INDEPENDENT
STRATEGY

Update

* The Fed's last fandango

11 March 2008

- **The Fed has launched a new instrument of liquidity injection by providing funds for primary dealers who can now use a wide range of assets as collateral, including mortgage-backed securities. In this way, the Fed hopes to relieve those parts of the credit market it has not been able to reach so far.**
- **It won't work. What drives liquidity contraction is risk aversion, deleveraging and the repricing of overvalued assets, all of which the Fed has already proven itself incapable of reversing. The Fed will just delay the cleansing of balance sheets, increase inflationary pressure and weaken the dollar further.**

The Federal Reserve announced today an expansion of its securities lending programme. Under this new Term Securities Lending Facility (TSLF), the Federal Reserve will lend up to $200bn of Treasury securities to primary dealers secured for a term of 28 days (rather than overnight, as in the existing programme) by a pledge of other securities, including federal agency debt, federal agency residential-mortgage-backed securities (MBS), and non-agency AAA/Aaa-rated private-label residential MBS.

The Federal Open Market Committee has authorised increases in its existing temporary reciprocal currency arrangements (swap lines) with the European Central Bank (ECB) and the Swiss National Bank (SNB). These arrangements will now provide dollars in amounts of up to $30bn and $6bn to the ECB and the SNB, respectively, representing 50% increases of $10bn and $2bn. The FOMC extended the term of these swap lines to 30 September 2008.

This latter measure is an enlargement of established facilities that aim to encourage foreign banks to fund their dollar needs in their own regions and relieve pressure on US money markets.

What matters is the former measure to inject liquidity into primary dealers. This shows the Fed is beginning to understand the structure of the liquidity pyramid, although it remains as ignorant as ever about the nature of credit cycles. By seeking to inject liquidity into primary dealers (which traditionally buy and trade treasuries — Figure 1) against a range of increasingly dicey non-treasury collateral, the Fed is attempting to encourage investment banks and prime brokers (which are by and large the same entities as the primary dealers) to lend to non deposit-taking financial institutions (NDFIs) like hedge funds.

As New Monetarism shows, the NDFI sector's balance sheets are equal to half that of the banks.

Figure 1

US primary government securities dealers

BNP Paribas Securities Corp.
Bank of America Securities LLC
Barclays Capital Inc.
Bear, Stearns & Co., Inc.
Cantor Fitzgerald & Co.
Citigroup Global Markets Inc.
Countrywide Securities Corporation
Credit Suisse Securities (USA) LLC
Daiwa Securities America Inc.
Deutsche Bank Securities Inc.
Dresdner Kleinwort Wasserstein Securities LLC
Goldman, Sachs & Co.
Greenwich Capital Markets, Inc.
HSBC Securities (USA) Inc.
J. P. Morgan Securities Inc.
Lehman Brothers Inc.
Merrill Lynch Government Securities Inc.
Mizuho Securities USA Inc.
Morgan Stanley & Co. Incorporated
UBS Securities LLC

Source: FRBNY

And NDFIs create far more asset money than even the banks. Recent weeks have seen the NDFI sector start to contract as the falling value of collateral caused prime brokers and banks to stop lending to it (see our recent report, *A very logical progression*, 10 March 2008).

Until now, this was a part of the financial anatomy that the Fed could not reach; the liquidity it injected into the banks stopped there and failed to get lent on, so no new credit was created. This is because the banks have suffered severe erosion of their risk-free capital and have to contract credit to maintain solvency ratios and control their risk level. Now the Fed is trying to replace the banks as lender to NDFIs.

Interestingly, despite the coordinated press releases and hype about international coordination of policy between central banks, not one other central bank has followed the Fed example. This is despite the fact that we estimate that the credit losses among NDFIs in Europe is about two-thirds of the size of their US peers.

The actions of the Fed will be judged not by principle, but by results. Will it work? The amount of liquidity being injected by repos to the prime brokers is theoretically $200bn for 28 days and it could be more according to the Fed briefing. At the end of 28 days the Fed can roll over the loan and you can be sure it will go on doing so.

But that means the liquidity injection is equivalent to only about one-third of the damage from the credit losses we estimate for US NDFIs.

Furthermore, there is a big difference between creating a lot of liquidity and resolving an issue of solvency, which is the driver of credit contraction in all sectors today.

Credit to leveraged investors is contracting because of declining asset values that reduce the value of hedge fund collateral and, by capital destruction, that of the hedge funds' creditors. The Fed's readiness to accept almost any asset at face value as collateral will prevent price discovery and balance sheet cleansing in this sector just as the Fed has sought to do among banks.

In a nutshell, the Fed is attempting to prevent NDFI balance sheets contracting as asset prices fall and leverage is reduced in a manner that is self-reinforcing and pro-cyclical. This happens in every cycle and is a process driven by falling risk appetite, deflating asset prices and deleveraging. These are more powerful forces than central bank liquidity.

The Fed is King Canute trying to halt an ebbing, rather than a rising, tide. It will succeed in producing a market blip. But the US financial system will remain burdened with uncleansed balance sheets penalising productive lending and economic growth. In addition, the dollar will be further debased and inflation will move higher as a consequence. Fed policy will not stop the process of deleveraging and asset price decline.