

## **Weekly Commentary 11 – Mar 2023**

*Banking Crises and What It Will Take to Solve Them.*

The several bank failures which have occurred in as many days in the US and Europe have led to numerous comparisons with the other big event in which banks have blown up. That was the Global Financial Crises of 2008.

I have stated in last week's Weekly Commentary, as well as the five intervening Daily Reports that I am not one to believe that the current banking woes are the same as the GFC. I am not even of the mindset, at least for now, that banks will fall like dominoes, like they did in 2008. There is no need to cry wolf when we see a dog, even if that dog is snarling with bared teeth and foaming at the mouth.

That, however, does not mean that I completely rule out that it will not get worse before it gets better.

When this upcoming disaster management cycle ends, the result would obviously not depend on what I think. It depends on the fellas who are actually managing the disaster, which includes the President of the United States, his economic officials and the politicians who create the general political climate in the country now starting on the next election cycle. I am willing to say that given the nature of the current problem, there are all the tools available for these folks to pacify the markets and solve the problem effectively. Based on the track record of these tools, in the history of their deployment, I do not expect the problem solvers to fail.

But there is a caveat.

The caveat is that these economic warriors must be sensible, and not ideological. If instead, they turn out to be complete idiots and do all the wrong things, then hey, all hell may still break loose. It's like saying that in the Ukraine war, I don't expect WW3 to break out from that conflict. But if there is a war-monger like Senator Lindsey Graham who calls for the US Air Force to shoot down Russian fighters after one such fighter peed on an American drone over the Black Sea and brought it down, then all bets are off. If the USAF takes orders from crazies like Graham, the shit that will hit the fan would be so abundant that we will have to swim in it. You cannot stop morons and assholes from harming themselves, as well as the rest of us.

The same is true of economic ring-fencing. Logically, and assuming normal human competence, we should not have too many negative consequences emanating from a deployment of the current tools available to the American and European central banks, as

these are sufficiently powerful to overcome the existing problem. That is to say, only if there is no Lindsey Graham talking shit on how the central banks should do their jobs.

It is almost with a sense of relief that I don't recall any American politician stepping forward to demonstrate leadership in economics and the running of the economy. All that they are programmed like robots to say is that irreverent Reagan line, "we can do no better than the free market and we should just leave it alone". The less they say, the better.

But of course, it has not been argued, alternatively, that Silicon Valley Bank is the financier of entrepreneurs and venture capitalists and so is Signature Bank, the home court of New York based crypto-cowboys. And across the pond, Credit Suisse is advisor to tycoons and magnates, or their families, and all three banks stand on the frontiers of capitalism. Yet, they stumbled. Clearly, Adam Smith did not write a canon on bank regulation and management. And any whisperings of "leave it to the market" in bank regulation is really just a convenient excuse to dodge supervisory responsibility.

And when these free-market types are guaranteed on their deposits by the government, they cheered, something of a hypocrisy when they will castigate governments when these get in to protect other depositors.

The hand book on what to do in prudential banking risk management can be traced back only to about a century ago, when Franklin Delano Roosevelt did a pretty good job managing the bank failures of his era. The lessons of that period for proactive government action have been applied, with varying success, since then. But perhaps, he was helped in his quest to end bank failures and the Great Depression, by a more determined effort to get involved in WW2 which unleashed the manufacturing potential of the US of A. In the context of WW2, FDR was brilliant. If another president today were to adopt his policies, nuclear Armageddon will consume us all.

Since that time, the other attempts by capitalist governments to manage their banks have been far less successful. I say that without hesitation, because as I have said in the last Weekly Commentary, it is my distinct recollection, having spent 40 plus years in the financial sector, that I have seen banking collapses happen with such regularity that I am inclined to believe that banking must actually be the worst managed industry in the world. Or perhaps to be more generous, bankers are lousy businessmen, because the only thing they seem to know how to do is to lend to real estate earning a margin of 3 percent when they are right, and losing 100 percent of the loan when they are wrong. What kind of business model is that?

