ECONOMY DERIVATIVES

Has the derivatives volcano already begun to erupt?

The risk remains that dollar credit will seize up globally, with disastrous consequences for countries that have to borrov to cover deficits

By DAVID P. GOLDMAN | OCTOBER 9, 2018 4:33 PM (UTC+8)

Stacks of one hundred US dollar banknotes, which may become more expensive for some. Photo: AFP/illustration

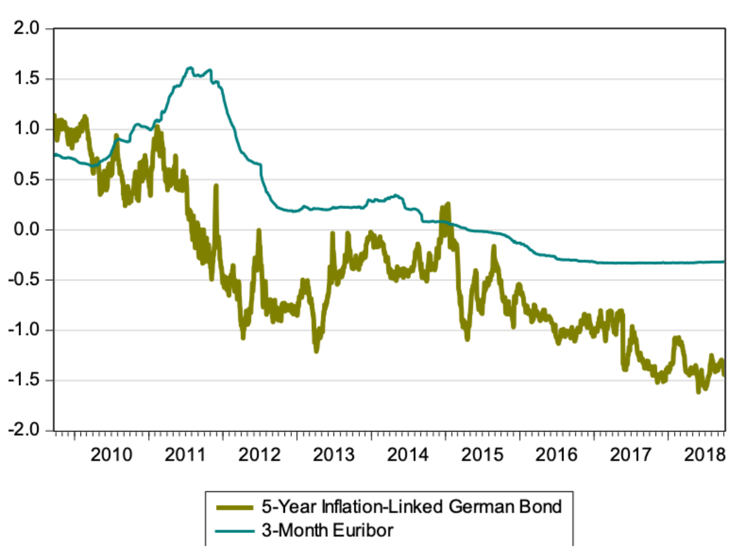
The cure for the last crisis always turns into the cause of the next one. The economies of southern Europe – Greece, Italy, Spain and Portugal – nearly collapsed in 2011, and Europe's monetary authorities responded with negative interest rates.

So did Japan. Europeans and Japanese pay to hold cash or own 10-year German government bonds, which means that every pension fund and insurer will fold in a finite time horizon. They responded by exporting more, saving more, and buying American assets that still pay a positive, if low, real yield.

Hedging the foreign exchange risk in this half-trillion-dollar per year business has exhausted the balance sheet of the global banking system. That explains a large part of the jump in the US 10-year note yield to 3.2% last Friday from 2.85% in early September. Hedging the foreign exchange risk in these massive flows created a derivatives mountain, and it has started to spew smoke and lava.

Banks are rationing foreign-exchange swap lines, making hedges so expensive that German and Japanese investors can no longer afford to buy US bonds. If the foreign bid for US debt dries up, the cost of financing America's $1 trillion annual budget deficit will rise, and so will interest costs around the world.

German Interest Rates Have Been Negative for Years



The mechanics of hedging trillions of dollars of capital flows are complex, but the economics are simple. Germany and Japan together export half a trillion dollars a year of goods and services more than they import. America imports more than half a trillion dollars of goods and services more than it exports.

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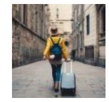

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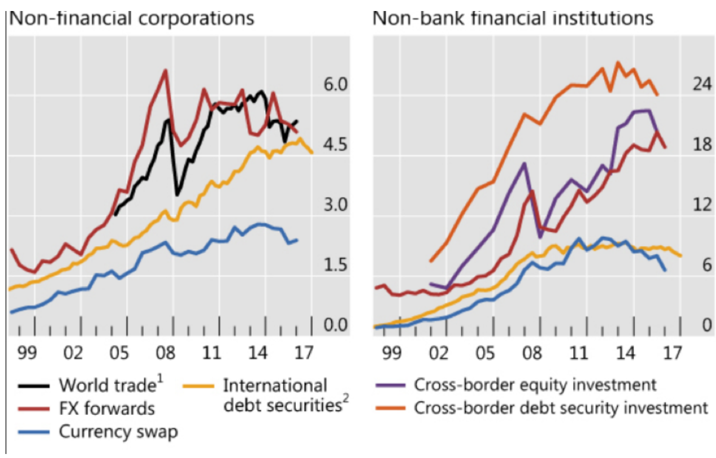
Germany and Japan have negative real interest rates, so their investors buy American bonds at positive real interest rates. But Germans and Japanese have to pay out Euros and yen, not dollars. They go to their banks to swap dollar income into local-currency income. The banks borrow dollars in the United States, sell them in the forward market and receive Euros and yen.

