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The Political Economy of LTRO

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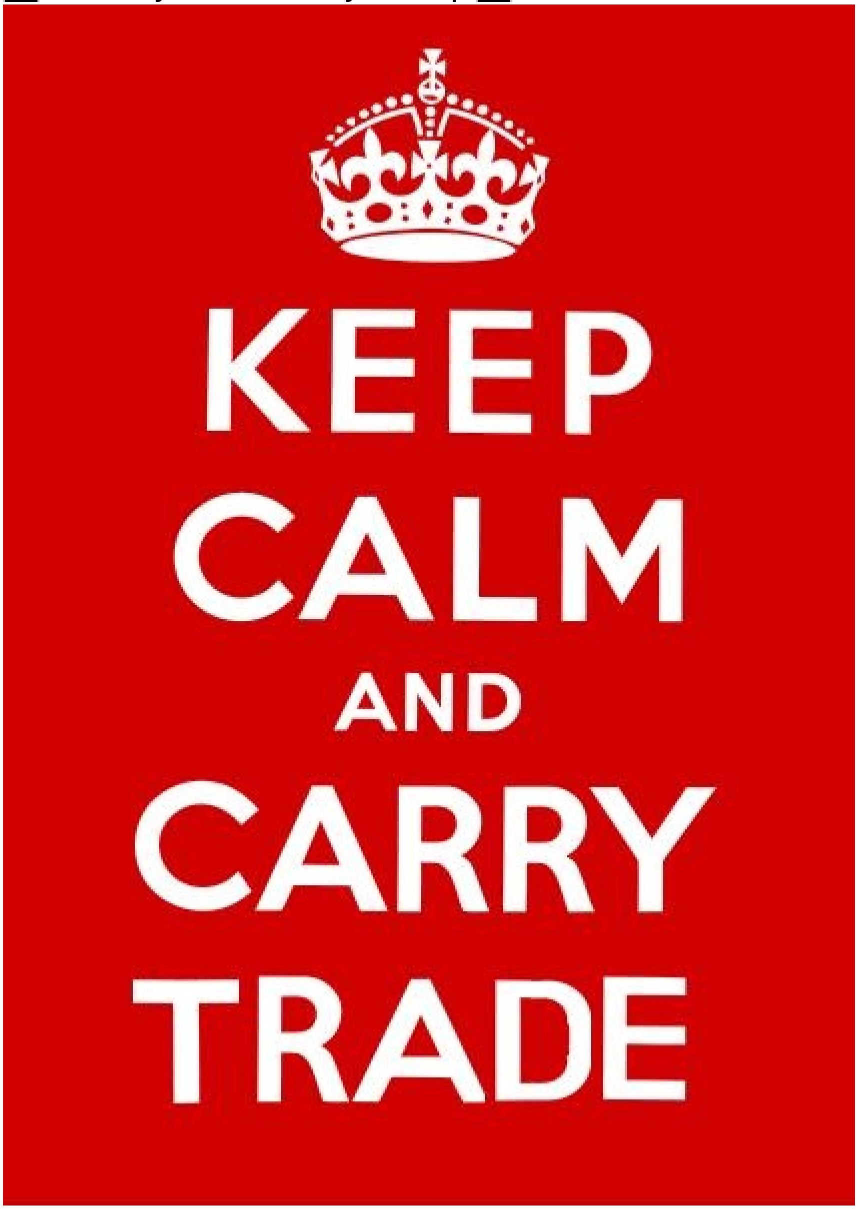

An asymptotix approximation by J A Morrison / " This is not a liquidity trap; in the political context it?s a confidence vacuum! "

INTRODUCTION

It's LTRO[1] [1] that I?m talking about this time! LTRO the latest version of ?economic life support those? crackpot surgeons in the Central Banks and Treasuries of Europe have come up with. What is the issue with it? As LTRO2 approaches, to on the leap day (29/2/2012) I present a number of theses about LTRO;

1. **LTRO is a workaround for Crowding Out**

2. **LTRO is executed via a process called 'Round Tripping' or known as a ?Carry Trade?**

3. **Hedge Funds are intrinsic to the success of LTRO**

4. **This makes governments dependent upon Hedge Funds (& not just the banks)**

5. **LTRO creates a cash balloon which props up the equity market**

6. **LTRO is a high-risk central bank strategy which could deflate at a stroke**

7. **Ironically the very Hedge Funds and Asset Managers who are intrinsic to the success of LTRO are already freaked out by the high risk nature of the policy,**

This is not a liquidity trap; in the political context it?s a confidence vacuum!

