



C A M B R I D G E A S S O C I A T E S L L C

INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Published Research Team

“The Implications of Not Raising the Debt Ceiling” by David McCormick et al., Bridgewater Daily Observations, July 7, 2011

The political gridlock in Washington over whether or not to raise the debt ceiling suggests that a technical default by the U.S. government on its obligations is a risk that cannot be ignored. The key decision points being priced into the market and of most significance to the debate are (1) whether a deal will get done before the government can no longer meet its obligations and (2) if a deal cannot get done, how the Treasury will prioritize its expenditures.

The political gridlock in Washington over raising the debt ceiling suggests that a technical default by the U.S. government on its obligations is a risk that cannot be ignored. August 2, 2011, is the current deadline to get a deal done. Even if a deal cannot be agreed upon by then, a default remains unlikely as the Treasury would have some flexibility and a few options to buy time. The key decision points being priced into the market and of most significance to the debate are (1) whether a deal will get done before the government can no longer meet its obligations and (2) if a deal cannot get done, how the Treasury will prioritize its expenditures.

Despite the political theatre going on in Washington over the debt ceiling, the bond and credit markets are not pricing in an imminent disaster. The lack of any kinks or distortions in the U.S. yield curve or pricing in the forward markets indicates that market participants are not overly concerned about a deal being reached.

One-year credit default swaps (CDS) have risen sharply over the last three months, but they remain below five-year CDS. Given the lack of transparency and other technicalities regarding sovereign CDS, it is difficult to draw any hard inferences from pricing—especially about a developed nation like the United States.

If the U.S. government has not reached a deal by August 2, it will not be able to meet all of its obligations as they come due. It is difficult to assess the exact day-to-day cash flow of the U.S. government, but on August 15 the next round of interest payments are due. To meet its obligations as they come due, the government could revert to extreme measures such as selling its gold or other loan portfolios, but these outcomes seem unlikely. As current receipts are estimated to be around \$170 billion a month, the U.S. government would be able to continue making legally required payments. After these mandatory payments are made, the U.S. government would only be able to pay out what it takes in and the likelihood of extreme austerity measures and government shutdowns become real possibilities. In terms of payments the biggest priorities are interest on Treasury securities, Social Security benefits, and Medicare. Notable payments that may be in jeopardy include federal salaries and benefits, as well as food stamps.

Issuing debt to roll over principal of Treasury bills and bonds that are coming due does not count against the debt ceiling limit so the likely point of official default for the U.S. Treasury would come if the United States misses a coupon payment. For holders of Treasury securities, the implications in the event of a default are varied. Much depends on how the rating agencies

interpret and characterize the default event. The major rating agencies have been open about what they may do in the event of a default by the U.S. government, but the extent to which the United States may be downgraded if a deal is not reached remains unclear. What matters more is what effect any downgrade would have and whether or not that would create forced sellers in the markets. Money market funds, pension funds, banks, and insurance companies are all major holders of U.S. Treasury securities and each has its own set of conditions and rules regarding what it can and cannot own.

In the event of a downgrade, the greatest potential for market disruptions is in the overnight lending and repo markets. Treasuries are the most common form of collateral and any downgrade could have ripple effects and spread through markets in an unpredictable fashion. Beyond the implications for holders of U.S. Treasury securities lies the risk of guarantees the U.S. government has provided to other entities. Through the use of its AAA rating and long-standing credit history, the U.S. government explicitly or implicitly backs the securities of many governmental and quasi-government organizations including Fannie Mae, Freddie Mac, and Ginnie Mae. While these institutions are not dependent on the U.S. government for day-to-day cash flow support, their long run credibility and existence is explicitly tied to their back stop of the U.S. government.

Though the risk of an outright default by the U.S. government remains small, politicians seem willing to drag the drama of raising the debt ceiling out as long as possible. While this makes for great political theatre and intrigue, the fact remains that credit markets continue to function and to date are showing few signs of worries that the United States will be able to meet its obligations to creditors.

“Global Liquidity” by Hyun Song Shin of Princeton University, Remarks at the IMF Conference on Macro and Growth Policies in the Wake of the Crisis, March 7–8, 2011

The persistence of developed world short rates (most notably in the United States) at historically low levels is driving capital flows into emerging markets, as banks seek to capitalize on interest rate differentials. As a result, emerging economies are overheating amid excessively accommodating financial conditions. However, these flows are highly cyclical and could destabilize the financial systems of emerging countries should they reverse abruptly. To combat the impact of surging capital flows, macroprudential policy that leans against the increase of non-core banking sector liabilities can work as a stabilizer.

