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Late last Friday afternoon, the following Bloomberg headline caught my eye:

*ECB TURNS DOWN ENERGY TRADERS' PLEA FOR FUNDING SUPPORT

The recent bottlenecks in commodity funding markets are stemming from commodity traders exhausting and then asking for bigger credit lines from banks – surging commodity prices mean credit lines must be fully utilized to move cargo but when credit lines are fully utilized, you don't have anything left to draw on to pay margin on more price-volatile cargo. Then you start to prioritize uses – you'll use your credit lines exclusively to lease ships and to fill it up with cargo and you won't hedge (because you exhausted your credit line and so cannot afford to hedge), which then means more uncertain price terms in the future…

…price terms in terms of the price level, that is, inflation!

In a bizarre twist of logic…

…commodities are core to price stability (a central bank mandate), but the liquidity needs of commodity traders that procure commodities were deemed peripheral by the ECB from a financial stability perspective. It must follow that if commodity traders ever get emergency liquidity assistance (ELA), they'll get it for price stability, not financial stability considerations. Regardless of the reason, today we'll try to imagine the price commodity traders might have to pay for ELA.

There is no free lunch. Unlike the military and diplomatic protection to commodity assets and the global sea routes through which they are shipped, central bank liquidity is never a free externality. There is always a price you pay: implementing the Washington Consensus in Southeast Asia in 1997, where the IMF played the role of the global central bank (no swap lines back then); implementing Basel III after the Great Financial Crisis of 2008; and, perhaps, rules limiting leverage in the RV hedge fund community for the bailout received during March 2020 (no rules have been proposed yet, but they may be coming).

To start our emergency liquidity discussion, consider four facts.

First, as Perry Mehrling taught us, always and everywhere, finance is hierarchical, and as Katarina Pistor taught us, the laws that underpin the hierarchy of finance are flexible at the core and rigid at the periphery. Emergency liquidity assistance is hard to get when you are a non-bank: it was impossible to get in 2008 if you were a conduit, a SIV, a primary dealer, a finance company, or a money fund, and once again it is impossible to get it today if you are a commodity trader. Commodity traders are at the periphery of the financial system, and the laws are rigid once again. But every crisis starts at the periphery and the bushfire ultimately encircles the core. The moat around fortress balance sheets at the core will help this time around – hundreds of billions of dollars of reserves at the Fed (the moat) will contain the fire and help the survival of the periphery for a while, but if the fire rages for too long or intensifies, the core can also sustain damage.

Second, according to Bloomberg, the ECB did leave the door open to emergency liquidity assistance (ELA) provided by national central banks, but the possibility of that depends on the laws defining national central bank mandates – that is, while hope is not lost completely, hope depends on legal interpretation.

Third, crises are about normally good collateral turning bad and impossible to finance and/or hedge. KRW in 1997, mortgages in 2008, Treasuries in 2020, commodities today. Mortgages and Treasuries are central bank eligible assets. Commodities aren't, and central banks only lend against collateral, but commodity traders don't have high-quality, liquid assets (HQLA) to pledge. Central banks also like to be "secured to their satisfaction" and central banks' legal departments, not markets departments, determine what is satisfactory.

Fourth, location matters. The ECB was the first, but perhaps not the last central bank that commodity traders have approached for liquidity. The largest commodity trading houses are based in Geneva, Zug, and Singapore, and so the Swiss National Bank and the Monetary Authority of Singapore are exposed. No, the dollar swap lines won't suffice, because the dollars that come from the swap lines with the Fed are just the inter-central bank bit. Central banks then broadcast those dollars via cross-currency repos to their local banks, where the collateral comes from the HQLA portfolio of local banks. Once again, commodity traders do not have HQLA. They are net borrowers in the system, not net lenders. They are long physical commodities and structurally short liquidity, and unless central banks decide to accept physical commodities as collateral, there is no easy way to for national central banks to provide emergency liquidity.

Irrespective of these four hurdles…

…all sorts of commodities are becoming more expensive and more volatile, and the commodity world's equivalents of G-SIB score-related price spikes due to physical disruptions are coming (see below) – and the price spikes won't follow calendar patterns, but rather the patterns of war and sanctions. Liquidity shocks never announce themselves, they just happen. That's why they are called shocks.

According to an ancient Andaman folklore…

…when you see the water levels recede, run to the highest ground you can find.

In 1997, clearing banks in New York saw the water levels recede for Southeast Asian banks and finance companies (they ran out of dollar balances). It was time to short the FX pegs, i.e. the concept of fixed exchange rates.

In 2008, clearing banks in New York saw the water levels rapidly recede for primary dealers and other shadow banks (they could not fund subprime MBS). It was time to short the ABX and then primary dealers, and the concept of par.

