EconoFact Chats: Bank Failures and Fighting Inflation

Binyamin Appelbaum (New York Times), Scott Horsley (National Public Radio), Greg Ip (Wall Street Journal) and Heather Long (Washington Post)

Published on 19th March 2023

Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of The Fletcher School at Tufts University. At a EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

Silicon Valley Bank collapsed a week before the date of this recording, followed by the collapse of Signature Bank. These events initially raised fears among some of a repeat of 2008, and the specter of a financial and economic crisis. But the quick actions of the authorities in ensuring that depositors would be made whole seem to have stemmed a wider crisis, although perhaps at the cost of greater moral hazard by depositors. Another consequence of these bank collapses is that they complicate the Federal Reserves fight against inflation. To discuss these issues. I am very pleased to welcome back to EconoFact Chats, Binyamin Applebaum of the New York Times, Scott Horsley of NPR, Greg Ip of the Wall Street Journal, and Heather Long of The Washington Post.

This is our seventh podcast episode featuring a panel of distinguished economic journalists and the timing is fortuitous for the podcast. Although the world could do with a few less challenging events. Binyamin, Scott, Greg, and Heather, welcome once more to EconoFact Chats.

Greg Ip:

Thank you.

Heather Long:

Hi, Michael.

Binyamin Applebaum:

Good to be back.

Heather Long:

Good to be back.

Michael Klein:

Great to have you here. So let's start off with some basics. Why are banks so fragile?

Scott Horsley:

Well, Silicon Valley banks seem to be uniquely fragile for a number of reasons. It had its...the deposits were sort of concentrated in a single industry, the tech industry in Northern California, and that's an industry that's fallen on hard-ish times of late. And they also seem to invest most of their deposits not in making loans or offering mortgages like another bank might do, but putting a lot of it into government securities, which although those are usually a very safe investment, can lose value when you're in an

environment where interest rates are going up rapidly, which they are right now as the Fed tries to control inflation.

Michael Klein:

Isn't it also the case that there was sort of a group of depositors who knew each other and so once the bank run started, news traveled very, very quickly?

Scott Horsley:

Yeah, this was a uniquely wired group of depositors in the tech sector. It's a tight-knit community and tightly wired or wireless. And because so many of the deposits had more than that quarter million dollars that's ordinarily insured by the FDIC, they had every reason to bolt at the first sign of trouble at the bank. And so as soon as the news of some folks leaving hit their cell phones, they switched over to their banking apps and pulled in a single day tens of billions of dollars out of the bank, or at least tried to.

Michael Klein:

Thanks, Scott. Binyamin?

Binyamin Applebaum:

Yeah. Look, I mean banking has some inherent fragility. The basic business model is that you take deposits that need to be returnable in the short term and you make long term investments that inherently tie up a good bit of that money in forms that can't be returned in the short term. And Silicon Valley Bank was an extreme example of that business model. It took a lot of short-term money from startups in Silicon Valley, and then invested it in long-term investments that it couldn't easily get out of once its depositors started demanding their money back.

That said, banking has become a lot more stable over time. The period before this failure was the longest period without a bank failure...the second longest period without a bank failure since the Great Depression. The previous high was right before the financial crisis in 2008. So it's not an entirely comforting statistic, but in general we've seen fewer bank failures over time. Banks have gotten bigger, more financially stable, more carefully regulated, but this failure is a reminder that significant fragilities remain, both inherent in the business model, and we can talk more about this, in the way that banks are regulated and allowed to operate in this country.

Scott Horsley:

I wonder if that long period without a failure breeds a little complacency in bank managers and regulators, and maybe the rest of us.

Michael Klein:

So let's talk about those things that changed. As Binyamin was alluding to, the Yale economist Gary Gorton called the period from 1934 to 2007, 'the quiet period' with respect to banking, and a lot of course, has changed since then. There was a lot of deregulation before the financial crisis. There were efforts to impose greater regulation with Dodd-Frank and so on, but then some of that was changed in the last five or six years. For example, the set of banks that were considered systemically important financial institutions, SIFIs, the threshold was changed down from $250 billion in assets to $50 billion in assets. And that meant, for example, that Silicon Valley Bank would no longer be considered a systemically important financial institution. Any comments on regulation and its role? Greg.

Greg Ip:

We don't know yet whether the changes to the laws in 2018 were a factor in Silicon Valley Bank's or Signature Bank's failure. In fact, the Fed was able to require stress tests of any bank that it wished, even it was below that threshold. So I think that before we conclude what went wrong here, it may not just be a question of regulation, but how the regulations themselves were enforced by the regulators. In other words, was it the quality of the supervision. And a lot of folks are pointing out that Silicon Valley Bank had a lot of red flags beforehand. There was their breakneck rate of growth, which is a big red flag because it suggests that a lot of the money flowing in was hot money that could flow out very quickly. It was the dependence...towards the end you saw very large borrowing federal home loan banks, which are sort of a quasi-governmental system of financial institutions, suggesting that this bank was having trouble raising funds from depositors of its own.

