-	0.8%	8.6%	1.0%	6.8%
Italy	16.4%	4.8%	0.2%	19.1%	-	1.5%	2.3%	3.0%
Portugal	1.6%	1.2%	0.0%	2.4%	0.2%	-	5.5%	1.0%
Spain	6.4%	5.7%	0.2%	11.9%	1.3%	10.3%	-	5.0%
UK	12.8%	14.4%	6.3%	97.8%	2.2%	3.4%	27.4%	-
Total	51.3%	37.6%	9.3%	158.4%	18.7%	33.7%	40.9%	35.9%

- Using BIS data we can get a glimpse into who lent whom what – but it is only a glimpse
- The data run vertically, so we can see Ireland's gross over-exposure
- But French banks are on the hook for more than 50% of French GDP to the rest of Europe, Spanish banks more than 40%
- The point is to whom did each of these systems go on to re-lend to?

Untangling European exposure

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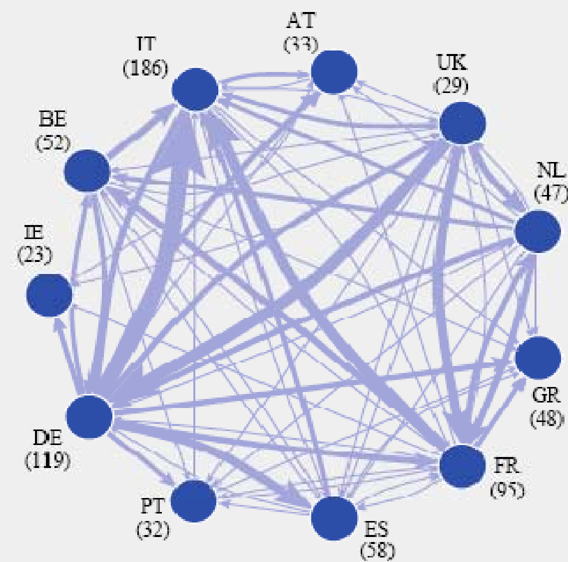
Chart B Foreign claims on sovereigns, broken down by nationality of the reporting banks in selected EU countries

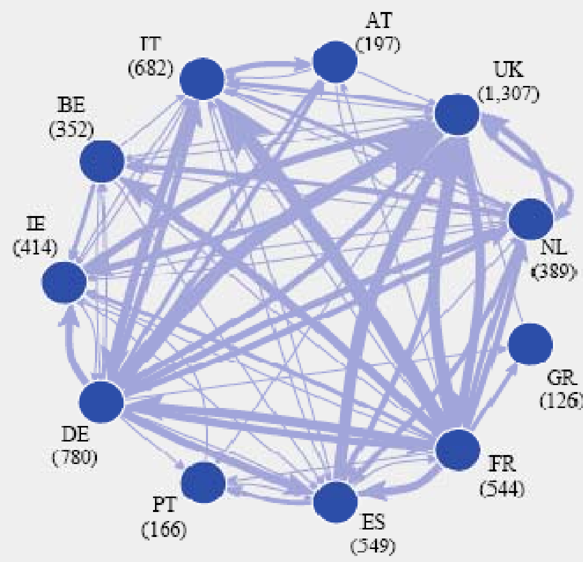
(Q1 2010; EUR billions)



Sources: CEBS and ECB calculations.

Chart C Foreign claims, broken down by nationality of the reporting banks in selected EU countries

(Q1 2010; EUR billions)



Sources: BIS and ECB calculations.

- The direction of the arcs reflects the direction of lending of funds, and the thickness the size of the total exposure.
- Chart B: the total cross-border sovereign exposure of banks to the particular country is reported by the numbers in brackets.
- Chart C: total foreign claims by country of banks reported by the numbers in brackets.

Banking Liabilities

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Debt due to be repaid in 2011

By country, per cent of GDP

Source: Reuters EcoWin / Fathom

The UK SLS – job done?