In 2019, clearing banks in New York saw the water levels rapidly recede and they got to their LCLoR – o/n repo popped in September 2019, and the Fed's bill purchases that followed were not fast enough to get the system ready for the liquidity storm that the onset of Covid-19 would unleash in March 2020. It was time to short Treasuries and the concept of a tight cash-futures basis.

In 2022, clearing banks in New York and banks in other financial centers are seeing water levels rapidly receding once again. This time for commodity players.

Commodity traders asking for central bank liquidity assistance is a symptom – the symptom – of liquidity stress. You don't ask for liquidity assistance without long-term consequences like regulatory oversight and liquidity rules, and so if you ask for liquidity assistance, you must really-really need it. Why?

Because as Perry Mehrling taught us, "liquidity kills you quick", and here we'll add that in the commodities world, where the nominal world of money trading (the four prices of money) and real world of physical commodity trading meet, liquidity means not one but two things: the flow of money and the flow of atoms.

Liquidity can kill you quick from two directions…

…if the financial flow of margin payments stops (can't pay margin), and also

…if the physical flow of commodities stops (why pay margin).

The ancient Andaman folklore will soon have its commodity trading version…

…when you see commodity flows recede, run to a central bank you can find.

In previous dispatches, we warned about potential disruption to the flow of gas (the buyer turns away because it does not want to pay in rubles; the seller turns away and turns off the faucet; or more covertly, pipelines get damaged in Ukraine through sabotage so no one knows why Europe ended up without gas).

In previous dispatches, we also warned about potential disruptions to oil flows due to VLCC shortages, not to mention risks to Saudi-U.S. relations due to the U.S.'s "rapprochement" with Iran or the increased risk of piracy due to a wheat crisis (see here). The release of oil from the U.S. SPR is welcome, but…

…it reminds us of J.P. Morgan lending its last penny in the o/n repo market in September 2019 and then nothing. The Fed had to top up the banking system with reserves, but that was easy. As we said in our last dispatch, it's easy to print money, but impossible to print gas and oil to fuel industry, transport goods, or heat homes, or to print wheat to eat. There are major risks to pipelines; there are risks in the developing world's willingness to provide commodities to the developed world (not just from Russia, but also from OPEC, which refused to increase the production of oil despite a pre-SPR release plea from the U.S.); there are risks in terms of shipping capacity; and there are risks to sea lanes – straits getting closed, tolls at the Suez Canal spiking, and piracy increasing.

Black gold meets the black swan…

We need to understand commodity traders' plea for ELA both in the context of a world where commodities flow freely, and the only worry is how to finance more expensive and more price-volatile cargo, but also in a world where commodities do not flow freely, and where ELA is needed by those who were owed margin but did not get paid because the other side called *force majeure*.

The nickel market is small, but…

…the oil and gas markets are big. The private sector could afford to deal with liquidity issues at the LME but won't be able to deal with liquidity issues at the much larger oil and gas markets. The banks that were owed margin payments during the recent nickel debacle reportedly preferred not to be paid margin by the troubled counterpart to protect the integrity of the LME. But remember:

if you owe a bank $1 billion, it's your problem. If $10, it's the bank's problem, and unlike the nickel market, the oil and gas market won't be a $1 billion problem.

Commodities are full of tail risks that are impossible to price, and the next leg of the liquidity crisis in commodities is just a headline away. This is a war, not a business cycle. In period of regime change, the normal rules don't apply…

…and as we learned from Andy Grove, "*only the paranoid survive*".

I want to continue to emphasize my concern about tail risks in the system, and also that I was wrong about how to express these systemic tail risks to date.

This is clearly not a STIR trade, or at least not yet…

I was wrong about the expression of these concerns (not funding spreads, since commodity traders do not fund in dollar funding markets directly, but indirectly through banks and banks are swimming in liquidity), but I was right about the early days of a liquidity crisis. Like Tolstoy's unhappy families (unlike happy families, they are all unhappy in their own way), every crisis is a crisis in its own way: 1997 was a crisis of the periphery in Southeast Asia, not the New York core; 2008 was a crisis of the periphery (subprime borrowers and the shadow banking system) that due to mismanagement engulfed the core – the New York core; 2020 was a crisis of the risk-free U.S. Treasury curve – the New York core was a source of strength but still needed help from the Fed.

Every major crisis is a crisis of money and collateral. Every major crisis is also a liquidity crisis. Not every crisis engulfs the core, but that doesn't mean you shouldn't care: 1982, 1994, 1997, and 1998 did not engulf the core like 2008, but you still had to care. And you have to care about commodity traders today.

If not through funding spreads, how else can we express these concerns?

