MAKING SENSE OF *THIS* WORLD

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Banking Crisis: Could The "Doom Loop" Return?

A few weeks ago, a series of banks across the Atlantic fell into trouble. In the US, as we discussed in our previous column, the Silicon Valley Bank went into receivership as the rise in policy and market rates made the simple, poorly managed business model of the bank (namely, gathering cash deposits and investing them in long-term Treasury bonds) miserably fail. Last week, the Fed released a report on this failure and blamed both the poor risk-management of the bank, which did not hedge against the interest rate risk and maturity mismatch, as well as the too-soft supervisory oversight by regulators. According to the Fed, the regulators' action was weakened by the reforms made during Trump era, which had called for a less intrusive approach.

The other US banks that were in trouble were Silvergate and, in particular, First Republic Bank. In the latter case, a group of 11 banks pooled resources to put together a rescue plan worth around $30 billion, in an attempt to stop the slide on the banks' equity prices, which had collapsed by 90% from their peak of $219, reached at the end of 2021. As we said in our column, "It is not yet clear whether this rescue plan will be effective, as the fall in the banks' equity prices has not yet stopped." Now we know it has not worked, because the Fed has asked other financial institutions, including JP Morgan and PNC, to express an interest in the acquisition of the bank.

In Europe, Credit Suisse was acquired by UBS with a "burden-sharing" approach that left everybody unhappy, apart from the management of Credit Suisse which got away with some form of a golden parachute. Most importantly, the market quickly turned its eyes against what was perceived to be the next weakest link, Deutsche Bank, which underwent severe stress when a small bet on its credit default swaps (CDS) hit the market.

Regulators across the board are trying to say that these are idiosyncratic cases, which do not necessarily need to be precursors of a more systemic financial instability episode. We dissent from this interpretation, for the following reasons.

First, all banks have been subject to the same shock, which was the rapid, large, coordinated increase in interest rates across the globe. Up to a certain point, for well-managed banks, higher rates are a bonanza, as banks can charge more for the money lent, while being slow in adjusting the remuneration of their deposit, in the absence of real competition. But above a certain level (that the Fed named r**), higher rates are detrimental because of their impact on overall financial conditions and on the strength of the economy, which is the most relevant factor in determining the ability of borrowers to repay their debt.

Second, as I argued at the recent G30 meeting in Washington, the apparatuses that have been put in place after the GFC to avoid a repetition of the serial banking failures of that period may not be proving fit for purpose. The return of blanket guarantees on deposits and the fact that regulators, instead of resolving troubled banks, always try to sell them to larger willing institutions, suggest that the instruments devised to resolve crises may have not worked when tested against reality. In this respect, it is scary to note that the total assets held by the *two* FDIC-insured banks that have failed in 2023 (at USD 319bn) are almost as large as the *combined assets of all failed* banks in 2008.

Third, as a consequence of the first two points, the risk remains that an episode similar to what happened to Deutsche Bank a few weeks ago may repeat itself. If it does, the government might then panic and announce that ALL deposits will be guaranteed. In 2008, this was the beginning of the end for Ireland, which first announced a blanket guarantee on deposits. This put the government in a very precarious position, from which it was rescued only by the ECB activating an ELA and the government issuing a promissory note. This was the beginning of the doom loop between government debt and banking debt that worsened the Euro crisis and proved hard to break. If a government were to do that again - and a simple line during the evening news such as "all deposits will be guaranteed by the government" may be enough for it to happen - we may see a return of the "doom loop." At that point, central banks, even if they are busy fighting inflation, would need to reconsider their stance and prioritise the solvency of the government and the banking system over the fight against inflation. They might need to cut rates and re-start QE.

As we have said, during the 2007-2008 financial crisis, it took one year between the Northern Rock bank run and the collapse of Lehman Brothers. This is the reason why it is essential that regulators, in the year ahead, will try to "fix the roof until the sun shines", as Christine Lagarde used to say when she was the head of the IMF, and adopt the necessary reforms to prevent the isolated cases of recent days from becoming systemic events in one year's time.

For this reason, Michael Barr, the Fed's bank-supervision chief, called for an overhaul of how the Fed oversees US financial firms. The Fed will revisit the various rules that apply to institutions with more than USD 100 billion in assets, including stress-testing and liquidity requirements. Regulators could require additional capital or liquidity, or limit share buybacks, dividend payments, or executive compensation when firms exhibit inadequate capital planning and poor risk management.

