Global Market Strategy-
On The Interdependencies of Central bank Balance Sheet Sizes of Nations Entrapped in Liquidity Traps

2 Weeks back we examined how Exchange rates belonging to US, EU and Japan depended on the differentials of their respective Central Bank's Balance sheet sizes. We also discussed that FX pairs belonging to countries entrapped in Liquidity traps would display such behaviour. So the natural follow up question arises as to how could we miss two of the other Nations reputed to be in a similar aqueous position : UK and Switzerland? So here goes: We fetch out the respective Balance Sheets of BoE and the SNB and see if the same relationship is exhibited.

Chart 1. SNB Balance sheet- US Federal Reserve Balance Sheet size , vs. USD/CHF

Chart 2. US Federal Reserve Balance Sheet - BoE Balance sheet size , vs. GBP/USD

Let us also refresh the charts for US, EU and Japan by including data over the last two weeks:

Chart 3. US Federal Reserve Balance Sheet - ECB Balance sheet size , vs. EUR/USD

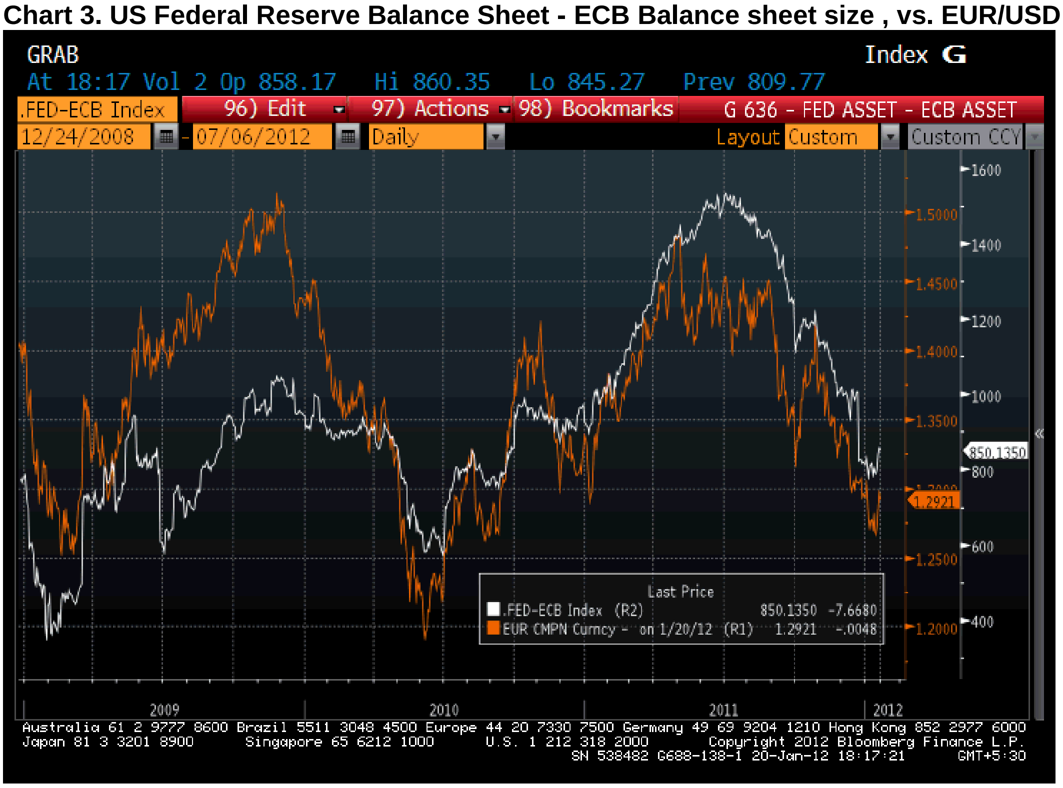

Chart 4. BoJ Balance sheet- US Federal Reserve Balance Sheet size , vs. USD/JPY

However this piece is not at all about harping on an old topic. This note is about issues which have wider ramifications. As we noted last fortnight, there are rumblings being heard of further QE by both the US Fed and the ECB. We have seen how the US Fed might be open to a USD 600 Billion QE-III program in it's FOMC in March and that as a consequence the ECB would have to open up it's own QE , read another 3 yr LTRO , admeasuring Euro 700 Bio. There has been much remonstrance on this principally from analysts who see really no need for the Central Banks to intervene again whilst the real economy heals itself with measures that are already committed working itself within the system and that requires some time to produce measurable results in the form of hard data. The problem is not so much in the real economy today, as much as in the behaviour of certain very "we hunt in a single pack" kind of formations in the financial world who wield their clout in a co-ordinated fashion. To put more flesh into these happenings, for instance, very many Banks who hitherto held Greek sovereign Bonds in November when the IIF led "soft restructuring" of Greece was announced with "voluntary haircuts" , many Banks had simply to toe the line since under they had to report back to their respective regulators , who in turn had to report back to their Governments. It so transpires that most of these Banks cease to be holders of Greek bonds, nay most peripheral bonds, and they have sold it to *eager buyers*- Hedge Funds. Eager buyers? Courtesy the booming Prime Brokerage services of some of the globe's largest banks , these hedge funds have purchased CDS protection on not just Greece , but also most other peripheral countries like Portugal, Spain and Italy. These banks that have been selling CDS protections are to big too fail in their respective geographies. The hedgies plan to establish without doubt that the slated restructuring of Greece is not as voluntary as is being touted and that ISDA will now have to declare any miss in a coupon payment by the Greek government in future as a default and thereby trigger the CDS contracts: a veritable nightmare for