European banks are running out of borrowing capacity. After five years of negative short-term rates, their profitability is low, their stock prices are falling and their credit is deteriorating. They can no longer borrow the dollars required to construct the hedges that local investors need.

Foreign exchange derivatives form the biggest mountain of obligations in the world financial system – a notional amount of about $90 trillion, up from $60 trillion in 2010. Breaking down the numbers, Bank for International Settlements (BIS) economists showed that the foreign exchange derivatives taken on by non-financial corporations tracked the growth of world trade, and the derivative obligations of nonbank financial institutions – money managers and insurance companies – tracked international securities investments (see chart below).



The BIS economists led by Robert McCauley note that non-US banks now owe $10.7 trillion in US dollars, most of which reflects the hedging requirements of these global flows. The banks don't report foreign exchange swaps with their customers on their balance sheets, but the BIS estimates that these obligations amount to $13 or $14 trillion.

The US

For more than one year, international bank regulators and the International Monetary Fund have warned that the banking system no longer can support these enormous flows. The Federal Reserve is tightening liquidity in the US, and in a volatile market, European banks might not be able to roll over nearly $11 trillion of short-term obligations – and might default.

As the BIS warned in September 2017: The combination of balance sheet vulnerabilities and market tightening could trigger funding problems in the event of market strains. Market turbulence may make it more difficult for banks to manage currency gaps in volatile swap markets, possibly rendering some banks unable to roll over short-term

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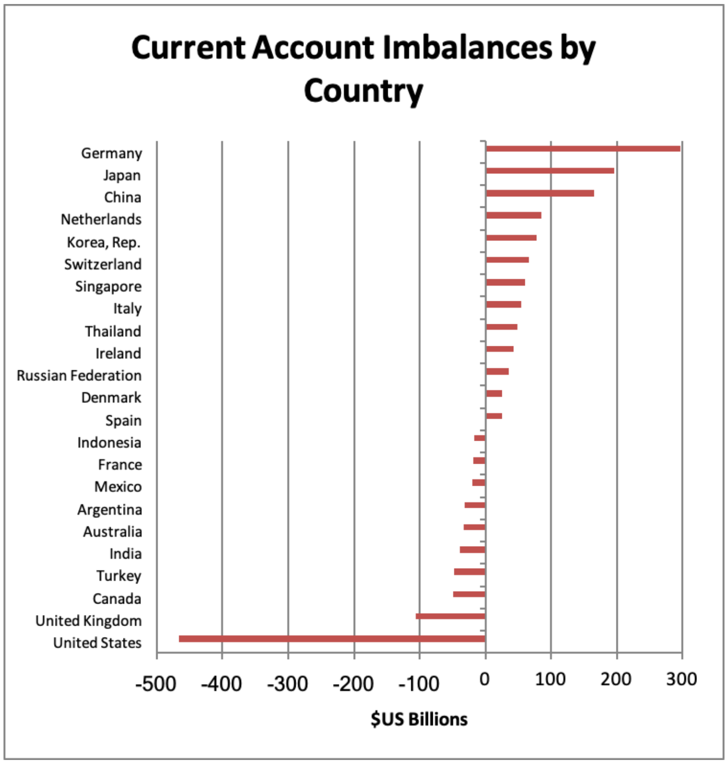
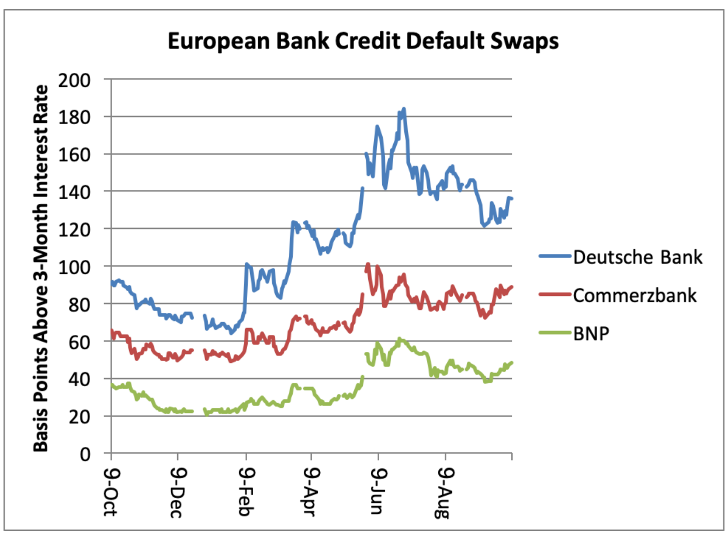


