Why the Banking System Is Breaking Up

Description

USA: The collapses of Silvergate and Silicon Valley Bank are like icebergs calving off from the Antarctic glacier. The financial analogy to the global warming causing this collapse of supporting shelving is the rising temperature of interest rates, which spiked last Thursday and Friday to close at 4.60 percent for the U.S. Treasury's two-year bonds. Bank depositors meanwhile were still being paid only 0.2 percent on their deposits. That has led to a steady withdrawal of funds from banks – and a corresponding decline in commercial bank balances with the Federal Reserve.

Most media reports reflect a prayer that the bank runs will be localized, as if there is no context or environmental cause. There is general embarrassment to explain how the breakup of banks that is now gaining momentum is the result of the way that the Obama Administration bailed out the banks in 2008 with fifteen years of Quantitative Easing to re-inflate prices for packaged bank mortgages – and with them, housing prices, along with stock and bond prices.

The Fed's $9 trillion of QE (not counted as part of the budget deficit) fueled an asset-price inflation that made trillions of dollars for holders of financial assets – the One Percent with a generous spillover effect for the remaining members of the top Ten Percent. The cost of home ownership soared by capitalizing mortgages at falling interest rates into more highly debt-leveraged property. The U.S. economy experienced the largest bond-market boom in history as interest rates fell below 1 percent. The economy polarized between the creditor positive-net-worth class and the rest of the economy – whose analogy to environmental pollution and global warming was debt pollution.

But in serving the banks and the financial ownership class, the Fed painted itself into a corner: What would happen if and when interest rates finally rose?

In *Killing the Host* I wrote about what seemed obvious enough. Rising interest rates cause the prices of bonds already issued to fall – along with real estate and stock prices. That is what has been happening under the Fed's fight against "inflation," its euphemism for opposing rising employment and wage levels. Prices are plunging for bonds, and also for the capitalized value of packaged mortgages and other securities in which banks hold their assets on their balance sheet to back their deposits.

The result threatens to push down bank assets below their deposit liabilities, wiping out their net worth – their stockholder equity. This is what was threatened in 2008. It is what occurred in a more extreme way with S&Ls and savings banks in the 1980s, leading to their demise. These "financial intermediaries" did not create credit as commercial banks can do, but lent deposits out in the form of long-term mortgages at fixed interest rates, often for 30 years. But in the wake of the Volcker spike in interest rates that inaugurated the 1980s, the overall level of interest rates remained higher than the interest rates that S&Ls and savings banks were receiving. Depositors began to withdraw their money to get higher returns elsewhere, because S&Ls and savings banks could not pay higher their depositors higher rates out of the revenue coming in from their mortgages fixed at lower rates. So even without fraud Keating-style, the mismatch between short-term liabilities and long-term interest rates ended their business plan.

The S&Ls owed money to depositors short-term, but were locked into long-term assets at falling prices. Of course, S&L mortgages were much longer-term than was the case for commercial banks. But the effect of rising interest rates has the same effect on bank assets that it has on all financial assets. Just as the QE interest-rate decline aimed to bolster the banks, its reversal today must have the opposite effect. And if banks have made bad derivatives trades, they're in trouble.

Any bank has a problem of keeping its asset valuations higher than its deposit liabilities. When the Fed raises interest rates sharply enough to crash bond prices, the banking system's asset structure weakens. That is the corner into which the Fed has painted the economy by QE.

The Fed recognizes this inherent problem, of course. That is why it avoided raising interest rates for so long – until the wage-earning bottom 99 Percent began to benefit by the recovery in employment. When wages began to recover, the Fed could not resist fighting the usual class war against labor. But in doing so, its policy has turned into a war against the banking system as well.

Silvergate was the first to go, but it was a special case. It had sought to ride the cryptocurrency wave by serving as a bank for various currencies. After SBF's vast fraud was exposed, there was a run on cryptocurrencies. Investor/gamblers jumped ship. The crypto-managers had to pay by drawing down the deposits they had at Silvergate. It went under.

Silvergate's failure destroyed the great illusion of cryptocurrency deposits. The popular impression was that crypto provided an alternative to commercial banks and "fiat currency." But what could crypto funds invest in to back their coin purchases, if not bank deposits and government securities or private stocks and bonds? What is crypto, ultimately, if not simply a mutual fund with secrecy of ownership to protect money launderers?

Silicon Valley Bank also is in many ways a special case, given its specialized lending to IT startups. New Republic bank also has suffered a run, and it too is specialized, lending to wealthy depositors in the San Francisco and northern California area. But a bank run was being talked up last week, and financial markets were shaken up as bond prices declined when Fed Chairman Jerome Powell announced that he actually planned to raise interest rates even more than he earlier had targeted, in view of the rising employment making wage earners more uppity in their demands to at least keep up with the inflation caused by the U.S. sanctions against Russian energy and food and the actions by monopolies to raise prices "to anticipate the coming inflation." Wages have not kept pace with the resulting high inflation rates

It looks like Silicon Valley Bank will have to liquidate its securities at a loss. Probably it will be taken over by a larger bank, but the entire financial system is being squeezed. Reuters reported on Friday that bank reserves at the Fed were plunging. That hardly is surprising, as banks are paying about 0.2 percent on deposits, while depositors can withdraw their money to buy two-year U.S. Treasury notes yielding 3.8 or almost 4 percent. No wonder well-to-do investors are running from the banks.

The obvious question is why the Fed doesn't simply bail out banks in SVB's position. The answer is that the lower prices for financial assets looks like the New Normal. For banks with negative equity, how can solvency be resolved without sharply reducing interest rates to restore the 15-year Zero Interest-Rate Policy (ZIRP)?

There is an even larger elephant in the room: derivatives. Volatility increased last Thursday and Friday. The turmoil has reached vast magnitudes beyond what characterized the 2008 crash of AIG and other speculators. Today, JP Morgan Chase and other New York banks have tens of trillions of dollar valuations of derivatives – casino bets on which way interest rates, bond prices, stock prices and other measures will change.

For every winning guess, there is a loser. When trillions of dollars are bet on, some bank trader is bound to wind up with a loss that can easily wipe out the bank's entire net equity.

There is now a flight to "cash," to a safe haven – something even better than cash: U.S. Treasury securities. Despite the talk of Republicans refusing to raise the debt ceiling, the Treasury can always print the money to pay its bondholders. It looks like the Treasury will become the new depository of choice for those who have the financial resources. Bank deposits will fall. And with them, bank holdings of reserves at the Fed.

So far, the stock market has resisted following the plunge in bond prices. My guess is that we will now see the Great Unwinding of the great Fictitious Capital boom of 2008-2015. So the chickens are coming hope to roost – with the "chicken" being, perhaps, the elephantine overhang of derivatives fueled by the post-2008 loosening of financial regulation and risk analysis.

Category

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