

The spectre haunting Europe (1999)

A spectre is haunting Europe. The spectre of illiquidity. A bit less dramatic than Karl Marx's prophecy, but a splendidly destructive assault on modern capitalism.

In recent months we have seen the confident markets of the mid 1990s knocked sideways. First the corruption of many of the Asian markets was exposed, and then the Russian default blew the assumptions of many mathematical models out of the water. But in the past couple of weeks, there has been a trickle of market confidence returning, though it's not clear why.

A confident capitalism of 1996 or 1997 could probably have withstood a sudden withdrawal of liquidity from the markets and the sudden lack of a ready market for one instrument or another, but the jittery markets of late 1998 may be about to experience the nastiest glitch yet. And it is directly attributable to the devilish detail of the euro conversion weekend.

By now everyone has realised that the conversion of government bonds over the New Year weekend is a pain in the neck. There is a lack of consistency as to how the conversion will take place, and there is genuine fear that one or more of the national depositories will fail to perform. There are rumours about of a French rehearsal where 40% of trades in SICOVAM failed, and that an Italian practice run collapsed completely when the systems experienced total failure.

So quite a few organisations have decided that they do not want to be holding more bonds than they have to – and quite a few have decided that zero is a good number. Bonds are not a particularly convenient type of instrument to hold over *le weekend*.

And if your own are a pest, what about someone else's? One of the main methods of funding nowadays is the repo agreement. This is a short(ish) term agreement between two parties to sell and buy back fixed income (or other) securities. The seller receives cash which can be used for other purposes, and the buyer receives a better return than if the bonds were bought directly. Nice work, it puts together the cash rich and the cash poor in a convenient, safe and profitable transaction.

But if you are holding the bonds over *le weekend* you will have to convert them. And one look at the Bank of England's recommended options for treatment of repos is enough to put off quite a few market participants.

So now it looks as though the cash rich providers of repo facilities may decide *en masse* that it's all too much like hard work, and they want to sit on their cash during December so that all they then need to worry about is their own portfolio and their cash balances. Not some pile of odd securities delivered at the last minute which need to be processed and reconciled.

So what? The cash rich sit like dragons on their hoard, and the bond holders wait until January to start up their businesses again. What's the problem?

The problem is December. If Bank A needs to make a cash payment on (say) 15 December 1998 but doesn't have the cash, it will expect to go to the market, repo some bonds and use the result to fund the payment. But what if there are no takers?

Well, they could borrow cash. But we can assume that their normal credit lines are full, and that there is not much joy to be had there.

In the old days, no doubt a few dealers would have been prepared to break management imposed limits and argue about the great profits later. But nowadays it's normal to be sacked on the spot for breaking limits, so there may be fewer willing to take this risk.

Even if a bank is prepared to extend a line, this will take time, and will certainly not provide the level of liquidity required for the entire market.

If there is no repo market, there is insufficient liquidity – probably even if the central banks step in. If there is insufficient liquidity, payments don't get made. If payments don't get made... people start wondering if money is really safest in a bank. Karl Marx would have enjoyed this.