Policy makers, Banks, Corporate, all governments and indeed for the entire global economy. It is against this backdrop that IMF resources are sought to be expanded by USD 1 Trillion. Indeed, the entire talk of further QE by the US Fed and the ECB is being necessitated by this threat.

But the next question arising is as to why should the US Fed precede the ECB in March to initiate QE -2012? If the problem is emanating from Greek/peripheral sovereign and EU zone bank debt rollover problems then why is the market talk veering around to the US Fed to fire the opening salvo of 2012? Shouldn't the honour belong to the ECB? Things get a bit complicated here - some pretty elementary stuff- however those interested can get a copy of the math from me ; it turns out that if the US Fed does not get to do the honours ahead of the others, the maximum QE capacity for ECB, BoJ and the SNB stand as follows:

Central Bank	**Maximum possible increment in size of Balance sheet**
ECB	Euro 533 Billion
BoJ	Yen 10.1 Trillion
SNB	Chf 345 Billion

So it happens that the maximum firepower today, if US Fed does not start QE 2012 , is USD 1 Trillion, leaving out the BoE. Not enough for what is being feared to be Lehman ^2.

But if the US Fed were to kickstart QE 2012, the maximum QE capacity for ECB, BoJ and the SNB expands considerably:

Central Bank	**Maximum possible increment in size of Balance sheet**
ECB	Euro 1.99 Trillion
BoJ	Yen 77.7 Trillion
SNB	Chf 640 Billion

Counting US Fed's US$ 600 Billion, the total firepower increases to USD 4 Trillion. (Up from US$ 1 Trillion)

That's something - Lehman ^2 - vs. US$ 4 Trillion- Bagehot would be pleased. Assuming that in the baseline scenario, the IIF is unable to get a consensus of atleast 70% of Greek bondholders to agree to a voluntary haircut of 50%, and a Greek default is feared on 20th March , the US Fed should go ahead and announce a preemptive QE-III a week before on 13th March , the scheduled FOMC. That will massively increase the firepower of the ECB, the SNB and the BoJ to initiate QE, if required, than if the US Fed were to sit silent on it's guns and wait before reacting to events. The ECB meets on the 4th of April - and the imminent threat of another 3 yr LTRO of Euro 2 Trillion should be enough to keep matters steady; in case things get worse then enter the SNB and the BoJ. Definitely it is better for the US Fed to shoot ahead of others.

However, from the Emerging market point of view, more QE from liquidity trapped nations increases the risk that they themselves will get dragged into this ever expanding vortex. To escape inflationary side-effects, emerging market policy makers need to be more vigilant than ever.

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<u>Strategy</u>

Anupam K Mitra, AVP

Axis Bank

Treasury, Global Markets Group

Contact details – 66043222, 42026622. anupam.mitra@axisbank.com