Credit Suisse Economics

Global Money Dispatch

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I'll never forget the late-night briefing on Friday before Lehman's bankruptcy where according to one line of argument Lehman's problems were so widely understood that the system had enough time to hedge itself so that the actual default would be manageable. It didn't turn out like that… If a bank closes a $200 billion balance sheet on Friday and doesn't open on Monday, someone's $200 billion wasn't hedged by definition. The same with exclusions from SWIFT – the payments messaging system banks use to send and receive payments.

Exclusions from SWIFT will lead to missed payments and giant overdrafts similar to the missed payments and giant overdrafts that we saw in March 2020.

Back then we warned that "supply chains are payment chains in reverse" and that lockdowns would lead to missed payments everywhere. Today we'll say that all global payments go through SWIFT (including payments for commodities) and so exclusions from SWIFT will lead to missed payments everywhere again: the virus froze the flow of goods and services that led to missed payments, and war has led to exclusions from SWIFT that will lead to missed payments again. But by design, and not without a risk of retaliation: if a freeze in activity can lead to missed payments, an inability to receive payments through SWIFT can freeze the flow of goods, services, and commodities like gas or neon in kind.

We are dealing with pipelines here – financial and real. In the present context, they are two sides of the same coin. Inability to receive may mean unwillingness to send. Commodity flows aside, one would assume that central banks would re-activate daily swap line operations now that the SWIFT option got invoked.

Central banks should stand ready to make markets on Monday again…

Sanctioning central bank reserves can turn a surplus agent into a deficit agent overnight as discussed here. The Bank of Russia (BoR) has neither Treasuries to repo with the new FIMA repo facility, nor dollar swap lines with the Fed, and if its assets are frozen, it can't raise dollars to provide for its domestic banks.

Central bank deposits, bank deposits, and securities are all "inside money" – that is, money and money-like claims that are someone else's liability – and it's situations like this when "outside money" – money claims like gold bullion that are no one's liability – is king, especially if stored in vaults domestically. Unlike balances at the Deutsche Bundesbank, western G-SIBs, or Euroclear, you control what you have. Gold is a sovereign's money under the mattress, and the BoR has more of it than deposits at foreign central banks (see chart)!

Gold can be pledged under repo operations to cover one's dollar needs with a willing, collateral-rich central bank that has enough Treasuries to repo, or perhaps even the BIS (which owes its origin to reparation payments), and one can accumulate dollar surpluses anew through ongoing commodity exports away from financial centers in the West by seeding financial centers in the East.

The options appear limitless:

U.S. dollars from Treasuries via repos.

U.S. dollars from local currency via FX swaps.

U.S. dollars from gold via whatever we'll end up calling that…

But make no mistake: transitions are never smooth.

Banking is about double entry bookkeeping. My assets are your liabilities…

…like the blue and red veins in a body in one's elementary biology book.

If you jam the flows by making banks unable to receive and send payments, you have a problem, much like when a tri-party clearing bank did not return cash to money funds for fear of ending up with an intraday exposure to Lehman.

In physics, knowledge is cumulative.

In finance, knowledge is cyclical – people come and go, we tend to forget…

We believe there is no difference between Lehman unable to pay back money funds because its tri-party clearing agent is unwilling to unwind o/n repo trades, and banks unable to receive and make payments because they are out of SWIFT.

The Herstatt risk – settlement risk – owes its name to a mishap at a single bank. The risk in the current scenario involves an entire country's banking system. Banks' inability to make payments due to their exclusion from SWIFT is the same as Lehman's inability to make payments due to its clearing bank's unwillingness to send payments on its behalf. History does not repeat itself, but it rhymes…

The consequence of excluding banks from SWIFT is real, and so is the need for central banks to re-activate daily U.S. dollar funds supplying operations.

