



# Monetary Policy as a Cause of Banking Crises

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***Roundtable: A Turbulent World and Prospects  
for Future Development***



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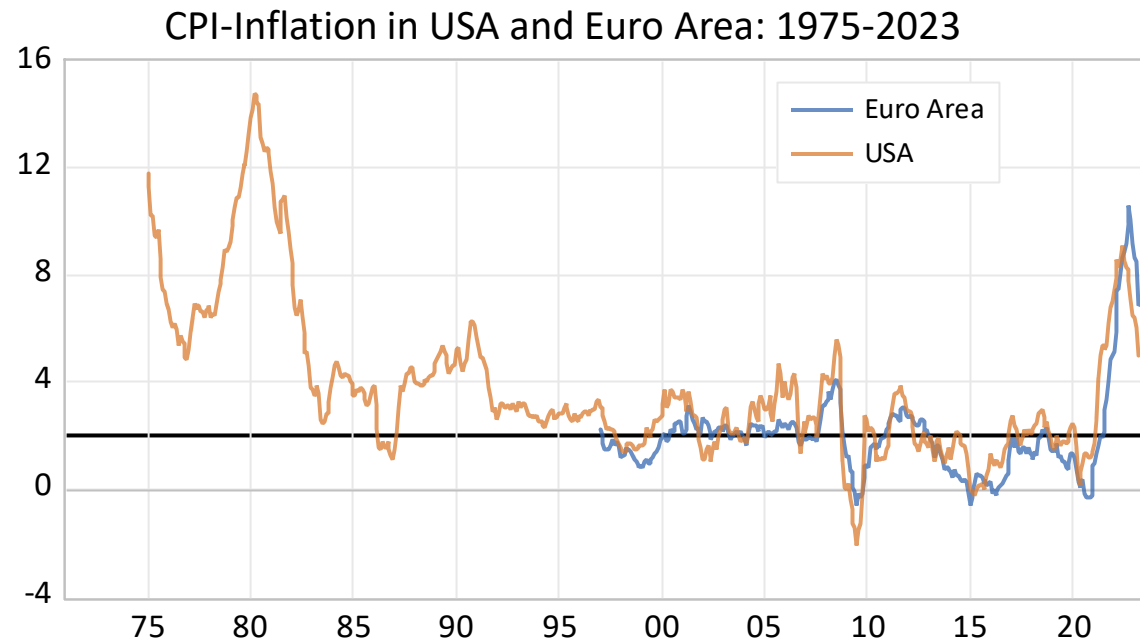
# Return of Inflation

## Large increase of inflation worldwide

- Especially **food and energy**
- **Core inflation** also increased
- Partly caused and amplified by **Russo-Ukrainian war**
- Increased **inflation divergence in Euro Area**
  - Minimum: Luxembourg: 2.7%
  - Maximum: Latvia: 15.0%
  - Average: 7.0%
- **Started in 2021** (values for Dec. 2021):
  - USA: 7.0%
  - Euro Area: 5.0%

# Return of Inflation

- Two-digit inflation in the US in the **second half of the 1970s** (“Great Inflation”)
- Successful **Volcker disinflation** 1979-82
- Low inflation rates since second half of the 1980s
- Is the surge of inflation in 2022-23 short-lived or will there be strong 2<sup>nd</sup> round effects?





# Monetary Policy: USA and Euro Area

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## Mandates of Central Banks

