Federal Financial Analytics, Inc.

# MEMORANDUM

**TO:** Federal Financial Analytics Clients

**FROM:** Karen Petrou

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A few years back, I gave a speech at SWIFT's annual meeting knowing little of what it did beyond the speakers I was invited to join. While the meeting was in a cavernous conference center, the off-hours discussions in magnificent chateaus were small, serious, and -- at least for me -- insightful as to the awesome power of a seemingly-simple "messaging system". Now, of course, the world knows why Swift matters-- indeed, Vladimir Putin is taking this so seriously that we're all reminded of the literal meaning of the "nuclear option." Putin is right --America's "soft" economic power gives it a weapon of formidable might.

Will it backfire? One of the questions I've repeatedly gotten over the weekend is whether U.S. banks can withstand market disruptions now or under even greater stress if sanctions expand to still more Russian banks and thereafter also to those still doing business with them. In short, there is no doubt that banks in the U.S. will withstand near-term stress and even less-resilient ones in the EU and Japan will do the same.

The reason for this is the demonstrable certainty that central banks will intervene to ensure dollar liquidity across the world and financial-market liquidity wherever it seems threatened. Unlike 2008 and 2020 when Fed windows were opened too wide and too long, this geopolitical crisis is of no financial firm or central bank's making. What all this new money might do to already-bloated financial markets is yet to be known, but central banks will run their presses red-hot to ensure the Russians aren't able to traumatized bond, equity, and derivatives markets.

However, that Western finance is resilient doesn't mean it's bullet-proof. Significant risks remain in highly-leveraged sectors that could create another dash for cash for which regulators and markets are about as unprepared now as they were in 2020. Banks will withstand much of this and central banks will back them and everyone else up. However, the result of unresolved moral hazard will be only more moral hazard and thus also markets made still riskier for the deeper and longer stresses Russia's invasion ensures.

Financial markets will also surely get riskier because large volumes of payments are likely to shift to the crypto sphere, -- see our report here, even as cyber-risks rise to unprecedented heights. Central banks are ill-prepared to handle threats to fiat currency launched outside traditional messaging systems because they've done little about digital assets despite speech after speech and working paper after working paper.

Central banks are even less well-prepared for broader macroeconomic stress. If they counter a sudden downturn with tightening, they'll make it worse; if they stand put, they'll have no impact; if they drop rates, we'll go negative and that raises a raft of instability risks all its own.

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Many of us have noticed the Fed's empty toolbox and worried a lot about it. It and many other central banks believed that they controlled markets so thoroughly that they could pick their time for tough decisions. Vladimir Putin has proved them wrong along with all the others who thought he was just bluffing.