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# Central bank campaign to avert financial crisis still in early stages

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## *Executive Summary*

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*Financial markets have stabilized somewhat following a bold policy response by central banks in the West. However, it would be premature to assume the crisis is over, as the risk has shifted from the banking sector (during the GFC) to nonbank financial institutions. Central banks' efforts to avert a crisis have only just begun.*

## Severe dollar shortage sparks financial market turmoil

The coronavirus fueled worries about the future and prompted people around the world to rush out and buy toilet paper and other necessities, triggering shortages of these goods. A similar phenomenon has occurred in the world of finance, where there is a severe shortage of dollars. Since the dollar serves as global reserve currency and is used in both trade deals and financial transactions, global trade and capital flows will grind to a halt without easy access to dollars. A shortage of the greenback can also lead to financial institution failures and defaults in emerging economies. As investors recklessly unloaded stocks, bonds, and other financial products in an attempt to obtain dollars, they aggravated the turmoil in global markets.

The Federal Reserve Board responded with a number of measures designed to ease the shortage. The Fed was already supplying dollar funds under standing currency swap lines with five other central banks. On March 15, it complemented its existing 1-week operations with 3-month operations and subsequently expanded the operation to nine more banks, including the central banks of Brazil and South Korea. On March 31, the Fed opened up a repo facility for more than 200 central banks and international bodies that allowed them to exchange Treasury securities for dollars. By giving central banks in emerging markets better access to dollar funding, the Fed seeks to prevent disruptions in financial markets and defaults on financial institutions' dollar-denominated debt.

The Fed has thus been busily supplying dollars in a bid to ensure stability in global markets. In contrast to the Trump administration, which has adopted an unabashedly America-first posture, the Fed continues to fulfill its role as the world's central bank.

## Measures to address financial crises plant seeds of next crisis

Global financial markets appear to have stabilized somewhat, owing in part to the Fed's bold policy response. However, it would be overly optimistic to assume the crisis is over.

Central banks around the world implemented a variety of aggressive and unprecedented measures to restore stability in the markets. Their rapid response was made possible by the lessons learned during the GFC in 2008. However, I worry the actions they take will once again veer into uncharted waters, inasmuch as the financial risks this time are entirely different from those faced in 2008.

It is often said that "every financial crisis is different," and that makes it difficult to prevent recurrences. The failure of Lehman Brothers and the global financial crisis that followed were rooted in an overheated US real estate market. The bank loans supporting that market were securitized and sold to investors, thus temporarily removing the risk from bank balance sheets, but banks ultimately assumed tremendous risk by investing in those same products. As the prices of these assets fell, reflecting a shift in real estate market conditions, the big banks experienced severe bad loan problems and were pushed to the brink of bankruptcy.

## Tougher bank regulation has shifted risk to nonbanks…

This experience led global financial authorities to take a tougher approach to regulation, forcing the big banks to set aside more capital, increase their holdings of liquid assets, and reduce the size of their balance sheets. As part of that process, banks substantially dialed back their investments in riskier financial products.

Western banks also largely abandoned their role as market makers, under which they had ensured that market participants could always buy and sell at a quoted price. These two roles—investing in risk assets and making markets for forex and securities, including those risk assets—were ceded to nonbank financial institutions (aka "shadow banks") such as hedge funds, mutual funds, sovereign wealth funds, and insurance companies.

While the adoption of more restrictive regulation improved banks' financial health, it also shifted risks onto the balance sheets of these nonbank institutions.

## And market-making functions have weakened

An extended period of ultra-low interest rates resulted in much higher prices for corporate bonds, securitized products, and other financial products. Now the coronavirus has triggered a sharp correction in those assets, effectively bursting the bubble. This poses a major threat to the nonbanks, which are not nearly as well capitalized as the banks.

Moreover, nonbanks cannot adequately perform the market maker's function of supplying liquidity to the markets during times of turmoil. Customer redemptions forced many investment funds to sell their holdings, undermining their ability to act as market makers. Financial market volatility therefore tends to be amplified during periods of market distress.

The same is true in the forex market. US and European nonbanks are now serving as counterparties to Japanese banks in the currency swap market, and their inability to provide a stable supply of dollars has left Japanese institutions increasingly concerned about their access to dollar funding.

## Central banks' long campaign has just begun

In short, the recent turmoil in financial markets is quite different from what was experienced during the GFC. The world's central banks will need to try new and untested measures as they search for a way to avert a severe financial crisis.

I suspect that the banks—especially those in the West—will try to gradually absorb risk by purchasing assets in increasingly dysfunctional areas of the market, including commercial paper, speculative-grade high-yield and BBB-rated corporate bonds, collateralized loan obligations (CLOs) consisting of risky corporate loans, commercial mortgage-backed securities (CMBS), and other securitized products. I also expect the list of assets acquired by central banks will be expanded to include lower-rated securities. The Fed has already decided to authorize the purchase of certain high-yield bonds.

Western central banks may also need to address the problems at nonbank financial institutions that are expected to surface going forward. Their campaign to avert another financial crisis has only just begun.

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