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The Current Banking Quake: Where Does It Come from and What Should Policy Makers Do?

The crises at Silicon Valley Bank and Credit Suisse have shaken the world of finance. While policymakers and central banks are being placatory, the markets are not calming down. Banks that very recently seemed healthy are running into liquidity problems. Interest rate hikes by central banks are a major driver of the crisis. They cause the market value of bonds and other long-term assets such as real estate and stocks, previously inflated by expansionary monetary policy, to fall. At the same time, short-term interest rates are rising faster than long-term rates. As a result, banks must either grant account holders higher deposit rates or expect at least the more astute investors to withdraw their funds and invest them elsewhere on better terms.

Confidence that banks are solvent is critical to financial stability. But it is fragile. If there is even a suspicion that a bank cannot service all its customer withdrawals because it has invested the money for the long term, there is a risk of a bank run. All it takes for such a run is for customers to no longer trust their bank because they believe other customers do not. Since the banks are aware of the danger, they will also stop lending among themselves in such cases. Such a run is rational from the point of view of each individual customer, because those who withdraw their money first will still be served – the devil take the hindmost. Collectively, however, a bank run is irrational because it can drive a fundamentally sound bank into insolvency, meaning customers damage each other.

Let Bank Failures Never Again Burden Taxpayers with Bank Bailouts

Policymakers and central bankers understandably try to reassure bank customers and financial market players. They say that banks are sound, that lessons have been learned from the financial crisis, and that regulation has been changed so that banks hold more equity and are less susceptible to crises overall. They said never again should bank failures trigger economic crises and burden taxpayers with bank bailouts. At Credit Suisse, the government still had to step in and bail out losses. Apparently, the precautions were not enough.

In fact, the improvements are relatively scant. For example, banks are still allowed to purchase government bonds on a large scale without setting aside equity capital. Government bonds are considered risk-free, although they are not, as the current falling prices show. Scientific studies on the soundness of the banking system calculate bankruptcy probabilities and measure the capital available for liabilities in the event of a crisis. These studies do show improvements. But whether they are sufficient in real crises is questionable.

Not only conventional equity is considered liable capital. Certain forms of debt capital also provide for creditors to bear losses if necessary. With such instruments, however, there is a greater risk of contagion effects. The writing down of bonds amounting to EUR 17 billion at Credit Suisse, for example, has caused a lot of unrest on financial markets.

Stricter Capital Requirements Are an Important Part of the Solution

A better endowment with hard equity does not yet mean that a bank is better able to withstand a liquidity crisis or even a bank run. After all, it says nothing about how liquid the bank's assets are. Nevertheless, more equity capital helps here, too. First, a higher equity ratio strengthens bank customers' confidence that they will eventually get their money back even in the event of liquidity problems. In this respect, it lowers the probability that a bank run will occur in the first place. Second, more equity reduces the risk that government liquidity support will ultimately lead to losses that have to be borne by the taxpayer. It therefore makes it easier to provide liquidity support.

Overall, the risk of liquidity crises is part of the banking business insofar as it consists of accepting short-term investments and lending the money on a long-term basis. This risk can be contained by regulating liquidity. However, it cannot be completely eliminated, because maturity transformation does have an economic function. A government lender of last resort – usually the central bank – is ultimately indispensable for hedging against liquidity risks. However, the risk of liquidity crises leading to bank failures with losses for taxpayers can be minimized by way of stricter capital requirements. That is why policymakers should step up their game here, albeit not immediately, but rather once this crisis is over.

Central Banks Face a Dilemma

There are various calls for central banks to reduce their planned further interest rate hikes or to suspend them altogether. This is justified insofar as the deterioration in banks' scope for financing is likely to dampen the economy in a similar way to an interest rate hike, which also reduces inflationary pressure.

At the same time, central banks face a dilemma in terms of their response to the banking quake. An all-too-sudden reversal in interest rate policy would send the signal that central banks see financial stability as threatened, which in itself may further undermine confidence. Moreover, it could give the impression that central banks are making compromises in fighting inflation in order to preserve financial stability. This could drive up inflation expectations

in the private sector. In this dilemma, the central banks were right to implement the interest rate hikes of the last few days as planned, while at the same time indicating that further interest rate steps will depend on economic developments in the coming months.

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