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OPINION

The Fed Squeezes the Shadow-Banking System

The central bank's purchases of Treasurys are leading to collateral shortages in the vital, $4-trillion repo market.

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Here is the great economic paradox of our time: Despite the Federal Reserve's vast, 4½-year program of quantitative easing, the economy is still weak, with unemployment still high and labor-force participation down. And with all the money pumped into the economy, why is there no runaway inflation?

Federal Reserve Chairman Ben Bernanke told Congress on Wednesday, that "We are pushing real hard at this point but there are a lot of headwinds." But the usual excuses—commercial banks not lending, not enough government spending, weak retail sales, Europe in disarray—are straw men. The Fed has even discussed an exit strategy from its asset purchases, but without ever explaining why its buying spree led to so little economic growth.

The explanation lies in the distortion that Federal Reserve policy has inflicted on something most Americans have never heard of: "repos," or repurchase agreements, which are part of the equally mysterious but vital "shadow banking system."

The way money and credit are created in the economy has changed over the past 30 years. Throw away your textbook. The usual story is that the Federal Reserve creates a monetary base (a substitute for gold), which acts as commercial banks' reserves. As the Federal Reserve Bank of New York once explained, "If the reserve requirement is 10%, for example, a bank that receives a $100 deposit may lend out $90 of that deposit. If the borrower then writes a check to someone who deposits the $90, the bank receiving that deposit can lend out $81. As the process continues, the banking system can expand the initial deposit of $100 into a maximum of $1,000 of money ($100 + $90 + 81 + $72.90 + . . . = $1,000)."

The monetary base has skyrocketed to almost $3 trillion today from $800 billion in 2007. The Fed is sitting on $1.8 trillion in Treasury bonds and $1.1 trillion in mortgage-backed securities. Yet bank lending has barely budged. What gives?

The traditional account of credit creation leaves out a new and vital source of funds that has nothing to do with lending by commercial banks. Much as in the 1980s when junk bonds, not traditional banks, funded long-distance provider MCI, Craig McCaw's cellphone service build-out and Ted Turner's

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broadcasting empire, today's important lending is happening in what Paul McCulley of the investment-management firm Pimco termed the shadow banking system.

Money-market funds, now $4 trillion in size, are part of this system—able to extend credit, even though they aren't traditional banks. Several more trillions consist of the lamented mortgage-backed securities. But there is also a dynamic, $4 trillion market for repos that Wall Street, hedge funds and others use to fund their investments.

Repos are pretty simple. A "borrower" puts up securities as collateral and receives cash from a "lender" in exchange for an agreement to repurchase the security at a later date, maybe a day or a week (even years), of course at a slightly higher price. Usually the securities are U.S. Treasurys or something liquid that can be easily disposed of in a default. Repos were often the backwater of Wall Street, where people the firm had to hire—sons or nieces of managing directors—were placed to do the least harm, until 2008 anyway.

But here's where it gets interesting. Since the repo lender owns a highly liquid security, the lender can do another repo with it, raising more cash to play with. This is known as rehypothecation, a fancy term for what basically creates a money multiplier similar to fractional reserve banking. Today, this means credit creation of 2½ or three times for every piece of highly liquid security used in repos (down from four times in 2007).

Just as the monetary base is commercial banking's gold, Treasury bonds are shadow banking's gold. Credit created by repos funds financial instruments (such as credit-card debt and mortgages) but also inventories, drilling projects, even fiber-optic buildouts. Hedge funds use repos for over half their funding and live for these riskier projects.

So what's the problem? Well, it turns out, there's a huge collateral shortage. Global bank-reserve requirements have changed, meaning more safe, highly liquid securities like Treasurys are demanded instead of, say, Greek or Cypriot debt.

And lately, Treasurys have been getting harder to find. Why? Because of the very quantitative easing that was supposedly stimulating the economy. The $1.8 trillion of Treasury bonds sitting out of reach on the books of the Fed is starving the repo market of safe collateral. With rehypothecation multipliers, this means that the economy may be shy some $5 trillion in credit. A classic unintended consequence. Ben Bernanke's Federal Reserve is to blame—enabling the U.S. government to run huge fiscal deficits is bad enough, but messing with the lifeblood of the American economy is even worse.

While commercial bank and savings and loans assets are back up to $14 trillion, the shadow-banking system may have been halved since its size was estimated by the Deloitte Center for Financial Services to be $20 trillion in 2007 (some of the shrinkage is thanks to the popped bubble of mortgage-backed securities). No one knows its size for sure. But there are plenty of signs of trouble, especially in the repo market.

In March, the demand for 10-year Treasurys—for use as repo collateral or for rehypothecations—surged. The result was a spike of $79 billion, six times the average, in what are called "fails to

deliver"—bonds that were promised but couldn't be found. Collateral shortages in the repo market continued in May.

In other words, the Federal Reserve's policy—to stimulate lending and the economy by buying Treasurys, and to keep stimulating until inflation reaches 2% or unemployment is lower than 6.5%—is creating a shortage of safe collateral, the very thing needed to create credit in the shadow banking system for the private economy. The quantitative easing policy appears self-defeating, perversely keeping economic growth slower and jobs scarcer.

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