It seems apparent that bankers like to think that their risks are always adequately covered by land and buildings which is fine for peasants who love their land. But peasants don't manage banks. No, banks pay multi million dollar salaries to MBAs, not peasants, to do the job and yet, invariably, every few years, the world witnesses banking crashes like clockwork. There

seems to be a running competition for which country has the largest banks in the world, and how long they can be mismanaged until they crash into oblivion.

In the last forty years in which I have followed banking self-destruction, I have seen the top global ranks of banks come from the US, Japan, the UK, France and now China. The names which we, as laymen, get comfortable with, arise mostly from slick advertising, starting with banks invariably trying to fool their customers by hiding their offices inside huge edifices, many with Roman or Gothic columns that would convey the impression that their banks would last a thousand years. That is all brain washing, because it is more likely that those banks with the formidable front, will be bankrupt in the next bank crisis. The Continental Illinois Bank in Chicago had put out such messaging as did many financial institutions housed in the Lower Wall Street-Water Street area before 2008. The Japanese banks also used to be headquartered in magnificent Tokyo skyscrapers with typically minimalist décor in marble and steel. Where are most of these banks now? If case you don't remember, they have all gone bankrupt.

A safe way to consider what is a prudent bank is not to look at how impressive their HQ building is, but how good their balance sheets and business models could make money from a normal interest rate yield curve. And you should not be surprised if you discover, lo and behold, they lend mostly to real estate, time and again. Or that they fail, time and again, for the same goddamned reasons.

For those of you who are parents who believe that a great career path for your next generation is banking, think again. Put them into a hedge fund instead. At least hedge fund managers are trained to cut loss long before their assets go to zero, a valuable skill in today's environment of multipolar economics and the shifting sands of competitive big power politics.

The above is a concise qualitative recollection of the most recent 30-40 years of the history of banking failures. Entirely my take. Quantitatively, there were two great banking disasters in that period. In the first, all the Japanese banks that were ranked BIGGEST in the world during the 1980s, with names like Dai-ichi Kangyo Bank, Bank of Tokyo, Sanwa Bank, Sumitomo Bank, LTCB, Fuji Bank, Mitsubishi Bank, Mitsui Bank to hold our admiration. Remember them? By the mythology of their era, not only were most of them in the list of top ten banks in the world, they were said to be so strong that the worst Japanese earthquake would not bring them down. Today, all those names have "disappeared" and if you google for the largest Japanese banks today, you will find MUFG, Mizuho Group, Sumitomo-Mitsui Financial Group and so on. Mostly unrecognizable names, these are the new banks with a history of not more than 20 years. The Japanese banking giants of today all contain bits and pieces of the different banks that were blown to pieces during the banking crisis of the mid 1990s. Euphemistically, the old giants were "merged" together hastily to form the new banks. In reality, they were all bankrupted by lousy business models.

The extracts from the following article published by the National Bureau of Economic Research (Japan), explain briefly what happened.

*In Japan, a variety of banks have been consolidated since the 1990s when most banks suffered from a huge amount of non-performing loans. The number of city banks, which operate nation-widely and internationally, remained at 13 during the 1980s but decreased almost by half to 7 in 2005. While the number of first-tier regional banks, which operate in one or a few prefectures, virtually did not change over the last two decades (63 in 1980 and 64 in 2005), the number of second-tier regional banks, which are smaller than first-tier regional banks and operate mainly within a prefecture, decreased from 71 in 1980 to 48 in 2005. The number of cooperative 3 (shinkin) banks, which are deposit-taking cooperatives operating within a prefecture and specializing in small and medium-sized enterprise (SME) loans, also dropped from 462 in 1980 to 301 in 2005.*

