All That is Solid Melts into Air

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Luiz Fernando de Paula
Professor of Economics at IE-UFRJ, Brazil
&
Fernando Ferrari-Filho
Professor of Economics at UFRGS, Brazil

Minsky's answer to his question is that despite the growing tendency toward financial fragility typical of an economy in euphoria (his well-known aphorism is that "Stability - or tranquility–[….] is destabilizing"),a big financial crisis would not happen, since the American financial system was still reasonably regulated, and, along with this, the government, by playing its role of "Big Bank" (central bank as lender of last resort) and "Big Government" (counter-cyclical fiscal policy), would prevent another Great Depression from happening.

As is well known, the belief in the market's ability to self-regulate in a context of increasingly deregulated financial markets created the conditions for IFC to happen. A crisis in a specific segment of the real estate market (subprime) ended up short-circuiting the entire North American financial system, spreading sequentially to the rest of the world.

From the IFC, it was found that the banking sector had an eminently pro-cyclical behavior to risk, i.e., in the cyclical boom, banks tend to take higher risks in granting credit, due to improved expectations regarding the performance of the economy, something that Minsky, by the way, had already observed.

Similar to the aforementioned 2007–2008 crisis, recently, both the U.S. financial system and the world economy have been going through difficulties due to the bankruptcy of three U.S. banks: Silicon Valley Bank (SVB), Signature Bank, and Silvergate Bank. Consequently, there was a crisis of confidence that led to strong concerns about the solvency of First Republic Bank and Credit Suisse, this bank had Swiss government intervention, and Deutsche Bank AG, which became the focus of the banking turmoil in Europe, thus evidencing that financial globalization contributes to the rapid spread of a crisis in the world.

In the midst of this turmoil, the Federal Reserve tried to act quickly to avoid a panic in the banking sector, in its role as "Big Bank" by announcing a number of measures. First, it created a one-year emergency loan line ("Bank Term Funding Program") in which it discounts government bonds at face value rather than market value, a measure that goes against the Bagehot Doctrine that the lender of last resort should charge punitive interest rates. Second, the Fed announced an agreement with the European Central Bank, the Bank of England, the Swiss National Bank, the Bank of Canada and the Bank of Japan to change the rules of the dollar auctions from weekly to daily (daily swaps were used for the first time during the COVID-19 crisis).

Third, it was announced that the guarantee for all SVB and Signature deposits would be extended — the existing rule guaranteed deposits up to $250,000 by the FDIC (deposit guarantee fund), which would be insufficient for more than 90% of the deposits of SVB depositors — the vast majority Silicon Valley companies. Such a guarantee measure for all depositors had not been taken even during the financial crisis of 2007–2008.

The feeling is that, to paraphrase Marshall Berman's famous 1982 book, "all that is solid melts into air", the banking stress we have had recently was not the result of a long cycle of economic expansion with price stability, which was the case leading up to 2007, in what became known as the Great Moderation. On the contrary, the economies in general had been recovering from the effects of the COVID-19 pandemic, but without a vigorous growth cycle. In other words, it is not possible to talk about a trend of financial fragility *à la* Minsky.

To understand what happened, without claiming to exhaust the subject, we would like to raise two questions.

First, it is necessary to understand the nature of the banking firm: banks are maturity transformers, as they receive (or create) demandable deposits and raise funds in the short-term market by investing longer maturity assets (loans and bonds in general). This maturity mismatch allows them to offer risk sharing to depositors, but also exposes them to the possibility that all depositors could withdraw their deposits at any

time. If it can be priced that banks will have losses that threaten their net worth, then depositors quickly withdraw their funds.

The fear of insolvency of one bank raises concerns about the insolvency of other banks, and bank runs can generate a contagion effect that results in a "banking panic" and, consequently, a systemic crisis (and eventually a banking crisis). Usually, before this occurs, the central bank and regulators seek to act quickly to prevent a panic from ensuing due to a breakdown in confidence in the banking sector.

The economic literature in general shows that systemic risk can result from three phenomena: *i*) chain reaction, in which the initial failure of one bank leads to a series of other failures, given the strong interconnectedness of banks; *ii*) a result of a cyclical expansion of the economy that generates a tendency of financial fragility in the face of the increasing indebtedness of economic agents and consequent reduction in their margin safety; and *iii*) common shock, arising from a "macro shock" that produces simultaneous and adverse effects on the entire banking sector (an example is the convertibility crisis in Argentina in 2001).

Let us return to the current crisis. In the case of SVB's bankruptcy, its liabilities were concentrated in a poorly diversified clientele (and with deposits above deposit coverage) and its assets, in order to exploit gains in a low-interest rate environment, concentrated in long-maturity government bonds. As a banking firm that aims at maximizing its profits, SVB did not hedge such bonds against interest rate changes with the use of derivatives. With the rapid increase in the interest rate by the Federal Reserve– raising it from 0.25% in March 2022 to 5.0% in March 2023 — the market prices of these securities fell sharply, raising doubts about their long-term solvency, thus generating a crisis of confidence that led to the rapid withdrawal of deposits by clients. Note, however, that this is not a bankruptcy caused by an expansion of risky lending or by an exogenous shock hitting all or part of the banking sector. After all, in theory, what is a safer investment than government bonds, especially U.S. Treasury bonds?

Secondly, another factor highlighted by Minsky should be emphasized: the danger of a poorly regulated financial system. He was already showing concern in the 1990s with the deregulation of the North American financial system. What can be observed is that since the Trump administration there has been a relaxation of rules related to the Dodd-Frank Act of 2010, a law that aimed to repair regulatory failures and abusive and irresponsible conduct of financial institutions. By the Economic Growth and Regulatory Relief Act passed in 2018, SVB was exempted from the expanded supervision of regulatory bodies. There was also a 5-year exemption for compliance with the Volcker Rule, which limits banks from making speculative transactions, such as hedge fund and private equity investments, which allowed the SVB and other banks to invest in venture capital funds. In addition, the post-2008 regulatory reforms, which created the Financial Supervisory Council, did little to change the complex and inefficient institutional regulatory structure in the U.S.

Given that, it is very unlikely that we will have a financial crisis on a global level, as we had in 2007–2008, even as a result of the prompt reaction of the economic authorities. However, one of the lessons of the current banking stress is the need to take seriously the implementation of a regulatory framework sufficiently comprehensive and secure to reduce the probability of global banking stresses and even crises. We will conclude with a final reflection: the Fed finds itself in a trade-off, that is, to continue raising interest rates to control inflation that is not necessarily related to demand or to maintain and, perhaps, reduce the fed funds rate to ensure the stability of the North American financial system.