Looking Ahead

The Week Ahead: EZ Headline Inflation To Rise; Unemployment To Rise In US, And To Stay Same In EZ; CBs To Tighten Policy

In the US, in April, S&P Global Manufacturing and Services PMIs are expected to edge up to 50.4 (*p*: 49.2) and 53.7 (*p:* 52.6). Composite PMI is seen rising to 52.3 (*p:* 53.5). Unemployment rate is likely to rise to 3.6% (p: 3.5%) and NFPs are likely to rise by 180K (*p:* 236K).
In the EZ, in April, headline inflation is seen increasing to 7.0% (*p:* 6.9%), while core inflation is likely to stay the same at 5.7% y-o-y. In March, unemployment rate is expected to remain at 6.6%. In April, HCOB Manufacturing PMI is seen falling to 45.5 (p: 47.3), whereas services PMI is likely to increase to 56.6 (*p:* 55). Composite PMI is expected to increase too to 54.4 (*p:* 53.7).
In the UK, in April, S&P Global Manufacturing PMI is expected to edge down to 46.6 (*p*: 47.9). Services and Composite PMIs are seen edging up to 54.9 (*p:* 52.9) and 53.9 (*p*: 52.2) respectively.
CBs to tighten policy stances. In US, the Fed is expected to increase its target Fed funds range by 25 bps to 5.0% - 5.25%. In the EZ, the ECB is also expected to raise its main policy rate by 25 bps, i.e it will raise its *i)* interest rate on the 'main refinancing operations' to 3.75%; *ii)* interest rate on the 'marginal lending facility' to 4.0%; and *iii)* 'deposit facility' to 3.25%.

The Quarter Ahead: Drone Attack On Oil Depot In Crimea; 5 EU Countries To Allow Ukrainian Food Exports; Biden Announced Bid

War In Ukraine. A reported-to-be Ukrainian drone strike sparked a massive fire at a fuel storage facility in the Russian-occupied Crimean port city of Sevastopol. The death toll from Russia's aerial attacks on cities across Ukraine early on Friday has risen to at least 25, including children.
Zelenskyy called for removal of restrictions on Ukrainian food exports. After temporary bans were imposed on food amid farmer protests, Bulgaria, Hungary, Poland, Romania and Slovakia have agreed a deal to allow the transit of Ukrainian food exports. 5 EU member countries are going to allow certain products from Ukraine without quantitative restrictions, customs and official inspections.
Biden announced re-election bid. Biden argues he needs more time to "finish this job". Biden plans to point to his work over the past two years shoring up American alliances, leading a global coalition to support Ukraine's defenses against Russia's invasion and returning the U.S. to the Paris climate accord.

Last Week's Review

Real Economy: QoQ GDP Decelerated In US, And Rose Slightly In EZ; Inflation Felll in Germany, While Rose In France

In the US, according to advance estimate, in Q1, GDP decelerated to 1.1% q-o-q (*c:* 2.0%; *p:* 2.6%). In March, PCE and core PCE price ease off to 4.2% (*p:* 5.1%) and 4.6% y-o-y (*c:* 4.5%; *p:* 4.7%).
In the EZ, according to flash estimates, in Q1, GDP advanced by 0.1% q-o-q (*c:* 0.2%; *p:* 0.0%) and decelerated 1.3% y-o-y (*c:* 1.4%; *p:* 1.8%). In April, economic sentiment increased to 99.3 (*c:* 99.9; *p:* 99.3) and consumer confidence shrank to -17.5 (*c:* -17.5; *p:* 19.2).
In largest EZ economies, according to preliminary estimates, in Q1, the economy: *i)* decelerated to 0.2% q-o-q (*p*: 0.0%) in France as expected; *ii)* stagnated (*c:* 0.2%; *p:* -0.5%) in Germany; and *iii)* advanced by 0.5% q-o-q (c: 0.2%; *p:* -0.1%) in Italy. In April, the inflation rate: *i)* rose to 5.9% y-o-y (*c:* 5.7%; *p:* 5.7%) in France; and *ii)* eased off to 7.2% y-o-y (*c:* 7.3%; *p:* 7.4%) in Germany.

Financial Markets: Stock Prices Were Mixed, While Bond Yields Increased; Dollar Index and Oil Prices Fell, While Gold Prices Rose

Market Drivers: In US, the stocks performed well, boosted by big tech rallies. In Europe, shares moved down, as investors are pessimistic that ECB rate hike would tip the economy into recession. EZ bond yields fell on weaker than expected economic growth.
Global Equities: Increased *w-o-w* (MSCI ACWI, +0.4%, to 655.00). The US S&P 500 index edged up (+0.9% w-o-w, to 4,169.48). In the EZ, share prices were down (Eurostoxx 50, -1.1% w-o-w, to 4,359.31). In EMs, equity prices moved down (MSCI EMs, -0.4%, to 977.05). Volatility fell to 18.5 (VIX S&P 500, 52w avg.: 24.6; 10y avg.: 18.5).
Fixed Income: *w-o-w*, the 10-year US treasury yields were down (-14 bps to 3.43%). The 2-year US Treasury yields also decreased (-16 bps to 4.02%). The German 10-year bund yield edged down (-17 bps to 2.32%).
FX: *w-o-w,* the US Dollar Index declined (DXY, -0.1%, to 101.7; EUR/USD +0.3%, to 1.1). In EMs, currencies decreased (MSCI EM Currency Index, -0.1% w-o-w, to 1,687.35).
Commodities: *w-o-w,* oil prices decreased (Brent, -1.7% to 80.26 USD/b). Gold prices rose w-o-w (+0.9% to 1,999.40 USD/Oz).

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The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*