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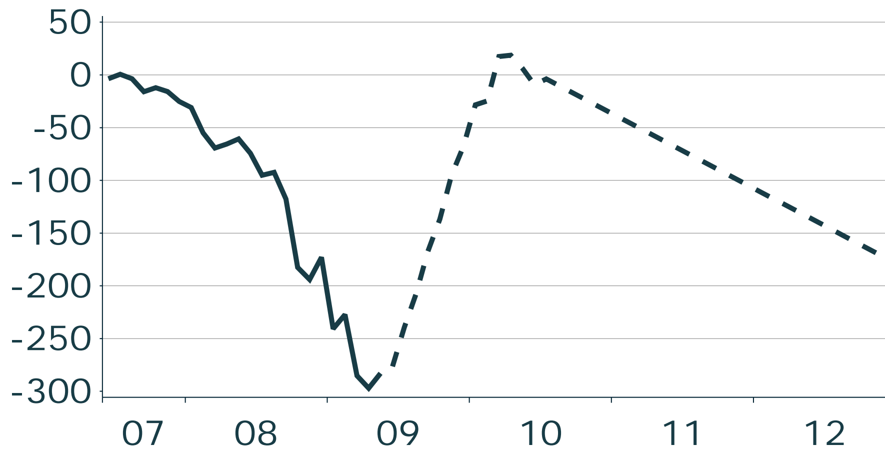
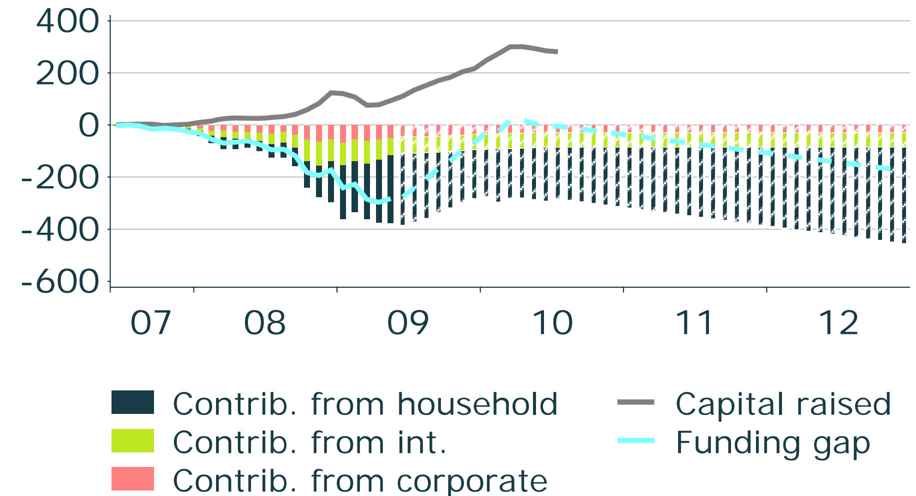
- The Special Liquidity Scheme was designed to provide support on a one-off basis, in large size and for a long maturity.
- It took the form of an asset swap. For a fee, the commercial banks were lent 9 month Treasury bills against a broad set of eligible collateral.
- In practice the collateral received in the Scheme was dominated by own-name residential mortgage backed securities (RMBS and covered bonds).
- The banks could use the Treasury bills to raise liquidity in the market, at a time when the primary, secondary and repo markets for RMBS were all closed.
- The principle was that the Bank shouldn't support the banks in issuing new securities for which there might not be a private market or to subsidise new lending.
- Following standard accounting practice, it was not on the Bank's balance sheet.
- The Scheme will expire at the end of January 2012. It will not be extended or replaced.
- After three years of large-scale liquidity support the Bank expects each institution to be in a position to fund itself through normal market mechanisms.
- Of the £185bn of Treasury bills initially advanced, some £94bn has already been repaid.

The UK funding gap





- On the face of it, UK banks appear to have closed their funding gap...
- ...but only if the level of house prices stays where it is
- Assuming a 20% fall in house prices reopens the funding gap to £180bn by 2012, without more capitalisation
- And then there's the removal of the SLS (Jan 2012)...

Trust the market