Here on asymptotix a couple of years ago I wrote two pieces (which you can still find here); one called ?Crowding Out?[2] [2] & one called ?Round Tripping?[3] [3] (RT). These are both important monetary phenomena and they do exist. Both are well understood and have seen published research in Monetary Economics. Monetary Economists and Central Bankers have understood them for many decades. So have Prop-Desk traders and Hedge Fund Managers.

Round Tripping has been (until now) dismissed as recalcitrant opportunist behaviour of capital market traders. An inevitable and bearable tax upon government monetary policy which most of the populace don?t really understand and care less about.

The battle ground recently and now the pivot point in debates of Political Economy in regard to government capability of (in particular Monetary) Economic stimulus (again up until right now) was the crucial phenomenon called Crowding Out. The debate centers upon its existence.

CROWDING OUT

The fact that Crowding Out did not exist was a key foundation principal of Social Democratic Applied (or Policy Formulating) Macro-Economics. It is they key aspect of the Monetary Economics of the Left that a phenomenon identified by Monetarists (Crowding Out) did not exist.

The logic runs that if Crowding Out does exist then Government stimulus through capital markets eventually reaches a wall (is effectively ?Crowded Out?) i.e. the hosepipe of government cash eventually becomes ineffectual because it reaches a point of over-supply since such a large supply of cash (or inversely demand for capital market paper) eventually crashes yields to zero by swamping out all other (private sector) capital market activity and thus makes all forms of investing impossible.

On the other hand the quasi socialist Left wing thesis is that Crowding Out does not exist. Believing that Crowding Out does not exist entails that the government can go on an on stimulating the economy open-ended-ly and it can do that with multiplied effects (i.e. it just gets better and better the more you do it!) The absence of Crowding Out means there is no limit to the potential for Government stimulus to an Economy in a recession, a government in a democratic state can do what it likes. No Crowding Out entails a quasi-socialist nirvana of a government able to drive the economy forward forever. Orwellian utopian bliss is just over that next government stimulated bubble. If you do believe in Crowding Out then you are a Monetarist if you don?t you are a Keynesian.

As Monetary Economists we have observed Crowding Out in sub-markets around the world. But whether or not it exists in the global capital market system of today has not been finally empirically proven as yet. Not until today, is my view. As I said discussing Crowding Out all of more than two years ago;-

> ?A statistical model can predict precisely where current evidence points you; two or three years out but it cannot tell you where you are today, you have to use your own assimilation of absolutely current evidence to do that.?

Does anyone understand the transmission mechanism[4] [4] through M4 from Monetary Stimulus like LTRO to the equity market; are there any papers modelling that? Not yet really. We have never experienced in Western Capital Markets, so far as I am aware, such plain evidence for the "Crowding Out" proposition; 'Crowding Out' is in fact the driving phenomenon of not only capital markets but also politics and society in Europe right now. Even the British Labour Party have given up on their null-hypothesis on Crowding Out and all those fine or coarse tuning golden rules they dreamed up from holding it true.

Forget UK Gilts for the moment; you can?t get any of them even if you wanted, even if you wanted to actually pay for the privilege of holding them instead of taking a yield, not a great deal different from having a Swiss bank account today but both manifestations of the same 'safe haven' incentive in a Crowded Out context. Talk about ?perverse effects?? We now have a fully crowded out UK Gilt market but there is still demand at infinitesimal yields with massive elasticity downwards.

Recent data & empirical study[5] [5] demolishes the Keynesians. This quotation of Bank of America research in the context of years of various forms of Monetary Stimulus (QE) sums it up;

> The latest credit numbers from the Eurozone, corroborate [Crowding Out]. December [2011] saw the largest contraction in the provision of credit to non-financial corporates in the history of the time series. Lending to households also contracted. On a 3M MA basis, the flow of credit relative to GDP is now contracting considerably faster than in the midst of the post-Lehman phase[6] [6]

Look at the Bank of England Trends in Lending - January 2012 - Lending to businesses contracting[7] [7] or the Capital Issuance statistics - December 2011 - Down ~£4bn in November[8] [8] thus the UK economy probably shrank in the final quarter of 2011[9] [9]. But what did the FTSE do? I could cut and paste a fancy graph for you but chances are if you are reading this, (this far!) then you probably already well know and are as bamboozled as me. Some now argue that the ECB is actually telling us that we have regime-shift in the Transmission Mechanism; we have now a new Transmission Mechanism to which all the research of the recent past does not apply. There are no new studies of this new Transmission Mechanism, not yet but there will be soon.