*M&As in the banking industry occurred only when the government requested healthy banks to acquire failing banks. As the financial liberalization made progress in the 1980s, the regulatory authorities found it more and more difficult to maintain the convoy system; healthy banks had little incentive or capability to rescue failing banks. In the early 1990s, stock prices and land prices fell sharply, which hit hard banks' asset quality. Risk-based capital requirements based on the Basel capital standards, introduced in fiscal year 1992, spurred consolidation of weak banks. Two mergers among city banks and three mergers among regional banks occurred in the first half of the 1990s (Table 1). Mergers among shinkin banks also occurred more frequently in the 1990s than before. Despite the introduction of the Basel capital standards, which were supposed to be rule-based regulations, financial regulations and supervisions by Ministry of Finance were still affected by political pressure until a banking crisis occurred in 1997, when three large financial institutions, including a city bank named Hokkaido Takushoku Bank, failed. In 1998, two long-term credit banks named the Long-Term Credit Bank of Japan and the Nippon Credit Bank failed.*

*In response to the severe banking crisis, the Japanese regulatory authorities introduced prompt corrective actions in 1998, applied stringent accounting standards in implementing the Basel capital standards, and recapitalized banks. Taiyo Kobe Bank was acquired by Mitsui Bank in 1990 and Saitama Bank was acquired by Kyowa Bank in 1991. The government's resolutions of the failed "Jusen," nonblank finance companies specialized in housing and real estate loans, were severely criticized by the public that the government rescued agricultural cooperatives that had invested in Jusen and had a strong political influence. The Financial Supervision Agency (FSA) was built and took over financial supervisions from Ministry of Finance in 1998. FSA refrained from "arranging" mergers, not intervening in bank mergers to rescue weak banks.*

*Major banks tried to survive through mergers, resulting in the merger wave in the early 2000s. Financial Rehabilitation Plan, released by Takenaka, Minister of Financial Services Agency, in October 2002, forced major banks to apply strict accounting standards and to reduce their non-performing loan share to a half, urging weak banks to be consolidated. Seven mergers among major banks occurred from FY 2000 to FY 2002.*

*Mega banks are now reorganized into three groups (Mizuho, Mitsui-Sumitomo, and Mitsubishi-UFJ). The government also promoted consolidation of regional banks and shinkin banks. New legislation*

*has enabled the government to recapitalize a consolidated bank since 2002-3. Six mergers among regional banks occurred from FY 2000 to FY 2004.*

*13 bank mergers discussed in Section 3 have some implications concerning the time when and the space where M&A waves occur. First, if M&As are driven by the motivation for improving efficiency, then merger waves result from shocks to an industry's economic, technological or regulatory environment. These shocks lead to industry reorganization.*

And the background of the mergers and consolidation in Japanese banking were analysed by the Asian Development Bank in this manner:

*First, bank loans were overextended particularly in risky areas with inadequate supervision and regulation over banks during the bubble period. Specifically, loan portfolios were concentrated in property-related businesses such as construction, real estate, and nonbank financial services. As most of these loans were collateralized by land whose values plummeted after the bubble burst, and cash flows were inadequate to repay the loans, these became nonperforming.*

*Second, banks were allowed to hold common stock on their balance sheet and had accumulated sizable unrealized capital gains, boosting their capital base. The bursting of the stock price bubble reduced these unrealized capital gains and eroded the value of capital reserves of many banks. The decline of their capital base damaged banks' ability to extend loans and take risks. In fact, the amount of bank loans outstanding declined from the peak in 1997 until the mid-2000s, despite government efforts to avoid a credit crunch, partly due to weak demand from industry for funds. Third, the economic slowdown and price deflation in the 1990s also led to the growing levels of NPLs, especially in the late 1990s and the early 2000s.*

*If macroeconomic policy is not well managed to support the real economy, then more loans will become nonperforming and NPL levels will increase. This could delay economic recovery as capital constrained banks tend to discourage credit growth.*

*The initial policy adopted by the Ministry of Finance (MOF) was intended to protect ailing banks through regulatory forbearance and other forms of support, while gaining time for a hoped for recovery of economic growth and asset prices. The failure of Toho Sogo Bank in 1991 was the first bank failure in the postwar period in Japan. In 1994 and 1995, failures of small financial institutions accelerated. In 1995–1996, the government injected JPY680 billion to deal with jusen, specialized, nonbank housing loan companies. This policy was unpopular politically, and the government was heavily criticized for bailing out the nonbank financial institutions. As nonbank mortgage finance companies, jusen were less strictly regulated, and thus more aggressive in their lending to real estate-related small businesses than larger commercial banks during the bubble period. Large commercial banks, constrained by stricter oversight, essentially financed jusen and often exercised influence over their business.*

