The US dollar reckoning

By Elisa Barwick

The current banking turmoil cannot be separated from the fracturing of the US dollar system triggered by geopolitical actions—they are both features of a collapsing global economic framework. US banks are part of a broader platform upon which a massive financial bubble has been constructed, and which a growing portion of the world can see is crumbling. One way or another a new economic order will replace the current one.

Former IMF Deputy Managing Director Zhu Min, interviewed at the annual Boao Leadership Forum, held 28-31 March in Boao, China, addressed the "broad mismatch of assets and liabilities in the US banking system" causing a crisis that is "much more serious than in 2008". "Assets", he said, "are heavily speculative and may be long-term" (and are currently dropping in value due to rising rates), whereas "short-term liabilities are running out of banks because those liabilities (deposits) are earning nothing for depositors." China, however, which has not seen periods of wildly low or high interest rates like many Western nations, does not suffer such a mismatch. Both governments and private companies in China do have high debt, he acknowledged, but there are growing industrial and real assets to show for it. Chinese Premier Li Qiang told the forum that "In this uncertain world, the certainty China offers is an anchor for world peace and development."

Playing into this mismatch, is a combination of a white anting of the US Treasury market itself ("The fall of the hedge funds?", p. 9) and a Treasury bond sell-off by major nations. This is causing a drastic crunch point, for the entire US dollar-dependent world. Once upon a time when the USA issued new debt certificates it was guaranteed that someone, somewhere in the world would buy them. But that "superpower" of the US dollar is waning, wrote columnist Fareed Zakaria, in the 24 March *Washington Post*. Since sanctions were levied on Russia, he wrote, China and Russia are conducting most of their trade in Chinese currency, the yuan, and "making efforts to get other countries to follow suit". Zakaria notes that US public debt has grown *fivefold* in the last 20 years and in the same timeframe the Fed has solved numerous financial crises by expanding its balance sheet *twelvefold*. "All of this only works because of the dollar's unique status. If that wanes, America will face a reckoning like none before."

Departing the dollar

At the instigation of the BRICS+ club (Brazil, Russia, India, China, South Africa), trade is increasingly conducted without using the US dollar for exchange purposes. China has just made its first purchase of energy from the Arab world using the Chinese yuan, and so has France! On 28 March, China National Offshore Oil Corporation and France's TotalEnergies announced their first yuan-settled liquefied natural gas deal, with a purchase from the United Arab Emirates, conducted through the Shanghai Petroleum and Natural Gas Exchange. This follows Chinese President Xi Jinping's December 2022 trip to Riyadh, where China and Saudi Arabia made progress in agreements to settle gas and oil trade in Chinese currency. ("China-Saudi agreements a marker of new economic system", *AAS*, 14 December 2022.)


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Forex

China and Brazil Agree to Dump Dollar for Trade – AFP

March 30, 2023

China and Brazil have struck a deal to trade in their own currencies instead of the US dollar, the Brazilian government said on Wednesday, in another hit to US economic influence

A new China-Brazil arrangement to trade in local currencies was revealed at the Brazil-China Business Seminar in Beijing on 29 March. Photo: Screenshot

The same topic was discussed during Xi's trip to Russia last month, including trade in local currencies with Asian, African and South American countries. BRICS nations India and South Africa have declared their intention to increase the usage of local currencies for trade settlement. Much trade between Russia, China and India is already conducted without the dollar. A new report from independent European agency, the Centre for Economic Policy Research, shows that trade invoiced in Chinese currency now exceeds that conducted in euros, according to a 31 March article in London's *Financial Times*. The report heralds the emergence of a "multipolar" currency world.

On 28 March ASEAN finance ministers and central bank governors meeting in Indonesia discussed reducing dependence on the US dollar, euro, yen and British pound, by expanding the Local Currency Settlement scheme agreed to in November 2022. According to a report by ASEAN Briefing, Indonesia's banking regulator announced on 27 March that the Bank of Indonesia will be introducing its own domestic payment system. President Joko Widodo is encouraging use of local credit card systems rather than Visa and Mastercard, to shield the country from "possible geopolitical repercussions" in the future.

On 29 March the Brazilian government announced that China and Brazil had reached an agreement to settle trade payments in yuan. "An agreement on settling payments in yuan has been signed with Brazil, which greatly facilitates our trade", China's Vice Minister of Commerce Guo Tingting said 30 March. "We are planning to expand cooperation in the field of food and mineral extraction, and to search for a possibility of exporting goods with high added value from China to Brazil and from Brazil to China", he said. In January an agreement to establish a clearing house was reached, for currency settlements and lending in national currencies. China is Brazil's biggest trading partner.