European banks are also hoarding cash and halting new loans[10] [10] (to normal people) Moreover, S&P indicates that without the recent ECB LTRO actions even stronger downgrades (of European banks) would have been pursued but capital markets both bond and equity markets continue to go in a positive non recessionary direction.

On 19 Jan 2012, Robert Peston, the BBC's esteemed Business Editor, tweeted that the FTSE100 closes at 5741, back where it was before early August 2011 despite the obvious worsening of European crisis. Peston reported a ?Huge? bounce in European bank shares today; further Peston went to report in an open conversation with a Stockbroker pal that the 19 th January 2012 was the best day for UK banking stocks since October last year with the FTSE 350 banking sector +5.5% on the day. Later BBC News reported more formally big rises in bank shares push the 100 share index to its highest close for almost six months[11] [11]. Perverse Effects or what, whilst the real world collapses around our ankles, the banking sector is whooshing up, how can this be? Its simple, the authorities pump money in, capital markets go in one direction but the real economy goes in the opposite one; we are Crowded Out.

THE MONETARY STIMULATION PROCESS

QE, SMP, LTRO; it all amounts to the same thing; monetization, handing the banking system piles of paper cash, immediate, 3 month, 3 years; its all effectively liquid, if you have acronym fatigue then my mind is crowded out and round tripping ? as I have said before;

> ?One has to take some regard of the challenges of "Kapital"; its function in society, its inherent drivers, the subtle differences in how it morphs along the liquidity spectrum and the complex interlinked signals which it sends through that wireless network. ?

These Central Bank authoritarian acronyms are intended to bamboozle you. The Hedge Funds (& the Banks) scream for cash from the State to be given to the banks whose balance sheets would simply implode if the state didn?t provide that cash and ?not to mention? all those lovely bonuses, passed over or not, what would happen to them? Why are the Hedgies screaming for cash to be given to the banks? Because the banks simply transparently (sic) as a ?pass-through? lend it to them through a functional unit called ?Prime Brokerage?; which might as well be a department of the Hedge Fund rather than the bank. What do the Hedgies then do? They pump the cash via derivative contracts into the equity and other securities markets! This is my new thesis: LTRO (all forms of Monetary Stimulus) are just propping up the equity market & all securities markets not necessarily directly via Banks prop-desk trading but more crucially via Prime-Brokerage lending to Hedge Funds that's the [new] transmission mechanism. But if the new Transmission Mechanism is effectively LTRO predicated so when

LTRO (or QE, in the UK) stops, what happens?

ROUND TRIPPING 2

Back in 2009, Poynton York, the noted Hedge Fund commentator had this to say about Round Tripping triggered by the initial UK QE;

There was no shortage of liquidity in the banking system, but there was an intense shortage in small and medium sized companies. The commercial banks had failed the innovative part of the corporate sector then, and were continuing to do so now. Why? Because they could make much more money, much more safely, by lending to H. M. Treasury and the Local Authorities. Banks were able to secure funds from one part of the public sector at negligible rates and pass them on to other parts of it at higher rates! It was round tripping on an heroic scale. It was extraordinarily costly to the taxpayer; and produced no benefit to the economy[12] [12]. This logic rather reinforces my exposition of around that time.

More recently, Shaun Richards in his Mindful Money blog, has this to say about Round Tripping again raising its ugly head;

> Now if you can get cash from the ECB at 1.25% now and possibly less next week some government bond yields are looking very attractive. For example on Tuesday night the two-year Spanish government bond yield closed at 5.6%. So you buy an asset which pays you 5.6% and you pay 1.25% for the money making you 4.35%! I am exaggerating the gain slightly as there will be some margin or haircut for doing this from the ECB but even so there are clear gains[13] [13]

The consequence for the banking system Sean argues further is that if this works they declare a profit and then tell us how clever they are and pay themselves bonuses. On the other side of the coin their bank may well have failed or been in trouble so where is the loss for them? At the limit they may have little or no downside in a ?too big to fail? world.

My model is slightly more complex; that is the cheap money pump primes the Prime Brokerage function which on lends short term to the Hedge funds who then effectively engage in Round Tripping at Arms Length, it is a win / win for the capital market system it inflates the equity markets and supports yields in risky government securities. In summary this monetary inflation has all sorts of perverse effects in all sorts of (actually) indeterminate securities markets.