*The unpopularity of jusen intervention discouraged the MOF from pursuing policies to use public funds to address bank balance sheet problems. The government did make efforts to contain the emerging difficulty in the banking sector without using public funds. In June 1996, the deposit*

*insurance system was strengthened through a major amendment of the Deposit Insurance Law including a temporary suspension of limits on deposit protection—at first, until March 2001, then extended to 2002, and after another amendment in 2002, eventually until March 2005—(thereby introducing a blanket guarantee of bank deposits), and an increase in the insurance premium from 0.012% to 0.084% of total deposits outstanding.*

*Growth began to resume in 1995–1997, but the adoption of tight fiscal policy and the outbreak of the Asian financial crisis sent the economy back to recession. This fueled the banking crisis in Japan, which became acute in late 1997, affecting large financial institutions and major banks. Stagnant economic conditions and falling asset prices intensified market pressures, leading to the 1997–1998 systemic banking crisis. The pressure exerted by the crisis forced the government to take much more decisive action than in the earlier years.*

*In the fall of 1997, Yamaichi Securities, one of the four largest security houses, collapsed and a medium-sized one, Sanyo Securities, also failed. These security houses were not able to obtain short-term funding in the Japanese interbank market due to their heightened risks as judged by market participants.*

*Hokkaido Takushoku Bank, a city bank, became unable to raise funds in the interbank market and had to announce its discontinuation of business operations in November 1997. Subsequently, the premium for offshore foreign-currency interbank loans extended to Japanese banks by foreign banks, called the “Japan premium”, surged from the fall of 1997 through the spring of 1999.<sup>2</sup>*

*2.3 Decisive Policy Action (1998–2001).*

*The government announced in December 1997 that up to JPY30 trillion of public funds would be made available to the Deposit Insurance Corporation of Japan (DICJ) by March 1998—comprised of JPY13 trillion to bolster bank balance sheets and JPY17 trillion to strengthen the deposit insurance system.<sup>3</sup> Public funds were augmented to a total of JPY60 trillion—more than 12% of gross domestic product (GDP)—at DICJ for financial support for banks in October 1998.<sup>4</sup> Public funds totaling JPY1.8 trillion were injected to the 21 major banks in March 1998 to help banks meet the required capital adequacy standards. Nevertheless, the government had to intervene in two major banks, the Long-Term Credit Bank of Japan (LTCB) and Nippon Credit Bank (NCB) which were temporarily nationalized in October and December 1998, respectively. Both banks had problems with mismanagement in their loan portfolio during the bubble period and thereafter. Their shares were acquired by DICJ with zero value and, after the restructuring of their assets, they were put on sale to the private sector.*

*In order to induce buyers, the government guaranteed all assets of LTCB at the sales date for three years if they went bad (a “put” option), while NCB was sold without such support.<sup>5</sup> It turned out that JPY1.8 trillion was not enough to fully recapitalize the ailing banking system. As a result, JPY7.5 trillion more of public funds were injected into 15 banks in March 1999.*

*The second recapitalization operation encouraged private sector-driven capitalization and thus improved banks’ capital adequacy ratios and addressed bank NPL problems. By the spring of 1999, banking sector stability was largely restored and the “Japan premium” narrowed substantially. The authorities had long refused to recognize the full extent of bank NPLs. However, the 1997–1998 crisis*

*forced the authorities to assess the solvency and soundness of the balance sheets of individual banks. The bank regulatory agency, together with the Bank of Japan, identified the total amount of NPLs of all banks to be JPY34 trillion, including JPY22 trillion for major banks, as of March 1999. However, these inspections were based solely on 2 See Nakaso (2001) for detailed accounts of the banking sector crisis and distress in the 1990s, particularly as viewed from the Bank of Japan's perspectives.*

To put it simply, these banks all believed their own hype that Japanese real estate and stocks were infallible and they lent/invested heavily in those assets. I was there in the 1980's and the common refrain was heard about Ginza property and the Nikkei going to the moon. Just Ginza alone would be more valuable than the whole of California. (I heard those same silly notions again when bitcoin was in vogue). They were all blown apart and in Japan, 13 banks became 3.

