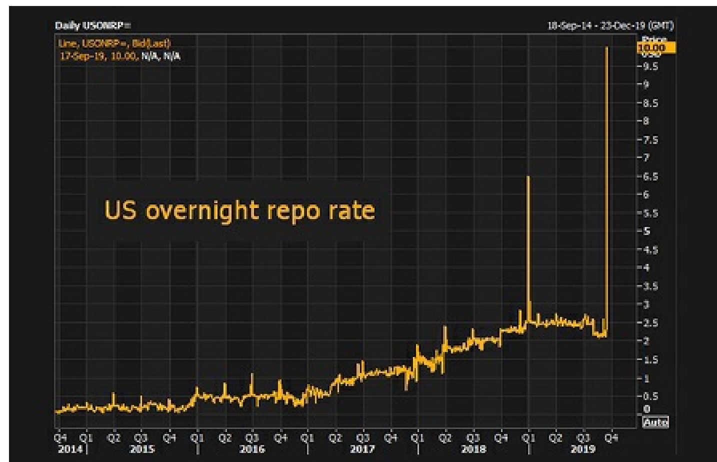
Pre-tremors of the next global banking meltdown?

A sudden liquidity crisis in US overnight bank lending, and rapid growth in global and Australian bank derivatives, are eerily reminiscent of the lead-up to the global financial crisis in 2007-08. These developments underscore the urgency of reforming the financial system to protect the public from economic catastrophe and stop the reckless banking practices that cause such crises, which political leaders failed to do in 2008.



The massive jump in the overnight repo rate on 16 September. Source: Mother Jones

On 16 September—11 years and a day after the collapse of Lehman Brothers—the interest rate on short-term interbank lending in the United States suddenly soared, from just over 2 per cent to almost 10 per cent. The New York Federal Reserve quickly injected US$53 billion into the "repo" market, which is the market for short-term lending based on the borrower agreeing to "repurchase" the collateral it puts up for the loan—essentially a way to guarantee repayment in the agreed time. It is significant that this is the first time in a decade that the Fed has had to intervene in this market, as the last time was in the middle of the global financial crisis. The first injection was not enough, however. The Fed pumped in US$75 billion the next day, and kept pumping, so by the end of the week it had injected well over US$200 billion. On 20 April the New York Fed announced in a press release it would pump $75 billion a day into the overnight repo market for the next three weeks, as well as three injections of US$30 billion into the two-week repo market—well over US$800 billion!

More than a week later, the specific cause of the repo crisis is still not clear. What is known is that suddenly one or more financial institutions needed to borrow a very large amount of money that wasn't available in the trillion-dollar overnight market. We know it was sudden because the interest rate started surging on the Monday afternoon of 16 September, well after the vast majority of trading in the overnight market had taken place and just before the 3:00 PM deadline for placing orders. That indicated sudden demand for a very large amount of cash for which the desperate borrower or borrowers, i.e. banks, were willing to pay four times the normal interest rate.

But who was it? Nobody is saying. Neither is it known why they needed the money. The Fed tried to explain it away, by attributing the need for money to corporate debt payments to Treasury falling due on the Monday. This explanation was greeted with scepticism. Finance reporter Heidi Moore tweeted 18 September: "Those are expected payments. It's like if you know all your bills come due on the first of the month. Yes it's a big hit but you already know it's coming, and you keep money in the bank for it. Same with banks. They're not ready for corporate taxes and Treasury auctions? What? That's amateur hour."

Kevin Drum commented in a *Mother Jones* blog on 18 September: "It seems like somebody needed a whole lot more cash than they had anticipated, and for some reason other banks were reluctant to lend it. Maybe that's because the other banks really were short of cash. But it might also be because they knew who the counterparty was and they were afraid that even a 12-hour loan ran the risk of not getting paid back. It's the kind of thing that happens during a banking crisis—which, as it happens, is the last time the Fed had to intervene in the repo market."

Moore echoed his suspicion in her tweet: "This issue involves the ghosts of 2008, when banks were so freaked out about which one of them might suddenly collapse that they stopped lending to each other. Banks not lending to each other is VERY BAD." (Emphasis in original.)

When the cause of a crisis that requires an US$800 billion plus bailout is so uncertain, the chief suspect must be over-the-counter derivatives, the dangerous gambling instruments that banks hide "off balance sheet". These instruments can cause sudden large losses which force banks to scramble to plug holes. In 2007-08 it was the collateralised debt obligations (CDOs) and credit default swaps (CDS) on bad residential mortgage-backed securities (RMBS) that caused both massive financial losses in banks, and a loss of trust between banks, leading to a credit crunch when they stopped lending to each other out of fear that they wouldn't be repaid. Today, while we don't yet know if there has been a massive derivatives loss inside the banking system, we do know that there has been a rise in

derivatives gambling in the global financial system.

On 22 September the Bank for International Settlements (BIS) reported that the market in risky leveraged corporate loans, which often have poor lending standards and few protections for investors, is now US$1.4 trillion. BIS warned that the securitisation of these loans into derivatives called collateralised loan obligations (CLOs), intended to hide their risks, which has mushroomed in recent years to US$750 billion, is now a bigger market than the CDOs that caused the 2008 crisis, which reached US$640 billion. That said, CDOs are also making a comeback, with the rate of issuance now higher than their pre-crisis peak in 2007.

Derivatives speculation has driven a steep rise in foreign exchange trading, only a fraction of which is for trade in physical good and services. According to the BIS's Triannual Central Bank Survey, forex trading has increased 30 per cent in three years to US$6.6 trillion per day. The bulk of this growth comes from a 34 per cent rise in forex swaps to US$3.2 trillion per day, and a 43 per cent rise jump in outright forwards to US$1 trillion per day.

Meanwhile, Australia has experienced its steepest ever rise in bank derivatives, up $10 trillion in six months, from $38 trillion to $49 trillion, according to RBA's quarterly figures on banks' off-balance sheet business. While outsiders cannot know what the specific derivatives contracts are for, the unprecedented growth rate hints at desperation and panic. Derivatives can be used to create artificial liquidity, and to hide losses—for a time.

Banking reforms to protect the real economy from the next financial meltdown are urgent, starting with a Glass-Steagall separation of normal banking from speculation, a proper audit of bank derivatives, an end to the “bail-in” policy of confiscating deposits to save banks, and a national bank to direct credit away from speculation and into the real economy.

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