dollar funding. Banks could then act as an amplifier of market strains if funding pressures were to compel banks to sell assets in a turbulent market to pay their liabilities that are due. Funding pressure could also induce banks to shrink dollar lending to non-US borrowers, thus reducing credit availability. Ultimately, there is a risk that banks could default on their dollar obligations.



The market turbulence of which the BIS warned in its September 2017 quarterly report is now upon us: Italy's populist government threatens to increase the country's sovereign debt, already at an unsustainable 130% of GDP. Yields on Italy's debt have soared, and bank stocks have collapsed.

The creditworthiness of some of Europe's largest banks has deteriorated. In the case of Deutsche Bank, the cost of hedging against bond defaults over the next five years has doubled since the Italian crisis erupted in May.

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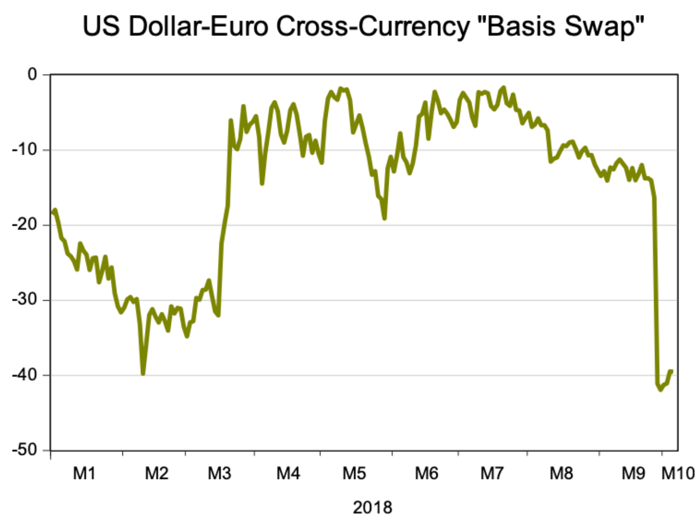
As the credit of European banks deteriorates, US regulators require American banks who lend to them to put up more reserves against their exposure. That raises the cost of refinancing the $12 trillion or so of European bank borrowings from American banks, and it probably has led to a reduction in credit lines. European banks, in return, have to charge exorbitant rates to customers for hedging.

The crunch hit at the end of the third quarter, when European banks' short-term credit line in US dollars had to be renewed. Data for the volume of interbank lending aren't available yet, but the cross-currency "basis swap" between Euros and US dollars – the spread that banks charge their customers for expanding their balance sheets to provide foreign exchange hedges – suddenly widened.



The 0.3%, or 30 basis points, shift in the so-called basis swap was big enough to wipe out any advantage that European investors might obtain from buying US dollar securities and swapping the cash flows back into euro.

Meanwhile, Deutsche Bank researchers noted in an October 3 report: "On 27 September, the cost of dollar-denominated forex-hedged investments from Japan jumped to 315bp, the highest level since the 2008 financial crisis ."

