Long-Term Austerity and Implications for Monetary Policy Risks

Unfortunately, even if the US Congress and President Obama resolve the fiscal cliff challenge positively, the economy's problems are not over. Any long-term fiscal compromise will involve considerable fiscal austerity, even if spread over 10 years instead of concentrating half the pain in just one year. Thus, our optimism about economic growth if a fiscal compromise can be reached is based on removing uncertainty and rebuilding confidence in the future.

There should be no mistake, however, that the long-term growth path, given a possible decade of fiscal austerity and coupled with the aging demographic pattern of the country, is much more likely to produce 2.5% to 3% annual average real GDP growth than 3.5%-plus average growth. It is worth noting, that we would have argued for closer to a 2% to 2.5% long-term path if we were not projecting an "energy dividend" over the coming five years from the expanded natural-gas and crude oil supply in the US, but that is a separate story.

Given a long-run growth path that limits the country's ability to outgrow its debt, the conduct of monetary policy will be extremely complex. That is, if the risks associated with the fiscal cliff are resolved, the focus will turn to the appropriate monetary policy to accompany fiscal austerity. Yet, the Fed's future policy options have been vastly complicated by the balance sheet expansion of quantitative easing (QE) and the maturity extension program. A little historical context is useful.

In the last quarter of 2008 and in early 2009, the Fed expanded its balance sheet by roughly $1 trillion in what became known as QE1, or the first round of quantitative easing. There is little doubt that this action prevented a recession from turning into a depression, saving millions of jobs. More controversial, however, are the long-term and potentially unintended consequences of the additional $1 trillion (and growing) of quantitative easing since 2010, known as QE2 and QE3, as well as the maturity extension program known as Operation Twist.

As argued in our research study published in September 2012, "Quantifying QE", QE2, Operation Twist, and QE3 helped lower long-term Treasury bond yields by 50 basis points, distorted the yield curve, yet did nothing for creating jobs. Basically, we got no short-term economic lift while the long-term unintended consequences may be huge, as argued in William White's working paper, "Ultra Easy Monetary Policy and the Law of Unintended Consequences", from the Federal Reserve Bank of Dallas (Globalization and Monetary Policy Institute, Working Paper No. 126).

Assuming that the US economy avoids the fiscal cliff and the unemployment rate declines in 2013 toward 7% (after a brief Sandy-induced return above 8% in Q4 2012), at some point, probably in 2014, the Fed is going to have to decide how to manage its exit from quantitative easing. A normal, yet still accommodative, monetary policy would probably have the Fed funds rate equal to or slightly above the measured core inflation rate.

That means when the Fed is managing its exit from QE, it will be incrementally raising the Fed funds rate from near zero to 3% or so. That is, a rising Fed funds rate may coincide with massive asset sales, which could put additional upward pressure on long-maturity Treasury yields. This will raise fears that the bond markets could be destabilized and the economic expansion derailed. Moreover, higher bond yields could require more fiscal austerity as federal government debt service costs rise above projections.

Once the economy is growing closer to its potential output, delays in returning to a normal monetary policy have huge inflation risks — potentially exacerbated by a weaker dollar — which are not apparent when the unemployment rate is as elevated as it is now. Chairman Bernanke states that these problems are manageable, and we do not doubt this. We remain concerned, however, that the "manageable" solution will involve delays in returning to a normal policy and that the exit from QE may involve dollar weakness, rising inflation expectations, considerable Treasury market volatility, and the potential for elevated long-term yields that could slow an expanding economy.

All examples in this report are hypothetical interpretations of situations and are used for explanation purposes only. The views in this report reflect solely those of the author and not necessarily those of CME Group or its affiliated institutions. This report and the information herein should not be considered investment advice or the results of actual market experience.

Making the most of the changing regulatory framework

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In the wake of the financial crisis, new regulations introduced by the European Market Infrastructure Regulation (EMIR) and the Dodd-Frank Act make increased electronic trading and central counterparty clearing (CCP clearing) of standardized OTC derivatives an inevitability.

CCP clearing promises significant progress in the OTC derivatives space. Reduced systemic risk, increased transparency and gains in efficiency will benefit both the buy and sell-sides. With EMIR having legally come into force on 16 August 2012, the full impact of the legislation will not come into effect until the European Securities and Markets Authority (ESMA) finalizes the technical standards of implementation later this year. This will give market participants a chance to position themselves to capitalize on the business opportunities under the new regulatory regime as well as achieve readiness for the mammoth operational changes on the horizon.

Regulatory overview

In September 2009, G20 leaders emphasized that all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, whenever appropriate, and should be cleared through central counterparties. In Europe, these ambitions were integral to the content of the MiFID Review consultation, as well as the European Commission's Sept 2010 Proposal for Regulation of OTC

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Derivatives, Central Counterparties and Trade Repositories — the result is known as EMIR.