Sean and me are violently agreeing however and his more simplified exposition of 'Round Tripping' is an easier more tractable depiction than my first over-complex depiction which is an attempt to capture the complexity of Round Tripping in the London markets.

In effect Round Tripping is a Carry Trade[14] [14] but much easier since the former is not a currency exchange arbitrage but a bond yield arbitrage[15] [15] or a bond/equity arbitrage. What makes Round Tripping so aberrant though is that it is the traction point, the engagement process if you will by which the state authorities attempt to effect an impact upon the yield spectrum which is their actual policy target. The state is bribing investment banking and securities trading operations with close to free money to go and make huge profits by altering yields as a consequence of their bid activity. If this was not a state triggered process it would be tantamount to criminal, something close to market rigging, would it not? But it all happens under the capital market hood. The other key factor which makes Round Tripping aberrant is that it is indeterminate; once the bank takes that cash from the central bank, the authorities have neither clue nor control over what the bank does with it![16] [16]

Let's be clear this kind of arbitrage is going on all the time in response to QE in the UK, SMP in the EU and now LTRO in the EU. It is continuous; it just becomes more apparent and more important to commentators in direct proportion to the size of a given Central Bank hosepipe! But be clear Round Tripping on the ?Q-T? or 'on the nod' from the Central Authorities is the key process or technique through which investment banking and securities trading houses continues to generate (in some selected instances) super-normal profits whilst the rest of us can't pay our fuel bills! This is the Political Economy of the thing, the other side of that coin being exemplified most clearly in the little Prince of France, on the one hand disparaging and disdaining anglo saxon style Hedge Fund behaviour whilst at the same time knowing clearly that he is intertwined up to his neck in a partnership with them, since without them the CAC40 would collapse and his election hopes would shrivel away. So in so far as frau Merkel, impoverishing the Greek nation with an iron glove on the one hand is supporting Sarkozy on the other, she is up to her neck in this hypocrisy also, in fact they are all at it, all over Europe, total hypocrisy but worse, clue-less-ly indeterminate and hyper-risk to boot (of which more below).

CROWDING OUT3 & ROUND TRIPPING2

If we agree Crowding Out is a manifest fact when the Government attempts to refinance itself thus supply side or real economy policies must be predicated on austerity then we are effectively implying that the only tool to stimulate the economy or keep it on life support remaining to any form of central authority is essentially monetary. What I am arguing then is that the monetary tool which the authorities use (QE, SMP or LTRO; call it what you like explicitly) relies implicitly upon a market aberration, a total perversity of market economics. The authorities have no choice but to get in cahoots with the bogey men and pump the hedge funds full of cash to prop up securities markets.

Crowding Out and Round Tripping were seen as two independent phenomena both a consequence of Government (Keynesian style) stimulus but thoroughly independent. Economics is a social science, sure, but it is empirical, it learns as it goes, and one thing that is becoming clearer and clearer into 2012 from this LTRO variant of government life-support is that Crowding Out and Round Tripping are intrinsically intertwined. In fact it could be argued today that Central Bank and Treasury Monetary Policy officials have in fact accepted the existence of Crowding Out and are using Round Tripping as the only possible ?work around? in its massive obstinate face!

THE HEDGE FUNDS (& ASSET MANAGERS)

Two or so weeks ago, ?Business Insider? reported from Davos:

> "Things are screwed up. Here's how we want you to fix them?[17] [17]

The Hedge Fund managers and proprietors loudly demanded more air in their balloon, i.e. government printed cash. It doesn?t really matter if it?s a Central Bank printing press or one in the basement of a Treasury, as in Budapest, only Barroso and Van Rompuy worry about that piece of fine detail. Call it what you like and there are several variants of acronym denoting effectively the same thing;

> State cash pumped through the capital markets!

But already this pivotal link in the LTRO supply chain is beginning to get a wee bit freaked out and if they freak out then it all falls apart. Let me for the sake of modelling simplicity conflate the Hedge Funds and the Asset Managers since public advice from the 'sell side' to the general 'buy side' is aimed at them both.