In the end, they managed to reform the banking industry, and not blow up the entire country. But the effort did not escape punishing costs. Firstly, the economy went through thirty years of slow growth, with some years doing a trifling 1.2% of GDP growth in succession. And even after the bank system was reformed, Japan as Number One, as described by Ezra Vogel, became a flash in the pan. Soon after the banking mergers, by 2014, China overtook Japan in economic performance irreversibly. Japan now trails far behind China.

The next humongous banking industry failure took place just a few years after the Japanese debacle described above. This is now known as the Global Financial Crisis (GFC) of 2008-2009. Sometimes also called the subprime crisis.

The scale of this problem was even bigger than the Japanese banking implosion. The GFC was an American problem and caused the failure of even more banks – 465 banks failed between 2008 to 2012. In contrast, in a similar period of time prior to 2008, only 10 banks failed. And there would have been more failures if the US authorities did not implement policies that basically saved those that were too big to fail, including Citibank.

What was the GFC? Yes, this was yet another property based mania that blew up.

For a very long time, US real estate was a ho-hum asset, never considered a very dynamic speculative asset class unlike in many Asian cities. But it became hot in the mid 2000s, partly because of expansionary monetary policies presided over by the Fed Chairman who succeeded the tough anti-inflation guy called Paul Volcker. Alan Greenspan was a researcher and he leaned towards giving the economy lots of room to grow with an ample supply of money. When a bond fund called LTCM blew up in 1998, he threw inflationary caution to the wind and poured money into the economy. This has the effect of an overheated economy in the mid 2000s, with real estate becoming very hot.

The steep rise in property prices in the country did not go unnoticed with the sharks. The top investment banks in the country took advantage of the bull market and basically created highly speculative instruments to enable all their clients to, well, speculate on American real estate. It was not so different from the Japanese boom of the 1980's or the technology/crypto boom of 2020-21. Except that in crypto, you cannot argue that you can throw caution to the wind, since it is just some arcane code in a computer, but in good old real estate, the narrative was that it was impossible to go wrong. Land is always scarce... or so the story goes.

As a matter of fact, these investment banks created new types of securities, called mortgage backed securities and another type called CDOs (or Collateralized Debt Obligations). The mortgage backed paper led to retail banks getting huge commissions to sell mortgages that are then repackaged by the sharks into mortgage backed bonds. The CDOs were created to obfuscate the credit worthiness of different types of bonds, and gave the ability to investment bankers to create Triple A bonds out of shit. We can talk for hours about how these things were done, but no point regurgitating history here. It's the future we want to focus on.

These financial innovations are what the smarty-pants investment bankers made so lucrative that every small town banker from Albuquerque to Zionsville imagined that they were Wall Street mortgage traders. But in reality, they were just hustlers, trying to get every poor family that never had a chance to get a mortgage due to inadequate finances to sign up buying houses with no down payment and all debt, which then got packaged into the latest offering of mortgaged backed securities. Similarly on the buy side, every mediocre bond fund manager, not just in America but across most countries in Europe, including Germany and Iceland, got enticed into buying the CDOs, again playing to their misplaced desire to become hot shot Wall Streeters. Between 2003 and 2007, the new industry boomed. This was the mortgage backed securities market, and everybody in the western world wanted in.

In fact, it got so shady that one large insurance company called AIG was brought in to guarantee that these mortgaged securities/CDOs so that they "would not fail". Only the so-called "dumbf—ks" in Asian institutions who didn't understand this new security, were left stranded by the wayside. Or maybe the Asian institutions were still licking their wounds in the aftermath of their own Asian Financial Crisis of 1998 which also blew away their banks (see what I mean??). Indonesia, Thailand, Malaysia, S Korea also lost many of their local banks during that crisis.