First, liquidity kills you quick and sudden deaths leave everyone exposed, and so large losses at the core of the financial system are not zero probability risks. The size of the commodity derivatives complex is big, about $1.5 trillion (non-precious metals only, $1 trillion of which are OTC swaps, see here). While not necessarily lethal, bank equities can be hit by unexpected losses.

Second, liquidity can save you but at what price? What if the liquidity help from central banks comes at the expense of nationalization ("secured to satisfaction") – or the forced sale or pledging of real assets, like mines? We are not talking about Russia nationalizing the assets of BP. We are thinking about parallels to AIG, where liquidity assistance came in exchange for a steep equity interest, and AIG having to sell its stake in AIA. Maybe it's a good omen that the SNB is an experienced investor in equities – a good omen for the New York core, but not for the equity investors of commodity trading houses. To summarize…

…bank equities can suffer if ELA to commodity traders isn't coming, and equity investors in commodity traders can suffer in the extreme both if liquidity assistance isn't coming (you fold), but also if assistance is coming (you can get nationalized, either in whole or partly, or are forced to sell assets).

Third, maybe the ECB and other central banks will decide to launch CEPP – a Commodity Emergency Purchase Program – where they buy unsecured debt from commodity traders to fund their needs. If the EBC buys corporate debt, and if the SNB buys corporate debt, maybe they will end up doing that for commodity traders, and will not request equity in return for emergency liquidity.

We do not know which of these three scenarios will happen.

What the steady inflow of U.S. dollars was to South Korea in 1997, and what the steady flow principal and interest payments were to the performance of subprime mortgages and CDOs in 2008 (and the entities exposed to them), the steady flow of gas, oil, and other commodities is to financial stability today.

Sudden stops are about to get a new meaning…

…for they can happen not only in the nominal, but also the real domain.

Shadow banking is "money market funding of capital market lending".

Shadow banking is also "money market funding of commodity trading"…

…for as discussed here, the legacy of Marc Rich and Pincus "Pinky" Green (Rich's right-hand in shipping matters) was to turn commodity trading into a highly levered trading operation, funded by unsecured credit lines from banks.

Bagehot was a commodity trader, and if you read Bagehot Was a Shadow Banker – first page, "What Would Bagehot Say" – you'll read about "*a world where government debt is not yet the focal point of trading and prices, as it came to be in the 20th century. Instead, the focal point was the private bill market, which domestic manufacturers tapped as a source of working capital, and which traders worldwide tapped to finance the movement of tradable goods. It was a market in short-term private debt, collateralized by tradable goods, quite different from the 20th century market in long-term government debt. What has come down to us as the Bagehot Rule for stemming financial crises – lend freely at a high rate of interest—was originally about the Bank of England buying bills freely but at a low price. The Bank also made loans of its own ("advances") against collateral, and the Bank's generous collateral valuations provided further support for market prices. Bagehot himself famously urged the Bank to accept as collateral "what in ordinary times is reckoned a good security" rather than at current market valuations. The point was to prevent troubled banks from being forced to liquidate fundamentally sound assets at fire sale prices.*"

The key concepts in the above passage – authored by Perry Mehrling et. al. – are private (real) bills and working capital. What would Bagehot do today?

He'd be quite surprised at Friday's ECB decision.

He'd launch CEPP (see above) right away.

The ECB's decision on Friday…

…shows not only an interesting twist of logic where the guarantors of price stability (which are not central banks, but commodity traders) are deemed peripheral from a financial stability perspective, without regard for what their liquidity problems mean for price stability. It also may show a disregard for financial history.

As the above passage reminds, emergency liquidity assistance was originally administered to backstop working capital needs for international trade in goods (which also include commodities). Today, we are in love with working capital needs of a different domain: the working capital needs of asset managers that come from the repo market and the FX swap market. What real bills are to the trading of real goods, repo and FX swaps are to trading financial goods (bonds).

It's great that we now embrace the concept of DoLR…

…but it took us a decade and a half to get used to that idea, and that idea was about adopting old ways of thinking in a new context. In that process, we seem to have forgotten about the origin of the old ways – the real world of commerce, the trading of commodities and goods more broadly. Central banks have to backstop the liquidity needs of commodity traders, for if they do not do so, they will soon have to be funding a series of price control measures through more QE. In a way, central banks are on the hook either way, they just don't realize it yet.

Once again, of the three ELA options (no ELA; ELA for equity; ELA unsecured – for each, see above), we don't know which one central banks will choose.

A lot will depend on the ECB's and other central banks' reading habits – is it the Old Testament (Old Testament justice for non-banks and no ELA); or is it the Merchant of Venice (ELA for a pound of flesh); or another English classic – Bagehot's Lombard Street as the polar opposite to Shakespeare's classic?

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