



R&R Weekly Column
By Brunello Rosa



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.

Our Recent Publications

🦋 [Looming Instability for Turkish Politics: An Explainer on the Upcoming Turkish Elections](#), by London Politica, 27 April 2023



[The AUKUS Alliance and Its Implications For the Indo-Pacific](#), by London Politica, 19 April 2023

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 Fell 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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Abbreviations, Acronyms and Definitions

a	Actual	LN	Northern League, Italy
AKP	Justice and Development Party, Turkey	MSS	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



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