When Will the Next Financial Crisis Start?

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The question is not “if” but “when” the next financial crisis will hit. The 2007 crisis has still not ended. The quantitative easing initiatives of many countries have not had the desired effect of inducing liquidity. Instead, quantitative easing has financed the mop up of the safest financial assets—including sovereign bonds—by central banks and several banks, effectively leading to another market liquidity crisis.

Although luminaries such as Bill Gross and David Stockman, academics such as Nouriel Roubini, and many others have started asking the question in the title of this article, a better question to ask is: Did the global financial crisis (GFC) that started in the summer of 2007 ever end? Given all the quantitative easings (QEs), long-term refinancing operations (LTROs), interventions in the bond, stock and other markets by such central banks as the United States (US) Fed, the European Central Bank (ECB), Bank of Japan, Swiss National Bank and others, and the approaching Greek default, the answer must be a resounding no! For otherwise, why would any of these have happened?

The GFC that started in 2007 has never ended.

Three Liquidities

Recent warnings have been issued by many (for example, Lefevre 2015 and Roubini 2015) of a looming market liquidity crisis, as if the GFC did not manifest itself in 2007 in another form of liquidity crisis in the repurchase agreement (repo) market (Acharya and Öncü 2010). One of the main reasons for the onset of the GFC in the summer of 2007 was a funding liquidity freeze.

Funding liquidity is about the ease with which traders can obtain funding to trade one or more classes of assets. That is, funding liquidity is associated with the liabilities side of balance sheets. Market liquidity, on the other hand, is an assets side phenomenon: asset market liquidity is about the ease with which it can be traded. Market liquidity can also be called micro liquidity, because it is about the liquidity of a particular asset or a class of assets.

For an asset to be of high market liquidity, it must be in sufficient abundance as well as safe to hold so that it can be traded easily. Further, while the market liquidity of an asset depends on traders’ ability to find funding to trade the asset, that is, their ability to meet the capital and margin requirements, this depends on the asset’s market liquidity. Therefore, market liquidity and funding liquidity are interrelated.

And, of course, funding liquidity is related to the availability of money in the economy. This is where macro liquidity comes in. What is called macro liquidity is about monetary liquidity, that is, about increasing the money supply or creating additional money.

Who Creates the Money?

There is a misconception that money is created or even printed by the central banks. As the story goes, the central bank injects some seed money it creates to the banks, and the banks multiply that money.

The banks start doing this multiplication by keeping a percentage of the seed—as required by the central bank—as reserves and extending the rest as loans to the public, which end up as deposits at some other banks. They then keep doing this among themselves until there is no money left to lend and, in the process, create deposits—that is, additional money—whose sum is equal to the sum of the loans extended. So, if the reserve ratio required by the central bank is 10%, the banks multiply the seed money injected by the central bank by 10.

The above is the textbook description of money creation, called deposit multiplication. Nothing can be farther from the truth. Had this been the case, in the first place, the central bank could have controlled the money the banks can create by controlling the seed money it injects, which we know it cannot.

The central banks can only print banknotes and/or mint coins. That is, they cannot create any other money, at least, in the absence of QEs or some similar mechanisms. They can create reserves, but reserves are not money that can buy things like bread and butter. They are just some numbers created by the central bank to settle accounts between

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banks for which the central bank acts as a bank as well as a clearing house.

Money Is Created by Banks

Unlike the usual beliefs, banks are not in the business of intermediation of loanable funds. They are in the business of financing through money creation (Jakab and Kumhof 2015). In the current monetary system, money is debt because deposits—that is, money—in the loans and other forms of credit, while in the process, creating the corresponding deposits—that is, money—in the accounts of their borrowers.

The banks then need to find central bank reserves to back the deposits they create either by borrowing from other banks or from the central bank, usually by pledging some liquid financial asset such as some government bond as collateral in a repo transaction. The amount of reserves that the banks have to find depends on the required reserve ratio determined by the central bank. If at the time there are not enough reserves to back the newly created deposits, then the central bank has to create those reserves. For otherwise, settlement failures among banks begin to occur, and the banking system eventually collapses.

