BIS warns of dollar debt “black hole”

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In its latest quarterly review issued last week, the Bank for International Settlements has identified a potential black hole for financial markets that could play a major role either in setting off a financial crisis or accelerating one.

The BIS, an umbrella organisation of the world’s central banks, said that “embedded in the foreign exchange (FX) market is huge, unseen dollar borrowing.”

The report, entitled “Dollar debt in FX swaps and forwards: huge, missing and growing,” focusses on the central role played by the dollar in the foreign exchange markets.

The amounts are enormous, around $80 trillion, and involve the daily transactions in currency markets of around $5 trillion. Each day, financial entities, pension funds, insurers and banks undertake deals centring on the dollar as the key global currency. At any given point there are myriad deals involving currency swaps between the dollar and other currencies.

For example, the review notes, “an investor or a bank wanting to do an FX swap from say, Swiss francs into Polish zloty would swap francs for dollars and then dollars for zloty.”

But the problem identified in the review is that there are no statistics covering these operations. The various dollar payment obligations “do not appear on balance sheets and are missing in standard debt statistics” and are recorded “off-balance sheet in a blind spot.”

Reporting on the review, *Financial Times* columnist Gillian Tett, posed the question: “Does it matter if you lose track of $80 trillion?”

The BIS clearly believes it does because, while dollar swaps and transactions proceed smoothly and routinely in “normal” times, it is a very different matter when a crisis erupts.

“The FX markets are vulnerable to funding squeezes,” the report said.

“This was evident during the Great Financial Crisis and again in March 2020 when the COVID-19 pandemic wrought havoc. For all the differences between 2008 and 2020, swaps emerged in both episodes as flash points, with dollar borrowers forced to pay high rates if they could borrow at all. To restore market functioning, central bank swap lines funnelled dollars to non-US banks offshore, which on-lent to those scrambling for dollars.”

According to the BIS, the lack of information regarding dollar debt because it is off balance sheet makes it “harder for policymakers to anticipate the scale and flow of dollar rollover needs. Thus, in times of crisis, policies to restore the smooth flow of short-term dollars in the financial system (e.g., central bank swap lines) are set in a fog.”

This meant that when panic was quelled, as the Fed allowed other central banks to supply dollars and backstop markets in 2008 and 2020, they acted on little information about who owed the debt.

The BIS warnings that the institutions supposedly in charge of the financial system are flying blind will be passed over by those who point to the fact the markets continue to function, ignoring the fact that two major crises have erupted in the past decade and a half.

This was the essential content of a discussion on the Bloomberg channel on the BIS review. In other words, nothing much to see here.

But, tasked with trying to secure the stability of the financial system as a whole, the BIS is clearly concerned and has called for the development of statistics that track outstanding short-term dollar obligations, conscious of the enormous disruption that took place in this area in 2008 and March 2020.

It noted that it was “not even clear how many analysts are aware of the existence of large-scale off-balance sheet obligations” and sounded a warning to those who might try to ignore the problem.

"Off balance sheet dollar debt," it concluded, "may remain out of sight and out of mind, but only until the next time dollar funding liquidity is squeezed. Then 'hidden leverage' and maturity mismatch in pension funds' and insurance companies' portfolios … could pose a policy challenge. And policies to restore the flow of dollars would still be set in a fog."

The issues highlighted by the BIS are by no means the only area of concern.

Last week, the FT published an article entitled "Financial Stability: the hunt for the next market fracture," consisting of a series of short comments from various journalists pointing to areas of growing concern.

It noted that after a decade of falling interest rates "global financial markets are facing a reckoning" because of the tightening interest rate regime being imposed by central banks, led by the US Fed. This was sucking liquidity—the ability to transact without dramatically moving prices—out of markets.

The result was that "violent" and sudden moves in one market "can provoke a vicious loop of calls and forced sales of other assets, with unpredictable results."

Elaine Stokes, a portfolio manager at the investment firm Louis Sayles, told the FT the market was "illiquid", "erratic" and "volatile". It was "trading on impulse and we just can't keep doing that."

Various shocks in the market, such as the closure of the nickel market in London at the start of the pandemic, the bailout of European energy providers and the September-October pensions crisis in the UK were "being scrutinised as oracles of wider dislocations to come."

A contribution by another journalist noted that while liquidity had long been a hallmark of the $24 trillion US Treasury market, it had "dried up" because of higher interest rates and reduced buying by the Fed and the Bank of Japan.

In her comment on the BIS findings, Tett noted that another area of "fog" was the US Treasury market which, like dollar swaps, underpins much of the financial system.

"During the dramatic market turmoil of March 2020, it became clear that secondary market trading structures have big vulnerabilities that were not understood—or reported—before."

While the US Treasury and Securities and Exchange Commission was trying to fix the problem "progress is slow."

Of course, like all financial commentators and analysis, while providing some insights at times, she did not draw out the essential conclusion: that the "problems" are inherently unsolvable because they are rooted in the contradictions of the capitalist economy and financial system itself.

This is why the very measures aimed at stabilising the financial system after the crises of 2008 and 2020 by pouring in trillions of dollars have only created the conditions for the eruption of an even deeper crisis.