On the sidelines of the Russia-Indian Business Forum held in New Delhi on 29-30 March, Deputy Chair of Russia's State Duma Alexander Babakov announced that a proposal for a "new currency" to serve a multipolar world will be presented at the BRICS Summit to be held 22-24 August in Durban, South Africa. He described the ongoing transition to settlements in national currencies as the first step in the process, and moves into digital currency as another. "I think that at the BRICS [leaders' summit], the readiness to realise this project will be announced, such works are underway", he said, adding that a new currency would be pegged to gold and "other groups of products".

US Treasury sell-up

Given this transition, and the financial and economic instability of the US economy, nations that have been major buyers of US debt, in the form of securities including US Treasury bonds, are increasingly moving out.

Brazil offloaded a monthly record US$21.5 billion of US Treasury bonds from its foreign currency reserves in March, almost equalling the US$22 billion it sold in 2022—which was close to 10 per cent of its total holdings.

China, which was the largest holder of US debt in 2013 with more than US$1.3 trillion worth of Treasuries, has reduced its total holdings by around 25 per cent. This has occurred via steady month-by-month reductions, amounting to a 17 per cent reduction in 2022, nearly US$175 billion worth. The decline continued in January 2023, for the sixth straight month.

Indicating that it is not only a matter of political allegiance, even the Bank of Japan sold off US$189 billion of its Treasury holdings in 2022, to diversify its foreign exchange reserves.

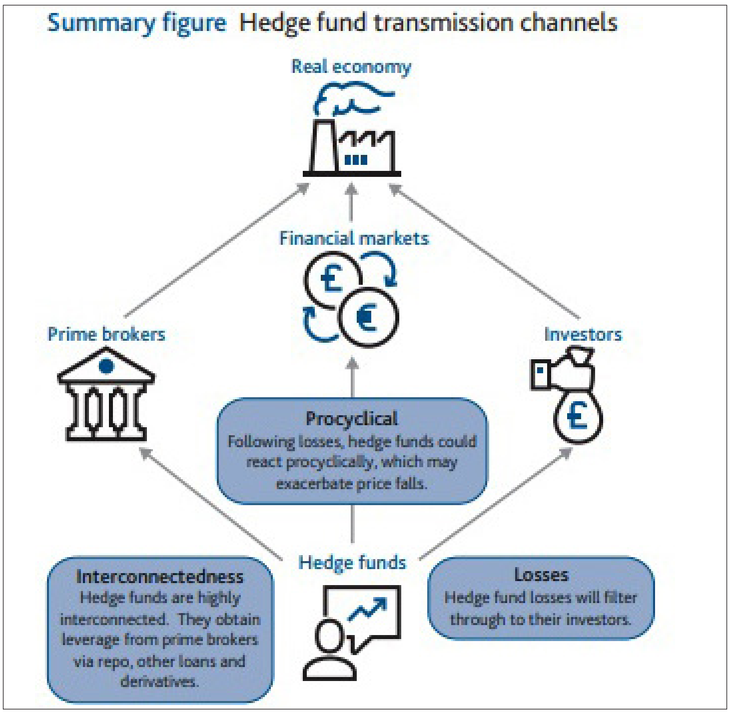
The fall of the hedge funds?

By Elisa Barwick

The rotten US Treasury market—the world's "single most important market"—is teetering on the brink of collapse.

On 18 March, following the collapse of three US banks and amid general turmoil in bond and bond futures markets, big swings in money flows, and disruptions to trading in both the USA and Europe, the London *Financial Times* reported that "the most important market in the world went, to use the technical term, completely bananas. ... This time, the market reaction in Treasuries was nothing short of apocalyptic." Head of fixed income at Union Investment, Christian Kopf, is cited, saying that "the Treasuries market has become a 'hall of mirrors,' packed full of hedge funds trading blows with the Fed.... 'The most important market in the world is being dominated by a bunch of hedge funds,' says Kopf."

The *FT* article, by Katie Martin, was headlined, "The tumult in Treasuries: are hedge funds partly to blame?" The response to the bank collapses, she noted, catalysed "a bigger shock than in March 2020", when Treasury markets almost caved in. Kopf, she noted, "points the finger of blame at the sector he previously worked in: hedge funds." Hedge funds "are displaying far more muscle in the market than more traditional asset managers."



The potentially destabilising role of hedge funds in crucial financial markets was recognised even in a 2017 Bank of England report, "Hedge funds and their prime brokers: developments since the financial crisis". Photo: BoE

Hedge funds had positioned themselves to win in a high interest rate environment, but, wrote Martin, "When SVB [Silicon Valley Bank] sparked a search for safety in Treasuries, that bet took a hit. When it did, many hedgies were forced to close out their positions, effectively making them buyers of Treasuries. That blew up more negative bets, and forced more buying. It was a classic short squeeze, and a big one at that. It has left a string of big-name macro hedge funds wearing ugly losses. 'The most important market in the world is being dominated by a bunch of hedge funds', says Kopf."