### **Federal Reserve System (Fed): Goals of**

- Maximum employment,
- Stable prices and
- Moderate long-term interest rates

### **European Central Bank (ECB): Primary objective**

- Maintain price stability

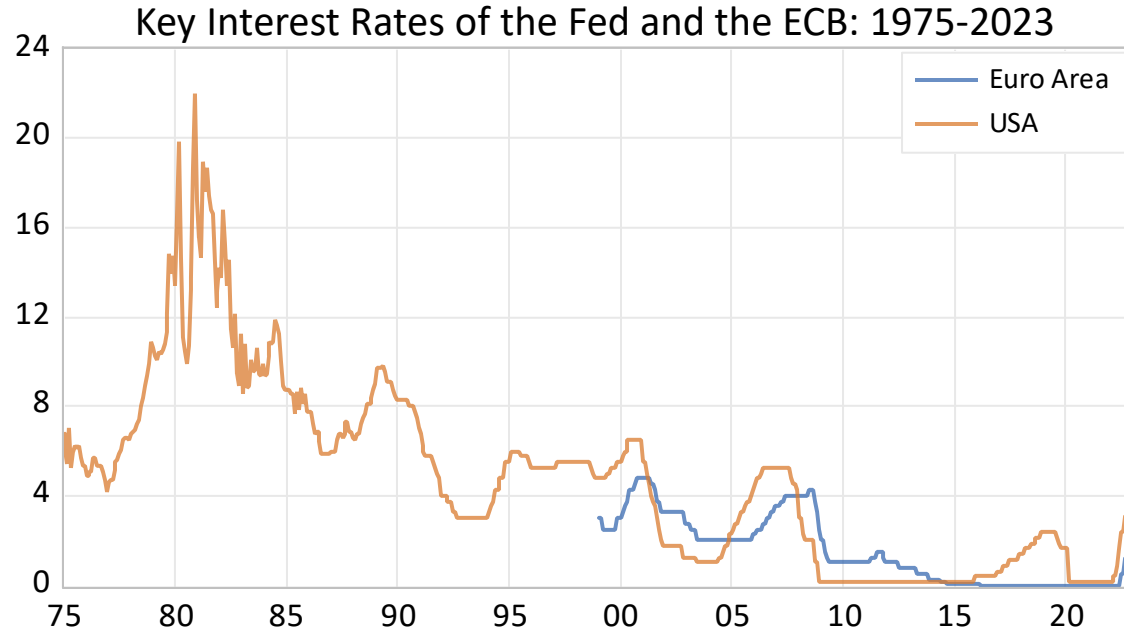
### **Mandate of financial stability?**

### Instruments: **Short-term interest rates** (key interest rates)

- Fed: Federal funds target rate (FFTR)
- ECB: Interest rate of main refinancing operations
- Both: **Quantitative easing** when key interest rate is at zero

# Monetary Policy: USA and Euro Area

- **Volcker disinflation** with very high and volatile key interest rate (1979-82)
- FFTR too low for too long after bursting of **dot.com bubble** (2001-04)
- Tight monetary policy contributed to **subprime crisis** (2007-2009)
- FFTR too low for too long (2010-15, 2020-22)
- Tightening contributed to **banking turmoil (2023)**

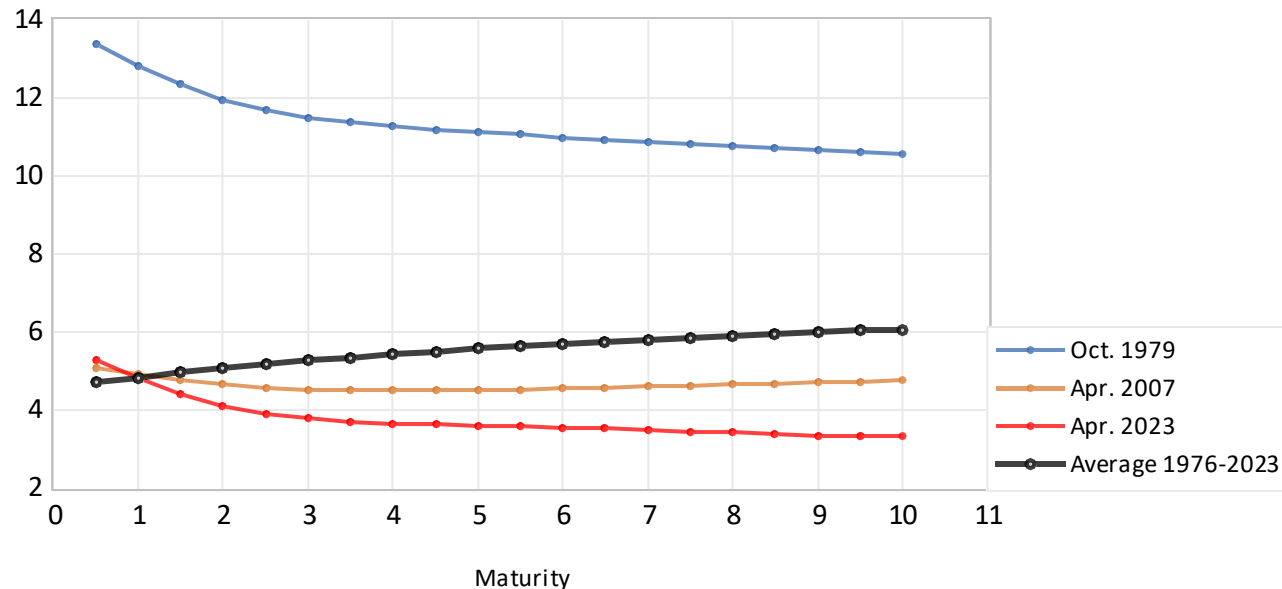


# Effects on the Banking System

## Effects of tight monetary policy:

- **Policy rate effect:** Short-term interest rates increase
- **Credibility effect:** Long-term interest rates decrease
- Twist of the term structure of interest rates: **Inverse term structure**