Effectively, that wiped out the incentive for Japanese investors to buy US bonds. Japanese 10-year notes yield about 0.14% and US Treasuries yield 3.23%, so the 3.15% cost of hedging wipes out the yield advantage for Japanese investors. The reason for the shift was a 0.46% jump in the yen-dollar basis swap in a single business day. Dollar loans are getting scarce for Japanese banks as well.

If overseas investors can't recycle the half-trillion-dollar US current account deficit into dollar-based securities because the banking system can't provide the foreign exchange hedges, US yields will rise, perhaps sharply. It will be harder for the US Treasury to borrow the $1 trillion it requires each year, and the cost of debt service will add to the US budget deficit – every 1% increase in borrowing costs adds $200 billion in debt service to the budget.

I doubt that European governments would allow their banks to default on dollar obligations; long before that could happen, European regulators would arrange shotgun mergers and emergency recapitalizations. But the risk remains that dollar credit will seize up globally, with disastrous consequences for countries that have to borrow dollars to cover deficits.

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MIDDLE EAST CHINA

China stakes out a role for itself in post-war Syria

As Syria's civil war winds down, China is looking to establish itself as an economic, and possibly military, partner for the period

By LOGAN PAULEY | OCTOBER 3, 2018 12:28 PM (UTC+8)

Syrian President Bashar al-Assad (L) accepting the credentials of Wang Qi Jian, the new ambassador of the People's Republic of China to Syria, in Damascus on Jur
Photo: AFP/HO/SANA

In recent weeks China has offered indications of a future role in Syria, comprising not only infrastructure investment and trade as the conflict appears to wind down, but also a novel desire to increase cooperation on the counter-terrorism front.

On Aug. 5, the Chinese Embassy in Damascus released a letter written by Ambassador Qi Qianjin, which pointed to Beijing's enduring rhetoric of using infrastructure investment and reconstruction deals to rejuvenate Syria and the region.

Ambassador Qi described Beijing's aims to develop railways and seaports to create greater economic interconnectivity. Increasing

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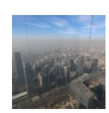

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cooperation with Syria helps China's Belt & Road Initiative (BRI) ambitions in the region and its promises of financial injections into the Middle East.

At a China-Arab States Cooperation Forum in July, Beijing pledged US$20 billion in loans for infrastructure development, accompanied by a nearly US$100 million package dedicated to humanitarian assistance for Syria and Yemen.

As the 60th Damascus International Trade Fair recently concluded, China pushed narratives that it is committed to building steel plants and power plants in Syria, producing Chinese-brand cars in Homs, adding that Chinese tourists are already returning to Damascus.

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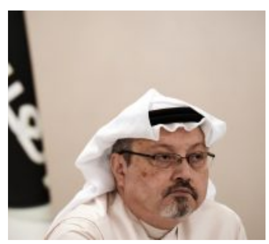

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MIDDLE EAST OMAN

Oman plans pipeline to Iran as US sanctions loom

Muscat is moving ahead with a planned natural gas pipeline to Iran, hopeful that US sanctions to be imposed Novembe strictly target oil

By JONATHAN GORVETT | MUSCAT, OCTOBER 2, 2018 7:40 PM (UTC+8)

An Omani man rests on a dhow cruising off the coast of Oman along the Strait of Hormuz bordering Iran. Photo: AFP/Marwan Naamani

While recent winters have sometimes seen a sprinkling of snow on the jagged peaks of Oman's mountains, this is not the main reason the Gulf sultanate is widely known as the "Switzerland of Arabia."

That title comes more from its decades-old policy of neutrality and mediation, with Oman often providing a channel of communications between warring parties, while staying well out of the disputes raging around it.

Now though, with the United States ramping up pressure on Iran with backing from fellow Gulf states Saudi Arabia and the UAE, there is

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growing uncertainty in the sultanate as to how much longer that neutrality can last.

Few issues illustrate this dilemma more than a planned pipeline to Iran.

In the pipeline

The Iran-Oman gas pipeline, a major energy and engineering project, was agreed to last year after more than a decade of talks. A joint committee was formed to finalize the deal in July.

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