Already their clients are rushing for the exit[18] [18] because they don't understand the market context, nothing makes any sense anymore! There isn't much the central authorities can do about that, that is why I argue that we are not in the grip of a Keynesian Liquidity Trap[19] [19]; in the political context we are in a confidence vacuum! If the asset managers are having to manage huge outflows despite their ability to leverage up cheaply, this constrains the asset management sector from fulfilling the function in the new transmission mechanism which the authorities require of them. Recently Man Group (the huge UK Hedge Fund Manager) could only blame market turmoil for serious outflows[20] [20]. Alan Howard of Hedge Fund Managers Brevan Howard[21] [21] said :

> "we continue to believe that markets remain at risk of substantial dislocation"[22] [22]

He is not alone, it?s an obvious question, Euro 500BN or so was handed out at Christmas and yet on the leap day the system needs another Euro 500BN, its just common sense to posit the question: how long can the ECB continue to provide a lifeline for Europe?s Financial System?[23] [23]. Of course the consequent is, what will happen if it stops? That is what the Asset Management industry is worried about. Citibank's equity research team likened LTRO to Science Fiction as summarised by FT-Alphaville[24] [24]. FT-Money Supply summarises the Counterfactual (presented in a Bank of England working paper) of what would or might have happened without QE in the UK, which thus argues that QE or strategies like LTRO do increase GNP growth rates at a level higher than would have been the case without the monetary stimulus. But the sell side remains sceptical and it advises the buy side, the buy side itself seems to be extremely wary in its advice to its clients. Deutsche Bank in a research note points out that some euro 120BN could have been used for what DB calls 'carry trade purposes ? contributing substantially to profitability'[25] [25]. John Mawby at European Credit Management summarises the buy-side concerns succinctly;-

> ? The ECB have undoubtedly bought a little more time by introducing the LTRO, but its impact will be limited in the face of further procrastination on the part of politicians, and a potential for Greek tail risks to once again come to the foreground. ?[26] [26]

LTRO: MASSIVE MONETARY STIMULUS

The degree to which central banks around the world are printing money is unprecedented. Effectively we are living in a Quantitatively Eased world[27] [27] If you want to understand the extent to which Central Banks are bending the transmission mechanism follow @ [28]zerohedge [28] over recent weeks this blogger[28] [29] extraordinary has been nothing less than first class in his coverage of this process. The big deal this month is the ECB?s 36-month LTRO with allotment on 29 February. (Argued by Danske Bank Research[29] [30]). The FT goes on to say;-

> We expect the Governing Council to wait for the outcome of this operation before they decide whether more measures are needed. The effect of the long-term refinancing operation, approved by the ECB?s 23-strong governing council on December 8, was dramatic. Just before Christmas, 523 banks borrowed a total of €489bn ? equivalent to about 5 per cent of Eurozone gross domestic product[30] [31]

This looks terribly important no? What is going on? Essentially LTRO is the provision of funding to banks in Europe by European Central banks, managed authorised and allotted by the the European Central Bank. LTRO accepts all sorts of collateral in quality layers (or lack thereof) for huge amounts of cash (3 year money) effectively. The measures could increase significantly the number of banks tapping a second offer of three year loans this month (February), and theoretically allow them to borrow an extra €200bn. In December, more than 500 banks borrowed a total of €489bn (just to repeat that mind-numbing number). There is some debate as to what might actually get 'taken up' (read: 'hose-piped in') on the leap day (29th February 2012); some latest LTRO2 estimates; BNP Paribas says demand will be "firm" at €350-450BN since new (looser) collateral rules could support demand whereas Goldman Sachs predicts: Investors expect take-up of €680BN in 2nd **LTRO**; banks that responded to poll expect €562BN thus total ECB injection of €1.1-1.2 TRILLION!!! Whoooah! You have to say this is all getting very weird, happening very quietly, the ECB is hanging right out there!

EVENT RISK: WHAT COULD BUST THE LTRO BUBBLE?

So what and when is the extreme event which bursts the LTRO bubble or halts the crank-handle (they amount to the same thing). Is there a real event or announcement of a data set which makes the men on the bridge of this titanic mission think again and instruct the engine room 'finished with engines'? QE, SMP and LTRO entail through Round Tripping that Stock Market Indexes are no real guide to much anymore and corporate figures, so often touted as leading indicators of green shoots are useless too since the corporate sector is awash with cash and barely transacting with the banking sector. All mixed literary analogies apart if you are building a factor model for a portfolio stress test today, the standard blueprints presented here on asymptotix or in my Analytic Bridge blog are obfuscated by these Monetary Expansions, they just don't apply in a world of a New Transmission Mechanism.