During the global financial crisis, developed world central banks cut short-term interest rates to historically low levels in an attempt to stave off further economic contraction. Since then, short rates are relatively unchanged, save a notable few exceptions (e.g., European Central Bank), as the global economy remains on fragile footing. The persistence of rates at these levels, however, has ignited a debate regarding capital flows into emerging markets. A carry trade, which seeks to capitalize on interest rate differentials between developed and emerging economies, is leading emerging economies to overheat amid excessively accommodating financial conditions.

The U.S. dollar is the cornerstone of this issue, as it underpins the global banking system (i.e., it is the funding choice for global banks). For example, the United States is home to roughly 160 branches of foreign banks whose main function is to raise wholesale dollar funding and then transfer it to their head offices. Collectively,

these banks have raised more than \$1 trillion of wholesale dollar funding, of which around \$600 billion has been channeled abroad to their respective headquarters.

It is worth comparing the greenback to the Japanese yen in this regard. Fuelled by the yen carry trade, yen funding grew rapidly in the mid-2000s, peaking at roughly ¥225 billion, before subsequently unwinding in the wake of the crisis. Indeed, yen funding is now at levels witnessed in the mid-1990s, at around ¥50 billion—down nearly 80% from its pre-crisis level. This may partly explain persistent yen strength over the last couple of years, as banks have repaid yen-denominated loans. Put differently, the demand for yen has increased, given banks must buy yen in order to repay these wholesale loans.

The comparison is even more striking on a net terms basis. Indeed, in net terms (e.g., yen shipped to bank headquarters less the amount obtained from the head office for allocation in Japan), foreign banks have maintained negative interoffice accounts in yen, save a brief period before the global financial crisis, for over 20 years. However, this is not the case for the dollar. Even in net terms, banks have been channeling hundreds of billions of funding to their respective headquarters since the end of the 1990s.

These large net positive interoffice accounts exemplify the potential for cross-border spillovers in monetary policy. Some of the borrowed dollars will ultimately be funneled back into the United States, but some of the funds will flow into Asia, Europe, and Latin America, as banks will seek to deploy the funds among their most profitable opportunities. At the margin, global banks become carriers of dollar liquidity across borders. As a result, easy monetary conditions in the United States will be transmitted globally (i.e., U.S. monetary policy becomes global monetary policy). On the flip side, however, this raises the

potential for a vicious dollar rally should global banks reverse these flows, as the demand for dollars would increase considerably.

Mechanically, one can trace the dollar's role as the funding currency of choice for global banks and subsequent capital flows. Although the internal global portfolio decisions of banks are not public knowledge, the trail of wholesale dollar borrowings can be followed by examining the banking sector capital flows in the balance of payments accounts for Asian, European, and Latin American countries. For instance, the recent issue of the IMF's Global Financial Stability Report disaggregates the capital inflows into 41 countries, which include many emerging economies. Of the flows, foreign direct investment is steady, while portfolio investment (i.e., both equity and bonds) is rather small in net terms. Banking sector flows, on the other hand, display a clear pro-cyclical pattern, surging during booms and changing abruptly with the deleveraging of the banking sector. The non-core liabilities of the Korean banking sector illustrate this tendency. For instance, non-core liabilities peaked immediately prior to the 1998 Asian crisis. After a lull, they picked up once again, increasing rapidly up to the 2008 crisis.

To combat the impact of surging capital flows and their potential to destabilize the financial system, macroprudential policy that leans against the increase of non-core banking sector liabilities perhaps has some merit. For instance, Korea has announced a levy on the foreign exchange-denominated liabilities of the banking sector, with a higher rate for short-term liabilities. This policy can be expected to work as a stabilizer given its base is larger during booms.

Although the levy will have some effect on exchange rates, holding down the exchange rate should not be the primary objective. Similarly, a debate that focuses exclusively on exchange rates and trade imbalances undervalues the financial

stability role of macroprudential policy. Indeed, policymakers should remember the main lesson from the global financial crisis—the leveraging and deleveraging cycle of the banking sector is the driver of financial instability, both for advanced and emerging economies. ■

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