

Fed report points to potential sources of new financial turbulence

Nick Beams
6 November 2022

In March 2020, at the start of the pandemic, the \$24 trillion US Treasury market had a “near death” experience when for several days no buyers could be found for US government debt, supposedly the safest financial asset in the world.

The US Federal Reserve intervened with a massive \$4 trillion bailout to restore stability, but two-and-a-half years on the threat of a recurrence remains ever-present as the Fed’s Financial Stability Report issued last Friday makes clear.

Summing up the report in a short statement, Fed vice-chair Lael Brainard wrote: “Today’s environment of rapid synchronous global monetary tightening, elevated inflation, and high uncertainty associated with the pandemic and the war raises the risk that a shock could lead to the amplification of vulnerabilities, for instance due to strained liquidity in core financial markets or hidden leverage.”

Strained liquidity refers to a situation where traders cannot make large deals in financial assets, including in the Treasury market, without setting off significant movements in prices, which, in the case of a sale, can trigger a rush for exits and a crisis.

Hidden leverage (debt), taken on by financial traders, but concealed from view when markets are stable, can become a major question if there are downward movements. Both issues feature throughout the Fed report.

In its overview, the report said that since its previous analysis issued last May, “the economic outlook has weakened and uncertainty about the outlook has remained elevated.”

Banks remained stable, but it is a different story in other areas of the financial system.

Bank lending to nonbank financial institutions “reach[ed] new highs.” Moreover, there is lack of

information, as the report noted, about “some parts of the nonbank financial sector, where hidden pockets of leverage could amplify adverse shocks” and monitoring could be “enhanced with more comprehensive and timely data.”

This is a euphemistic way of saying there are areas of the financial system where authorities have no real idea of what is going on.

“Short-term funding markets continue to have structural vulnerabilities, as some markets and institutions remain vulnerable to large and unexpected withdrawals, especially considering the highly uncertain outlook,” it said.

Many bond and bank-loan mutual funds “continue to be susceptible to large redemptions, because they hold assets that can become illiquid amid stress.”

In other words, conditions exist for the equivalent of what took place in former times—a bank run where the depositors demand their money back, but it cannot be provided because it has been put in assets that cannot be readily turned into cash.

The report said liquidity, that is, the ability to trade assets without a large effect on market prices, remained low in “in several key asset markets.”

This is the case in the all-important Treasury market, where US government debt is bought and sold, and which forms the basis of the US and global financial system.

While the market had continued to “function smoothly” in the recent period, liquidity appeared to be “less resilient than is typical.”

This had led to a situation where market participants had resorted to splitting trades into smaller chunks to minimise their effect on prices.

At this point, trading in shorter-term market securities appears to be the most affected, with the report noting

that the reduction in “market depth” was relatively large. It was down to levels “around the low point seen during the onset of the COVID-19 pandemic” because “the prices of those assets are more sensitive to news about the near-term economic outlook.”

According to the report, some types of non-bank financial firms were operating with high levels of debt. Their exposure was difficult to monitor because of limitations in the existing data and “these challenges raised the risk that hidden pockets of leverage could amplify adverse shocks.”

At the same time, changes in regulation, following the 2007-09 financial crisis had strengthened the ability of banks and broker dealers to absorb losses and increased “resilience in these institutions.”

But this on-the-one-hand, on the other approach obscures the causal connection between the two phenomena. The greater involvement of non-bank financial institutions, and their hidden debts, in key asset markets, is the outcome of the efforts by finance capital to circumvent the restrictions on profit-making arising from greater regulation in the banking area.

This has led to a situation where a smaller amount of activity in the Treasury market is being conducted by regular broker dealers.

“As the gap between dealer market activity and the total amount of Treasury securities held by investors continues to grow,” the report said, “there may be increased vulnerabilities associated with dealers’ reduced willingness or ability to accommodate a surge in intermediation demand during markets stress.”

This was the situation in March 2020 when no buyers could be found for government bonds, which the holders wanted to sell to meet their cash requirements, until the Fed stepped in.

The report also pointed to other areas of potential instability.

Bank lending to non-bank financial institutions had increased, the report said. But they also had alternative funding sources about which there was limited information and “the extent to which these sources may be fragile could contribute to vulnerabilities in the financial sector.

Open-ended funds also contained dangers. They are susceptible to “large redemptions because they hold assets that become illiquid amid stress while promising shareholders the right to redeem their shares every

day.”

Insurers have been able to lower their debts. However, at the same time, they have continued to increase their holdings of risky assets such as high yield [junk] corporate bonds, among others, which “leaves insurers’ capital positions vulnerable to sudden increases in default risk.”

The stresses in the global financial system arising from the rise of the dollar, could also rebound on the US financial system. This could come about in several ways. There are growing financial problems in emerging market economies as they struggle with the higher cost of imports, leading to inflation, and the greater burden of dollar-denominated debt.

Financial problems in China, arising from the debt crisis in real estate, could depress economic activity and lead to a contraction in world trade.

The rise in value of the dollar may also lead foreign governments and financial authorities to sell US bonds and other assets to try and shore up the value of their currencies. Private investors could do the same to build cash buffers in dollars.

The Fed’s report did not make front-page news, but its significance was reported in the financial press. The *Wall Street Journal* noted that “while there hasn’t been a serious breakdown in Treasury trading so far, the possibility is far from unthinkable given the tumult this year.”

The *Financial Times* commented that the “recent chaos in the UK sovereign bond market,” which threatened the holdings of €1.5 trillion held by pension funds, had “raised concerns for policy makers.” The selloff in gilts, long-term government debt, which affected US credit markets, “offered a glimpse of how quickly turmoil in one corner of the market can spread.”



To contact the WSWS and the
Socialist Equality Party visit:

wsws.org/contact