Then the US housing market started to weaken in 2007. Now, this mortgaged market is actually just a house of cards, and when the first mortgagees started to be caught with their pants down, unable to meet regular mortgage payments, margin was called. At the peak of the market, it was so lucrative that banks were leveraging their balance sheets 30 times to buy into these products. Just like the crypto market was leveraged in 2020-21. And the rest is history.



The banks at the centre of the mortgaged backed securities, except for the sharpest knife in the drawer, Goldman Sachs (who had helped to create the market) was leveraged to the hilt, climbing on board this sinking ship. When it did sink, the entire banking industry in the west went down like a sack of rocks. Bound tightly together through their collective holdings in the mortgage market, they all sank together fast on the earliest twitch in the real estate market.

Three top investment banks went under. These were Bear Stearns, Lehman Brothers and Merrill Lynch. Bear Stearns was bought by JP Morgan and ML was taken over by the Bank of America for pennies on the dollar. Only Lehman collapsed, not even worth a penny.

The other institutions that collapsed with the investment banks were the dull knives who all wanted to be like Goldman Sachs. They were sold deals at the end of the food chain, and they all lost big money. That was the banking industry collapse of the 2008-9 era, which was a huge trading scandal based on massive leverage and weakly collateralised or “sub-prime” mortgages.

Today the banking industry is on the rocks again. Or so it seems. But the crisis is very different from the GFC when the western banking system was invested in a novel, highly risky security that was designed to make average bankers think they are supermen. Here are the differences:

- 1) The banks are not as leveraged as those which failed in 2008 were. Those daredevils were leveraging their balance sheets 30 times, but today, that sort of behaviour has been suppressed by better regulation;
- 2) The banks in 2008 were in over their heads with the securities they invested in – mortgaged bonds which were highly sophisticated “toxic” assets understood only by “rocket scientists”. The parallel market of CDOs, which obscured true credit risks opened the markets to bankers who only had the mandate to do plain vanilla AAA stuff but were fooled into buying shit. The banks in trouble today are not because they tried to become supermen, but because they are obedient “bowling alley” types who only did what they were allowed to do, which is to buy “safe” government bonds (you cannot figure out a Mortgage backed or CDO with a computer, but you can figure out government bonds with a pencil on the back of an envelope);
- 3) The basic mortgages behind the derivatives were unsound, being aggressively created for people who did not have the financial background to meet the requirements of a mortgage. Today, the problem is not the bonds themselves but the mismatch between the liabilities and assets on the balance sheet of banks which is due not to fraudulent representation by sharks and fast-talking salesmen, but simply because the Fed moved too quickly, flipping from one type of monetary policy (Quantitative Easing) to another (Quantitative Tightening). That is the result of government policy mistakes.

- 4) I mean, if the problem has been created because of government policy, they can be reversed similarly by government policy. This is unlike 2008, when the best and the brightest in investment banking were ripping off suckers in traditional banking, something which cannot be easily reversed.
  
- 5) The subprime problem was about US\$500 billion dollars existing in a unique, singular market. Nobody, not even the US government had enough money to take over that problem and then chew on it and to digest it. In today's crisis, there are about \$600 billion of government bonds that are mismatched and with a national debt of 31.5 trillion, and an operating budget of 5.5 trillion, there is obvious capability in the US government to manage that problem if shove comes to push.

So the two crisis are different. Perhaps, today's problem is more similar to the banking crisis that occurred in Japan.

How so? Basically, the problem in today's America and 1990's Japan is that it was the respective governments who created the mess.

In the case of Japan in the 1980s, the government wanted to prevent a recession that they thought would be created by the very high Yen exchange rate caused by the 1995 Plaza accords which would disrupt the export economy Japan was (and still is). The easy monetary policy after Plaza was the result of the US wanting to contain Japan, and the Japanese reaction to it.

In the first months of Joe Biden's administration, the new president wanted to show he was god's gift to America after Donald Trump and in the face of a covid pandemic, he threw money out of a helicopter to every citizen in the land. They called it the New Monetary Economics which promised that government spending can increase significantly without causing inflation. Those clowns have been proven to be on the fringes of economic lunacy and so has Biden for listening to them.