In addition, the Basel Committee for Banking Supervision published a final interim solution in July 2012 on capitalization of bank exposure to CCPs. In this document it is confirmed that Clearing Members which are clearing OTC derivatives through qualified CCPs will face lower capital requirements (addressed in the Capital Requirements Directive). In efforts to align capital requirements more closely with the risks borne by banking entities, clients of Clearing Members will face lower capital requirements when their centrally cleared positions are segregated from the positions of the Clearing Member.

Running in parallel to official governmental regulations, the CPSS-IOSCO Recommendations for Central Counterparties have provided a global foundation for best practices for clearing houses. On 16 April 2012, the committees of CPSS and IOSCO published the new Principles for Financial Market Infrastructures, which provides updated guidance for the financial market institutions including CCPs. As IOSCO stated in a press release, "Compared with the current standards, the new principles introduce more demanding requirements in many important areas including: the financial resources and risk management procedures a Financial Market Intermediary (FMI) uses to cope with the default of participants; the mitigation of operational risk; and the links and other interdependencies between FMIs through which operational and financial risks can spread." Regulators from around the world participated in the formulation of these recommendations and compliance with the CPSS-IOSCO principles are now a prerequisite for a clearing house to be categorized as a qualifying CCP. National regulators are tasked with applying the standards. Many requirements set out in the principles are similar to requirements set out in EMIR, and represent a detailed description of internationally applicable risk management standards.

The goal of the regulatory timeline is to fulfil the different rule sets recommended and agreed upon by the G20 leaders. Thus the ESMA technical standards were submitted to the EU Commission for review and finalization on 30 September 2012, and these standards are expected to enter into force within the EU shortly afterwards. It will be crucial to safeguard the international alignment among the numerous regulatory changes envisaged by the regulators in order to avoid regulatory arbitrage. The spirit of the new legislation is clear. And the sell and buy-side already have begun preparing to meet regulators' deadlines for implementation.

Impacts for the buy-side

For the buy-side, the measures called for in the new rules usher in a completely new way of doing business. They are faced with a host of new requirements ranging from mandated CCP clearing right down to in some cases implementing electronic trading business models for the first time. As is the case for the sell- side, the sheer number of new requirements for the buy-side is a challenge in itself. Despite the ongoing regulatory uncertainty, many buy-side firms are beginning to move ahead in engaging clearing members and adapting their models to CCP clearing conditions.

The biggest change will entail dealing with margin requirements that have always been a central feature of any CCP clearing. As collateral demands increase, the buy-side investment models may need to be reconfigured from fully invested ones to models in which cash reserves are kept on hand to meet margin calls. Heretofore, counterparty margins were characterized by a patchwork of privately negotiated, ad hoc agreements that might have been more flexible but certainly were riskier. Bilateral derivative trades that are not cleared will also have to be margined but bilateral arrangements will not enjoy standardized processing and reporting, credit enhancement and other benefits that accrue from CCP clearing.

Capitalizing on the new situation

While market participants are encouraged to begin preparing for operational readiness, several key issues remain. For example, even in the US where the SEC and CFTC have been working together closely on implementing Dodd-Frank Act regulations, it is not clear if there will be different execution requirements for SEFs that handle interest rate products and SEFs that handle equity based products. This will determine whether current brokerage and execution platforms will pass regulatory muster or if new ones will need to be defined.

A very meaningful debate for both the buy- and sell-sides is also raging about the customer account structure for clearing accounts. While the general CCP structures have been largely unchanged over the past decade, major buy-side customers have become uneasy with commingling of risks with their clearing members even in traditional futures and have been pressing for enhanced protections including individually segregated accounts. Indeed, Article 39 of EMIR requires that CCPs and Clearing Members offer several levels of segregation alternatives to clients – individual client segregation, omnibus client segregation and non-segregation. It will be critically important for clearers to set up the correct accounts, design the right services and provide the appropriate documentation as well as for their customers to understand and be ready to work with centralized clearing.

A number of these tools already exist in the market or are being developed so members of both the sell- and buy-sides can achieve greater operational efficiency and collateral safety. Clearing house services that permit increased levels of segregation will in turn facilitate the portability of customer assets. All of these measures are designed to help provide smooth position and collateral transfers in the rare event of a clearing member default. In addition, portfolio margining is a key discussion topic that would allow cross margining between OTC and listed derivatives, which will spell major savings.

Market participants welcome the straight-through processing component of the new market structure. The current OTC model, which often relies on telephone transactions and a T+3 or longer settlement cycle, will be replaced by much accelerated transactional certainty. Long a feature of electronically traded cash and derivatives markets, straight-through processing will introduce major operational efficiencies.

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Going forward, safety, segregation of assets and capital efficiency will remain driving factors in the industry.

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