Fallout from Silicon Valley Bank collapse raises broader concerns over financial system

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Despite some easing yesterday of the turmoil which has hit the markets in the past two weeks—the shares of Deutsche Bank rose after sharp falls last week and First Citizens Bank acquired the failed Silicon Valley Bank—there is a growing recognition that deep-seated problems in the financial system are coming to the surface.

Their immediate cause is the actions of the Fed in response to the global financial crisis of 2008 and the market freeze of March 2020 when the central bank pumped trillions of dollars into the financial system to prevent a complete meltdown.

It achieved this objective, but only by the skin of its teeth, and its actions created the conditions for the eruption of the underlying crisis in a new form.

While Fed chair Jerome Powell has characterised SVB as an "outlier," and Fed vice chair Michael Barr sought to portray its problems as the result of poor management in testimony to Congress yesterday, its demise is the expression of deepening problems in the financial system that are being exposed by the ending of the ultra-cheap money regime which prevailed from 2008 to 2022.

When money was available virtually for free, SVB gorged itself on US Treasury bonds and other supposedly safe assets. But as a result of the Fed interest rate hikes over the past year, their market value fell below their book value. This meant incurring real losses when they had to be sold to meet the cash demands of depositors.

Recognising that, far from being an outlier, the SVB crisis was the sharpest expression of a worsening situation for a swathe of middle-sized banks that collectively play a major role in the US economy and financial system, the Fed instituted a new loan facility for banks earlier this month.

It enabled banks to obtain a loan using their Treasury bonds at their book value, rather than their market value, averting the need to sell them at a loss to meet the demands of depositors for cash.

And, according to Fed data, this facility is being widely used. Last week, banks borrowed a total of $163.9 billion, only slightly down from the $164.8 billion they borrowed the week before, compared to the normal weekly borrowing of around $10 billion.

But apparently even these measures are not sufficient, and the Fed is looking at ways to expand them, according to a report in Bloomberg.

The immediate focus of concern is the fate of the First Republic Bank which is in danger of going the same way as SVB and the failed Signature Bank. This is despite the depositing of $30 billion with it in an operation involving 11 major banks, organised by JPMorgan chief executive Jamie Dimon and Treasury Secretary Janet Yellen last week. First Republic's shares have plunged by more than 90 percent this month.

Because it is not allowed to take action with regard to particular banks, the Fed has to devise the new facility so that it is available to all, but crafted in such a way that First Republic can benefit.

As well as the problems of liquidity and solvency for banks, the deepening crisis is causing mayhem in the $22 trillion Treasury bond market, particularly at its shorter end.

An article by Joe Rennison in the *New York Times* last Friday expressed some of the concerns.

"In the typically tame market for government bonds, investors have been left reeling from some of the most chaotic trading conditions they have ever seen, entrenching concerns about the broader economy since the collapse of Silicon Valley Bank," he wrote, noting that the volatility struck "at the heart" of the financial system.

In the past two weeks the yield on the two-year Treasury note has moved within a range of 0.3 to 0.7 percentage points each day. Under so-called "normal" conditions daily shifts are a tiny fraction of this amount.

As Sonal Desai chief investment officer Franklin Templeton Fixed Income said: "These are monster moves for single days."

Another financial strategist, cited in the article, said he had never gone through what he was seeing now, which was "off the charts."

It is becoming impossible to ignore the fact that the immediate form of the crisis is rooted in the previous actions of governments and the Fed in mounting bailout and rescue operations.

Writing in the *Financial Times* (FT), financial analyst Ruchir Sharma, now chair of Rockefeller International, said while it is politically impossible for governments not to organise bailouts, the "snowballing problem" was one of their own making.

"The past few decades of easy money created markets so large—nearing five times larger than the world economy—and so intertwined, that the failure of even a midsize bank risks global contagion."

One of the justifications advanced by the Fed for its quantitative easing program initiated after the 2008 crisis—the aim of which was to enable speculation to continue with the virtually free money it provided—is that it would give a stimulus to the underlying real economy.

Sharma cited figures which dispose of this fiction.

"The rescues," he wrote, "have led to a massive misallocation of capital and a surge in the number of zombie firms, which contribute mightily to weakening business dynamism and productivity. In the US total factor productivity growth fell to just 0.5 percent after 2008, down from about 2 percent between 1870 and the early 1970s."

Long-time financial analyst and former Australian banker Satyajit Das, has taken issue with the outpourings of officials on the stability of the banking system in a *New Indian Express* column, reported on by the *Australian Financial Review*.

"If the authorities are correct," he wrote, "then why evoke the 'systemic risk exemption' to guarantee all depositors of failed banks? If there is liquidity to meet withdrawals, then why the logorrhoea [excessive and often incoherent talkativeness or wordiness] about the sufficiency of funds? If everything is fine, then why have US banks borrowed $153 billion at a punitive 4.75 percent at the discount window, a larger amount than in 2008–09?"

There is considerable unclarity about how the present crisis will develop. But one thing is certain: there will be a credit crunch that will hit all areas of the economy around the world.

An FT editorial, published at the weekend and summing up the crisis so far, said this would take place even if more banks were not toppled.

"Higher interest rates have already slashed lending to the real economy, and banks are likely to raise their lending standards even further in response to recent events. Property appears particularly vulnerable. If credit tightens significantly, a spiral of falling prices and defaults is possible. … Mortgage-backed securities held by banks are already taking a hit, a risking a self-reinforcing cycle."

The powers that be, who never acknowledge a crisis until crashes over their heads, hoping to prevent the working masses from drawing the necessary conclusions about the toxic character of the profit system they live under, are trying to pass off the crisis as merely a passing phase.

But this fiction has worn so thin that the FT editorial had to conclude: "Rather than a blip, this episode could be a sign of things to come."