Both the causes of bank failure in 1990s Japan and 2020 America were therefore the hugely expansionary monetary policies that came into being. Money printing with no end.

Both central banks had to eventually call a halt to that senseless policy. When the BOJ pivoted on interest rates in 1990, the stratospheric Japanese stock market and the overheated property market were immediately deflated, crashing to levels which in its first wave was 50% down from their highs. It went further down in subsequent years. But this twin crash in stocks and real estate in just the first year caused the Japanese banks, caught up in bullish hype and having lent to speculators, to suffer irreparable and catastrophic losses on their

balance sheets. These became underperforming loans because the capital had already been lost. The initial rescue efforts of the BOJ led to zombie banks (and companies) when the Nikkei index and Tokyo property market continued to go south for another 20 years. The system was put on intensive care for a decade by the Japanese government until they had to bite the bullet and started to merge the pieces that could be saved, leaving 3 out of 13 banks standing, after another ten years of reform.

In the case of America's problems today, it was Biden himself who f--ked it up. This is the octogenarian of a president who is no student even of Economics 101. When he wanted to show that he can do a lot for Americans in financial distress in the face of what everyone thought would be the worst economic recession in a hundred years, he initiated US\$1.2 trillion of spending after bargaining it down from \$2 trillion. The US Fed Reserve went along with it, printing money to support the effort. As a result, like the Japanese banks a generation earlier, the American banks in 2020 were flush with money, and had to either lend it all out to keep a positive margin or invest them in regulated ways, such as in government bonds.

This was followed by another American government mistake, which was to impose sanctions on a commodity rich country, Russia, and as we all know, that backfired badly. That, plus the continuation of the Trump tariff war on China, led to inflation rearing its ugly head until even the dimwit of a central banker, J Powell, was forced to admit that inflation was not "transitory". By the time he pivoted, it was already too late. And it led to the sharpest rise in interest rates in generations, leaving bonds bought just a year earlier to be reeking in sharp losses. That blew a big hole in the banks' balance sheets. It was this series of policy errors, frankly, that has eventually led to the implosion of the banks last week, and to the balance sheet losses in most medium sized banks. Central banks cannot lurch from crisis to crises and fighting them all with abrupt reverses in interest rates and expect the economy to suffer no consequences.

And on their part, both the Japanese banks of the 1990s and the smaller American banks of 2023 are just too conservative to become active managers of their own balance sheet risks. This is unlike in the subprime crisis when the problems were activated by a smarter group of people called investment bankers who outfoxed traditional bankers and sold them toxic assets the regulators and victims didn't even know how to handle.

What does all this history tell us about the future? My take is that if the current crisis is the result of a series of bad policy moves, then the removal of the people behind them may be necessary to solve the problem. Niall Ferguson, a British historian, summarised the action needed to be whether corrective action should be to put brakes on the high interest rate policy of the Fed or to continue to hike rates and consequently destroy the banking system.

It would be a trade off between price stability and financial stability. “Raising short-term interest rates acts as a *brake* on economic activity by increasing the cost of credit throughout the financial system.” Ferguson says. “But raising rates can also *break* financial intermediaries such as banks.” A clever play of words, but true.

In short, there is no way that a banking system in trouble can be fixed without any pain. “Soft landings” are just fairy tales.

At this time, the risks of a wider bank run in the United States appeared to have been abated. But the inevitable pain has not appeared yet. Depending on how the problem evolves, there will be other consequences.