Really one would be more astute in looking for factor variables quantifiable from the Monetary Spectrum under this new regime to more realistically drive a Credit Default Stress Test to estimate Risk Capital today (or its inverse, Stock Market returns). Think about M3 growth or delta M4 out of delta M3 factored into a yield curve with unemployment; something of that shape would reflect best current conditions, would it not? Effectively what I am saying is a stronger version of what I have said before;

> ?We are where we are, capital has transitioned to the state?

The new normal, the new transmission mechanism is about the state pump priming Capital back to the private sector via the securities markets complex, it?s a very strange zeitgeist ?ever been tried before?. But those factors indicated above are the quantifiable variables, the knowable unknowns; sure in this configuration you are bound to expect extreme value out-turns but what of the real extreme outliers out there, where are they? Where is the iceberg those guys on the distributed virtualised bridge between Frankfurt and Brussels could not see even if it was right up close in front of them? That type of event is more than likely 'political' in nature; created by groups of humans taking action and thus to the extent it is political, it is more than likely anarchic is it not? How do you factor for that?

EXPECT THE UNEXPECTED

We have already seen that overspill of earlier US QE-type experiments, massively inflated global dollar money supply, in a huge dollar overspill, having the unexpected (?) consequence of commodity price inflation through the Eurasian derivatives markets causing food prices to spiral and thus triggering the ?Arab Spring?! OK there is no definitive academic work on that supply chain yet, the IMF has not spoken precisely yet but the World Bank has given some pointers.

This LTRO howitzer is massive, its really weird and its regime shifting of the modern transmission mechanism, why would you not expect to see some wild and wonderful consequences and in pretty short order in the tail of your distribution, surely that would in reality be only simply Rationally Expectational?

THE POLITICAL ECONOMY

How can these officials of central authorities (for in the main they are not elected politicians) agree to a Programme like LTRO which reflects as much desperation as the manner in which Germany is bullying Greece right now, in my view, without expecting as much of an explosive set of consequences as a result? Only in the LTRO case the consequences will manifest with a lag, as Rational Expectations would tell us they would. Who are they trying to kid? You can?t take a hosepipe of that size full of money to the European economy, particularly funnelling it through a totally dysfunctional banking system and expect everything to go ?swimmingly?!

Look around you, there is an American battle group in the Straits of Hormuz, there is a subsystem of the world market for oil which is trading in gold. The real agenda from Europe right now, in terms of Greece is to impoverish its people to the extent that they change their political system because it?s not quite democratic enough and this is to a member of the EU whose banking system can actually be impacted by LTRO? Is that not bonkers enough?

Following twitter this afternoon they are on the streets in every major city in Spain, people are dying of cold and hunger in Athens, electricity prices are going ballistic (and that's only the lower bound of the gyratory amplitude if you ask me). If you are to add to your Stress Test factor model a factor constructed of a vector quantifying, let's call it ?Political Overspill Risk?; then Greece is in there, Iran, Ukraine, Spain, Portugal ?. what is it all about? Hang on in a white knuckle ride until the football championships in the summer? Mr Draghi? Is that what it is?

AND FINALLY

LTRO and all QE variants are like vitamins they pump up a bubble and then flush out the other side but they so confuse the risk appraisal heuristic with political uncertainty and underlying regime shifts that they trap the real capital markets and private sector into a vacuum of political uncertainty. The investment and risk appraisal heuristics just cease to function, analogously to a compass whirring around as it approaches a magnetic north, its lost its grounding. That is what is happening today. We have total economic irrationality; the psychological factor model in the rational economic agent doesn't have empirical data for the weird and wonderful factors which this state domination obliges it to consider. And the hubris of the unelected official is to march on as if everything is ?just fine?.

Finally there is one minor side effect of all of this which really gets my personal goat, there is a cadre of failures in middle management in European banking today who were the cowards scraping the smaller, below the headline, bonuses when everything did go wrong they still claw their smaller bonuses. By pumping their banks full of falsely created steroid profits, Mr Official; you are maintaining these dysfunctional cowards in position and you are holding Europe to ransom!

I may not believe in Keynesian multipliers anymore but there has to be a better way of going about this.

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Tags: Bank of England [93], Crowding out [94], ECB [95], John Angus Morrison [96], LTRO [97], political economy [98], QE [99], Rational Expectations [100], round tripping [101], stress test [102], Transmission Mechanism [39]

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