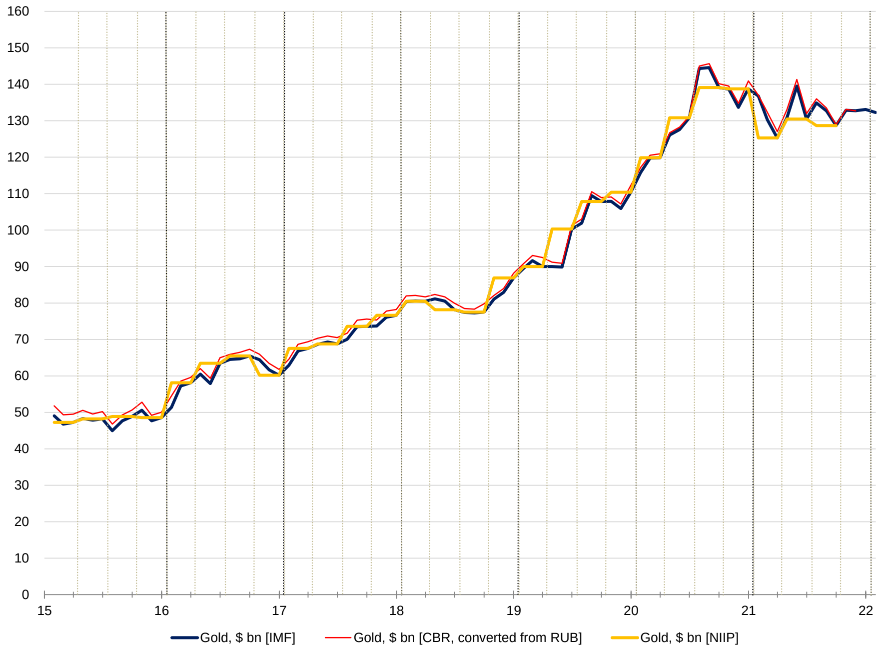
Excess reserves and o/n RRP balances won't be enough.

And so the Fed's balance sheet might expand again before it contracts via QT – and not just because of the swap lines. The FIMA repo facility is also there to turn collateral into dollars – anonymously, away from the prying eye of dealers, if a central bank becomes a friendly correspondent for a sanctioned central bank turning gold into cash. That, or an unforeseen call on unwanted reserves in the o/n RRP facility as the correspondents flood the repo market with collateral…

…before QT even began.

[Monthly]: The Bank of Russia Has More in Gold…

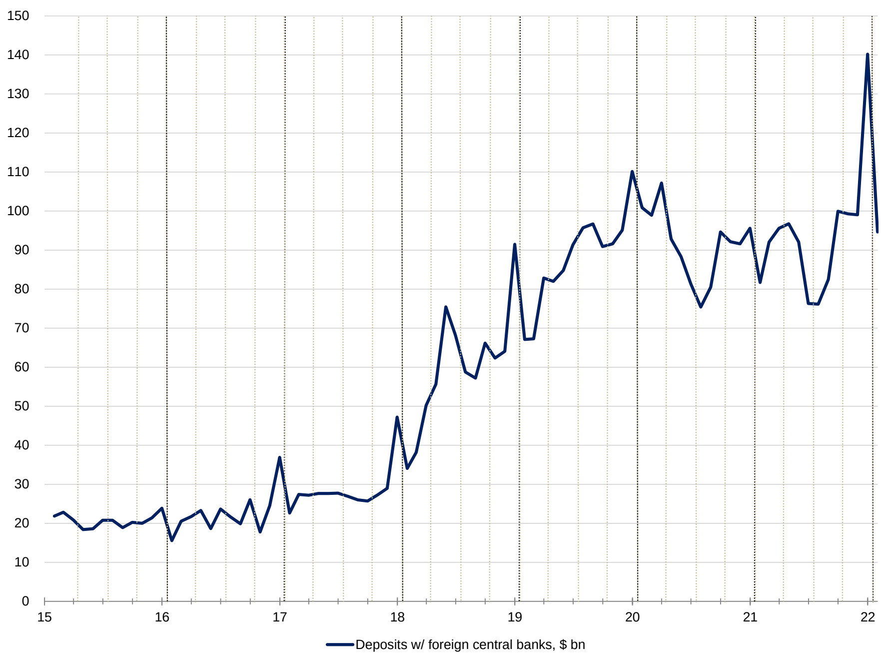
$ billion



Source: Bank of Russia, IMF, Credit Suisse

[Monthly]: …Than Deposits at Foreign Central Banks

$ billion



Source: Bank of Russia, IMF, Credit Suisse

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