Here is how I see things going forward:

- 1) If the problem of a widespread banking collapse is nipped in the bud, as it seems like it has been done, the revival of inflation will be the biggest consequence. In this week’s Fed meeting, there will be the wrenching question of whether to go ahead with the pre-crisis intention to raise interest rates by 50 basis points to try and bring inflation back to 2%, or to let go. Chances are that Powell will have second thoughts about hiking rates. If there is no hike or if the hike is just 25 basis points, there will be another big rally in the bond markets and a defacto announcement that we are back to monetary policy easing. We will be on track to unhinged money printing to reinstate zero interest rates.
- 2) The bizarre hole in the balance sheet of the medium size banks will be repaired in due course as rates fall. Bonds will recover their values and funding costs would become low again. This was how the Fed saved the banking system during 2009, when the likes of Citibank, basically bankrupt then, came back from a price of one dollar. While the problems of 2008 and 2023 are different, the solutions can be common. We should not doubt the tools, only the people wielding them.
- 3) In that regard, what if Powell stick to his guns and continue with an unchanged policy to tame inflation until rates hit 5.5 to 6%. Of course, then the world will break apart around him. When the banking system faces a debacle, so will the American economy. Powell will then have to go. It would finally dawn on his bosses that he is the wrong man for the job. America’s central bank needs somebody who has the necessary background in bond markets, a person who is more familiar with bank balance sheet risk management. People like Robert Rubin or Hank Paulsen, two Treasury Secretaries who came from hugely successful careers at Goldman Sachs. Powell was a PE guy, moderately successful in his own field but that has nothing to do with how to run interest rate policy in the highly volatile environment made endemic by idiotic politicians in the domestic economy as well as engendered by America’s conflicts with everybody else especially Russia and China prompting sharp economic dislocations. He failed to see how the easy money policies of the Biden Administration has caused inflation, which he initially thought to be just “transitory”. Within a year, he had to eat his words, and in fact turned around to be so hawkish that his strict regime of rate hikes is breaking the banking system. Therefore, the next week will be crucial for him. If he demonstrates Volckerian tendencies, I think he is

finished, as the non-confidence in the damaged banking system will worsen and bankruptcies will re-emerge. If he relaxes, the fight against inflation is finished.

- 4) If the banking system breaks, Biden is also finished. Forget a second term. It's the economy, stupid, and if banks go into paralysis, the economy will go to hell. His presidency will be over. On the other hand, if inflation is allowed to re-emerge and that gets from bad to worse, then Biden's domestic economic policies as well as all his foreign policies will also be over. I don't expect Biden to be re-elected again one way or the other, and it will be good riddance.
- 5) When Japan counted its wounds, after its banking crisis, it became Number Three in the world when China caught up. Now, with the Americans in this debacle, do we think it will fall behind China as the Japanese have? What do you think?

If the system breaks, hundreds of banks will go under. Nobody in the country will have the bandwidth to deal with Ukraine or Taiwan. Those conflicts will end.

If the system creaks forward until zero interest rates re-emerge, inflation will soar. The military budget of a trillion dollars will shoot to the sky. There will be no money for anything, and going to war is not an option. Even an intense arms race will break the US economy, and it will end like the Soviet Union, bankrupted by arms manufacturing. Ukraine and Taiwan conflicts, whichever way you look at it, will end.

All things considered, the policy actions that are necessary at this time in the crisis must be to ensure that the banking system does not fail. That is how things will have to work. Powell will not have a chance to become a Volcker and neither will Biden become another FDR.

As for Australian submarines built for a trillion dollars leading up to 2050 in times of the soaring American inflation, and more trillions to operate, they will be downgraded to museums.

What about Credit Suisse? The cavalier Swiss bank that did not conform to the practices spoken in hushed terms about the other gnomes of Switzerland has finally gone into the sunset. It was a cowboy taking on risks and practices which other private banks fear to tread. Its problems have been in the open for a long time, and its demise is being forced by the Swiss regulator who prefers to kill it than to let it damage the reputation of the country as a haven for European wealth. But after Credit Suisse, why would that wealth still use private banks to advise on wealth preservation, when one of its best, didn't even know enough to save itself. That's a very huge wake-up call about the private banking industry.

Well, UBS has all the experience to manage Credit Suisse since during the 2008 crisis, UBS was also on the brink of going under, rescued by the Swiss Government and Singapore's GIC. They will just have to do it one more time. All their tools used in 2008 will be available to the new enlarged UBS, unless they don't sack the fools who crippled Credit Suisse.

In short, everywhere, at all levels, it is a “people“ problem. The tools work; but we don’t know about the people.

Let’s just get on with it.

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