Selected Treasury Spot-rate Curves: USA 1976-2023



# Effects on the Banking System

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Business model of commercial banks: **Maturity transformation**

- **Short-term liabilities** (deposits)
- **Long-term assets** (loans, bonds)

**Effects of inverse term structure of interest rates:**

- Squeeze on profits
- **Loss** on bond and loan portfolios
- Danger of a **bank run**
- **Fire sales** realize and magnify losses



# Effects on the Banking System



Cover of The Economist on **January 12, 2006: Danger time for America**

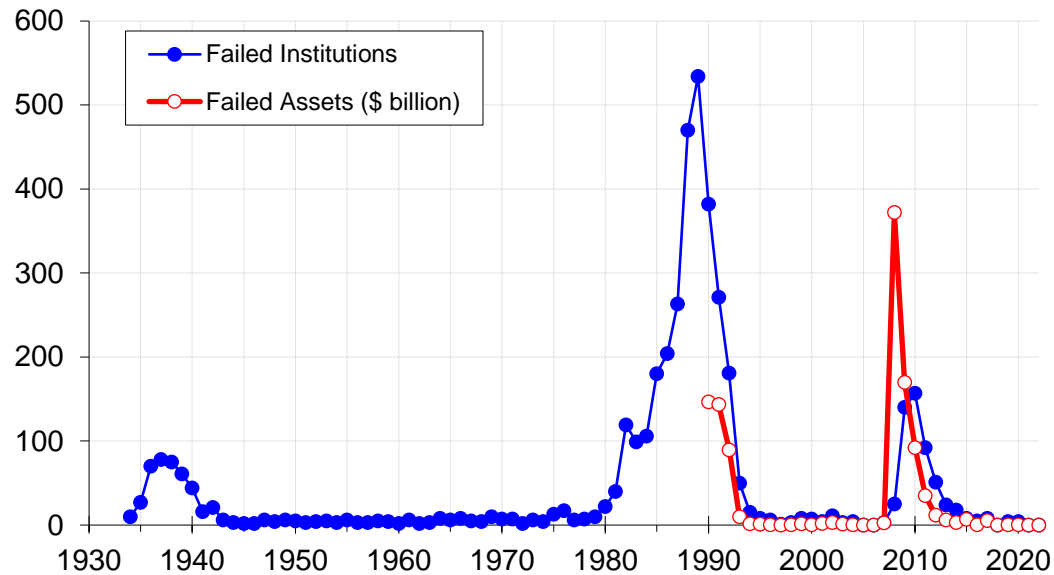
Alan Greenspan hands over, as chairman of the Federal Reserve, to Ben Bernanke at the end of January, 2006.

The Fed is in the middle of **increasing interest rates**.

**Dynamite** as a relay baton

# Banking Crises and Banking Turmoil

Closing and Assistance Transactions of the FDIC 1934-2022



- Banking crisis in the **late 1930s**
- Massive banking crises in the **1980s** and **1990s**
- Subprime crisis: **2008-2009**



# Banking Crises and Banking Turmoil

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## Current turmoil of banking sector (March and April 2023)

Fallout from the bankruptcy of the **cryptocurrency exchange FTX**

- **Silvergate Bank**: liquidated
- **Signature Bank**: sold to New York Community Bank

Victims of **bank runs**:

- **Silicon Valley Bank**: sold to First Citizens Bank
- **First Republican Bank**: sold to JP Morgan
- **Credit Suisse**: sold to UBS

# Conclusions

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- Monetary policy tends to **be too expansionary for too long**.
- Is there **fiscal and financial dominance** of monetary policy?
- Tight monetary policy puts **stress** on the banking industry.
- Whether the banking **turmoil** in the US and Europe will lead to a banking **crisis** is uncertain.
- Will central banks put increases of key interest rates on hold to ease the strain on banks?
- Crises can have very different **causes** (deregulation, pandemic, war etc.)
- **What crises** will us hit us next and **when**?

