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What does Wall Street's repo crisis mean?

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A bank run in 1932.

In the week of Sept. 16, the U.S. financial system ran out of cash. It was a modern version of a bank run, and it's not over yet.

That week, the rate of interest on bank to bank overnight loans — known as repurchase agreements, or repos — suddenly spiked as high as 10 percent.

The Federal Reserve Bank of New York responded with $75 billion in purchases of short-term U.S. government securities, essentially cheap loans to the U.S. commercial banking system.

This is the biggest such operation by the Federal Reserve since the panic days of 2008.

The Fed opened a money spigot, making the overnight loans daily, increasing the amount to $120 billion by Oct. 23, and quietly stating that this operation will continue through at least January 2020.

So what happened? No Wall Street banking crisis has been declared. There have been no hearings held by Congress. Not one elected official in the U.S. has authorized these loans, though they are backed by the U.S. Treasury.

Does this mean that a new 2008-type financial crisis and associated "Great Recession" — or worse — is imminent for the U.S. economy?

Banks are corporations

Banks are corporations with one goal: giving shareholders a profit. The primary asset of a bank, it's profit-maker, is loans, mainly to industrial and commercial capitalists, as well as consumer credit cards and the purchase of durable consumer goods such as houses, cars and appliances.

When there is a downturn in the capitalist industrial cycle, creditors start to fall behind on their repayment of loans.

Rather than reporting “nonperforming loans,” banks will often extend new loans or simply lengthen the terms of an existing loan. The banks hope that the nonperforming loans will become performing loans once again as business picks up.

However, if loan repayments continue to be nonperforming or a more severe economic downturn makes more of the banks’ loans nonperforming, a point is reached where the banks’ loan crisis cannot be concealed.

A bank run happens when depositors have lost confidence in the bank and demand payment in cash.

During a general bank run, the banks scramble for cash. To conserve cash, the commercial banks halt new loans and existing loans are called in. The owners of commodity capital—industrial and commercial capitalists—also are forced to scramble for cash as their debts are called in by the banks and other creditors.

Forced to raise cash quickly, they dump their unsold commodities at great losses, causing prices to fall sharply. Production, trade and, most significantly, employment contract sharply.

To avert this, commercial banks are required to pay into an insurance fund. In the event of a bank failure, the fund is used to promptly repay the depositors. In 1934, the Federal Deposit Insurance Corporation (FDIC) was established, backed by the full credit of the U.S. government.

Even if the Federal Deposit Insurance Fund were exhausted, the U.S. government is charged with coming up with the money to pay off the depositors of failed banks, at least up to the insured limit.

Student loans

Now, no banking loan crisis has been declared and no one is saying why the Fed is feeding more than $120 billion a day into Wall Street, but there are known financial crises looming.

Student loan debt burdens 44 million people in the U.S. The total national student debt is now over $1.5 trillion. Outstanding student loan debt has outpaced credit card and auto debt.

Every day, 3,000 student loan borrowers go into default. The Brookings Institution estimates that as many as 40 percent of borrowers could default on their student loans by 2023.

The rate at which student-loan borrowers can't pay their debt looks a lot like the rate at which people could not pay their mortgages during the 2008 financial crisis.

Banks too big to fail

It is clear now that in 2008 many of the largest banks in the U.S. were in reality insolvent. By law, insolvent banks should be liquidated. But these weren't small banks. Liquidating an insolvent mega-bank is virtually impossible.

Today, the FDIC holds $107 billion, which is enough to cover only 1.4 percent of insured deposits. The deposits of the five largest U.S. banks, with 40 percent of all U.S. bank deposits, alone exceeds $5.6 trillion. So five banks have about $5.6 trillion more or less in deposit liabilities.

The U.S. Treasury in 2018 had $507.5 billion in assets — not trillion. In other words, the cash that would be necessary to repay the enormous deposit liabilities of the mega-banks simply does not exist.

Although the Federal Reserve did not explain its actions, the current “repo crisis” does not appear to involve a crisis of bank insolvency, at least in the immediate sense, but rather a shortage of bank reserves. Bank reserves include the cash on hand to pay depositors who wish to withdraw all or a portion of their deposits from the bank and what the economists call “central bank money.” Central bank money consists of the deposits of commercial banks at the central bank — one of the 12 Federal Reserve Banks that make up the Federal Reserve System.

What are repos?

In order to maximize their profits, banks keep their reserves as low as economic caution and legal requirements allow, but they do have to maintain some cash reserves. On any given day, individual banks often find themselves short of cash reserves while other banks have surplus reserves.

Therefore, banks with surplus cash loan it to banks that are short of cash. Sometimes these are actual loans, and sometimes they are repurchase agreements or repos.

In a repurchase agreement, a bank that is short of cash reserves sells a short-term government security to another bank for cash. It agrees that it will buy back the treasury note the next day at a slightly higher price than it sold it. The difference between the price the bank with a cash shortage sells the treasury security for and the slightly higher price it buys it back for is the repo rate of interest.

As a general rule, the repo rate is more or less in line with the federal funds rate. But on Sept. 16-17, 2019, some banks were so in need of ready cash they were willing to pay a rate of 10 percent, far above the federal funds rate of around 2.25 percent.

What the banking system needed and the Federal Reserve System is now providing

is liquidity in the form of ready cash. A sudden demand for cash like this is a classic symptom of a capitalist economic crisis.

The shortage of cash reserves in the U.S. banking system is the strongest indication yet of a downturn in the industrial cycle. If a U.S. recession has not already begun, the repo crisis says that a recession is not far off.

But won't the U.S. Federal Reserve stave off a recession by moving to increase bank reserves by simply increasing the quantity of Federal Reserve-created dollars? Trump has been demanding that the Fed do exactly that, hoping that the next recession will be postponed until sometime after the November 2020 election.

Technically and legally under the current "fiat money" system, the Fed can create any amount of dollars it wants to. So maybe a recession is not imminent after all?

The Fed can maneuver but it cannot prevent a recession once conditions for a recession have fully matured.

There is only one answer to the bankers when they say they are too big to fail and demand to be bailed out. The answer has to be the expropriation of the capitalists and a turnover to socialism.

The banks being too big to fail means that capitalism itself has become "too big" to continue.

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