This is why the central banks cannot control the deposits—that is, money—the banks create by controlling the reserves. They can only influence—but not control—the money the banks create by changing the interest rate on, and/or requirement ratio of the reserves that the banks have to borrow—that is, by changing the cost of creating money to the banks.

The central bank reserves that back bank deposits are called required reserves. Since they do not back all deposits, the rest of the reserves the banks hold at the central bank—if any—are called excess reserves. The total reserves the banks hold at the central bank are the sum of required reserves and excess reserves.

Enter Quantitative Easing

If the above is how money is created, how can the central banks add macro liquidity? The answer to this question is clear: the central bank has to find a way to create deposits at the banks. The so-called QE is in which there are four players is one way to accomplish this. These players are: (1) the treasury that issues government bonds; (2) non-bank financial corporations (NBFCs) that purchase government bonds; (3) banks and (4) central banks.

Suppose the treasury has already issued bonds and NBFCs have bought the bonds either from the treasury or in the secondary market. The QE process through which the central bank creates deposits at the banks is as follows:

First, banks buy the bonds from the NBFCs by creating deposits. (Of course, banks can buy other assets from other issuers that the central bank deems safe, but I leave that aside in order not to complicate matters.) Then, banks give the bonds to the central bank in return for the reserves the central bank creates, effectively allowing the central bank to buy the bonds from the NBFCs by paying reserves which otherwise cannot buy things including bonds, because reserves are not money.

This is how the central bank adds macro liquidity through QE.

Why Did the QEs Fail?

Since the amount of reserves the central bank created is equal to the amount of deposits the banks created, some of these reserves are required and the rest are excess. Say, the reserve requirement is 10%. If the central bank bought $100 worth of bonds from the NBFCs, the banks now hold $10 required and $90 excess reserves. Therefore, given that the banks have already created $100 deposits, they could have created an additional $900 deposits by making loans. But, we know that they did not—at least, not much—given the dire economic conditions we have been experiencing since at least 2007.

This has been the main reason why the early hyperinflation fears have not materialised, as well as why the banks accumulated so much excess reserves at the central banks. In addition, although the QEs were intended to jump start economic growth, the QEs did not help the economies much because the money the central banks created ended in the hands of NBFCs, and not much additional money was created by the banks and lent to the productive sectors of the economies. Instead, NBFCs used much of this added macro liquidity for speculative purposes, leading to various bubbles around the globe.

Looming Market Liquidity Crisis

One unintended consequence of the failed QEs has been that the central banks involved have bought excessive amounts of safe assets, reducing their supply. In addition, because freezing funding liquidity was one of the triggers of the GFC, regulators started demanding that banks and other large financial institutions hold large amounts of liquid assets to protect against funding liquidity freezes during times of financial turmoil, thereby further reducing the supply of safe assets.

This made most of the formerly liquid safe assets, including even us Treasury bonds and German Bunds, less liquid than before. Furthermore, since QEs led to excessively low yields in the countries they have been implemented in, many financial institutions in search of higher yields loaded up their portfolios with illiquid assets.

Let us now recall how the GFC started in 2007 (Acharya and Öncü 2010):

The financial crisis of 2007-2009 to which the Dodd-Frank Act is a response was a crisis not only of the traditional banks, but also of the shadow banks, those non-bank financial institutions that borrow short-term in rollover debt markets, leverage significantly, and lend and invest in longer-term and illiquid assets.

Hence, we are set up for another disaster. So far, we have experienced only a few flash crashes and sudden jumps in interest rates and stock prices, as seen with the US and German 10-year yields, and the Shanghai and Shenzhen stocks just as recently as early June 2015.

When (not if) the next leg of the GFC will hit remains to be seen. All we need now is a straw to break the camel’s back.

REFERENCES