Who put the hedge funds in control?

Since the 2008 global financial crisis the US debt market, which underpins the US dollar-based global financial system, has been completely white-anted. From no later than September 2019 it has been at the point of caving in. The rot started much earlier, however. From 1971 when President Nixon de-linked the dollar from gold, the post-Bretton Woods era saw new debt issuance increasingly dissociated from actual economic activity, which was tanking rapidly.

The post-2008 bailout set off changes that would make this dramatically worse, where US Treasuries themselves became the foundation for new speculative bubbles. The size of the Treasury market has increased four-fold since the global financial crash, but this rising debt was not only *not* backed by an equivalent increase in productive capacity, speculators were given free rein to deploy it as a tool to expand liquidity for their gambling activities. As *AAS* documented in "The rise of the hedge funds" (14 July 2021), hedge funds that specialise in trading risky financial derivatives were given a central role providing liquidity to the banking system through "repo" markets. Repo (repurchase) markets consist of short-term lending between financial institutions and "primary dealers" acting on behalf of the Fed, against collateral held in the form of Treasury bonds.

Hedge fund participation increased with regulatory changes in 2017 and further adjustments in early 2019, building up to the September 2019 repo market crunch when the Fed had to step in to provide daily cash injections. In its December 2019 Quarterly Review the Bank for International Settlements (BIS) warned that the big four US banks that dominate repo lending had shifted their reserves into Treasury speculation, holding 50 per cent of the Treasuries in the market. Because they take 1-2 days to settle, this sometimes prevented banks from readily lending into repo markets, hastening the rise of the hedge funds in the market. In turn, hedge funds increased derivatives speculation, noted the BIS, and therefore were themselves demanding more cash in the form of repos. It warned that a "sustained disruption" of the repo market "could quickly ripple through the financial system".

The hedge funds were running a "conveyor belt", wrote American investigative journalist Christopher Leonard in *The Lords of Easy Money: How the Federal Reserve Broke the American Economy*, "magically transforming bonds into cash". (See "Landmines in the graveyard of high finance", *AAS*, 16 Feb. 2022.) But they ended up losing big in March 2020 when betting on the difference between current Treasury bond prices and "futures contracts" on Treasuries. *AAS* reported: "As their bets on Treasuries went bad, hedge funds were desperate for cash and sold close to 20 per cent of their Treasury holdings, worsening the Treasury market dislocation. The impact flowed through other capitals markets, which seized up. The Fed had to intervene, purchasing billions of dollars of Treasury paper itself."

The US Federal Reserve issued a report in April 2021 on "Hedge Fund Treasury Trading and Funding Fragility", which reported on this market dysfunction. The Fed noted "the speed and scale at which extreme moves occurred and in its impact on otherwise safe and liquid markets such as the UST [US Treasury bond] market." The Fed admitted that a big part of the problem was allowing hedge funds to act as players in the repo markets, increasing the opaqueness of a market vital to financial stability. Hedge funds are less regulated than other money market dealers, said the report, employ substantial leverage, and deploy less liquid investment strategies. But the Fed was essentially admitting it had to intervene to save hedge funds, *to save the system*, given their interconnection.

The same month, independent Treasury bureau the Office of Financial Research (OFR) released "Hedge funds and the Treasury cash-futures disconnect", also pointing to the risks created by "non-bank actors in the current structure of the Treasury market". As Fed Chairman Jerome Powell made clear in a 28 April 2021 press conference, "the US Treasury market is probably the single most important market in the economy and the world. It needs to be liquid." Nevertheless, the Fed was still considering letting hedge funds borrow from the Fed's repo clearing house *directly* rather than via middlemen as they currently did. The *Wall Street Journal* admitted that this would amount to the Fed "backstopping their bets".

Despite all this turmoil, crunch time didn't really hit until the Fed started raising interest rates in March 2022. Then, the Treasuries piled on the banks' books became increasingly worthless (the market value of a bond moves in the opposite direction to rates). As deposits on their books shrank (drawn down by squeezed businesses for capital or by savers who weren't earning enough), banks like SVB were forced to sell Treasuries at a loss, leaving big holes in their balance sheets.

Numerous other reports from the BIS, IMF, World Bank and Fed warned of the impact of Fed policy tightening, including a loss of liquidity in US Treasury markets and the impact it would have on emerging market economies with large US dollar-denominated debts. But they didn't take seriously their own advice, and neglected to fully realise how it would impact the USA itself.

Even at this late stage the worst can be avoided by excising this speculative cancer.