There was a fact that their assets were heavily invested in long-term bonds, and that they did not have adequate interest rate hedges. In fact, that they had explicitly decided to go without those hedges because they were essentially betting on rates going down. That's not what you're supposed to do when you run a bank. A bank is not a hedge fund, or at least it's not supposed to be. All these things should have been obvious to the supervisors at the Federal Reserve. That [inaudible] did not require earlier prompt corrective action from this bank, I think is going to be one of the big questions that has to be answered.

Heather Long:

Yeah, that's exactly right. There also was no chief risk officer for much of 2022, which now looks in hindsight, pretty damning. I would just take a little bit of a pushback on your initial premise though, Michael. It's stunning to me. Maybe you just misquoted it that economists you were quoting didn't bring up the 1980s and early 1990s. I mean, I know there's been a lot of focus on what happened since the financial crisis, but of course, we had the savings and loan crisis in the late 80s and early 90s that saw a very, very large number of financial institutions fail in this country, and in some ways ultimately shaped banking policy. We get to the 1990s and we have two huge changes in bank policy. In 1994, with the ability suddenly for banks to open branches across state lines. And then of course, in 1999, of the rollback of the Glass-Steagall Act. A lot of this encourages, of course, this massive wave of bank mergers, a real change in the business models of how banks, particularly mid-size and larger and larger banks, operate in the United States. And so I'm not going to sit here and make the case that this all led to this Silicon Valley Bank failure and the Signature problems. I do think that you kind of have to remember this huge shift that happened in the 80s and 90s and how we think about banking in this country and how we think about the role that a regional bank would play. They used to be mainly involved in funding commercial real estate, and suddenly we had these banks, such as Silicon Valley, that are being bigger and bigger players in kind of niche industries. And with Signature Bank, of course, they were trying to get more into crypto, and also some heavier dealings in the legal context. I think there's a broader arc going on here than just the last three or four years.

Michael Klein:

So a long way away from the Bedford Falls Savings and Loan.

Greg Ip:

It's actually a lot closer to Bedford Savings and Loan, I think than people appreciate. As I look at what happened here, the thing that I find really quite striking is just how boring a banking crisis this is, if a banking crisis can ever be boring. Silicon Valley Bank, if you look at their asset side, they were not getting heavily into subprime mortgage backed security derivatives or collateralized debt obligations, commercial real estate, subprime real estate, mortgages, anything like that. Their assets were almost entirely made up of boring government guaranteed bonds.

What about their funding? They were not getting wholesale funding from the repo market, asset backed commercial paper. They were getting deposits. Again, the most boring form of funding in the world. What brought them down was the mismatch between the maturity of the deposits, which could be taken out overnight, and of the bonds they owned, some of which didn't mature for 5 to 10 years, and suffered significant price loss because of the Fed's rise in interest rates. This is what I find really stunning is that this bank failure looks incredibly like the S&L failures of the early 1980s that Heather was just referring to. The fact that almost like 40 years later, we don't seem to have learned anything, I'm still trying to get my head around that.

Michael Klein:

I guess it would've helped had Jimmy Stewart been there to stem the depositors taking all the money out.

Binyamin Applebaum:

I think that this question of why we don't learn anything is an important one, but I guess I would answer it a little differently, which is that I think what this failure highlights precisely because the failure is just such a classic textbook example of a mismanaged bank that wasn't doing anything particularly dangerous, but just was failing at the basics and regulators weren't even able to catch or prevent that, is to my mind, it really underscores the limits of regulation. I think every time we get into a crisis like this, we sit here and talk about the fact that the regulators missed it, and we really ought to step back and say maybe we are over relying on regulators to prevent this kind of thing, and we need to think about structural changes that might make banks more resilient to this type of behavior.

And I think in particular, one idea that makes a lot of sense to me is that banks are allowed to operate with very little capital. They don't have much of a cushion from equity stakeholders and they go through it very quickly if they get into any kind of trouble. Silicon Valley Bank burned through that cushion very quickly. If it had had more capital, not even as much as a normal corporation, but just somewhere in between a bank and a normal corporation, it might well still be operating. And that's the type of structural fix that I think deserves a lot more attention because it's clear to me at least that if we're just going to talk about regulators, we're going to be doing this for the rest of time, because they are not fundamentally able to prevent misconduct by banks on any continuous basis, and they only need to be wrong once to get into a crisis, and that just is going to keep on happening.

Heather Long:

Binyamin, do you think what you just said is true for banks above $250 billion? Most people would argue that the tier one banks do have pretty sufficient capital at the moment.

Binyamin Applebaum:

No, I think that's right. I think that's an important distinction. I think we really have pushed those banks closer to becoming wards of the government. I'm uncomfortable with the degree to which they get to keep their profits given the fact that they are now essentially operating as public utilities, but I think they do have stronger balance sheets. They are subject to regulation that's commensurate with their role in the economy. I do think that for those, it's basically for institutions, we really have corrected a lot of the vulnerabilities that were exposed by the last financial crisis. The problem is that we decided to pretend that anything smaller than that could just be allowed to go on the way that it had been. And for those smaller banks, many of which are not particularly small, they're just not the size of Bank of America, we are now learning the hard lesson again, that if you don't correct problems, they will recur.

Michael Klein:

Well, as I mentioned before, part of that is that the threshold was changed from $200 and ... Oh, rather from $50 billion to $250 billion. So maybe they would look more like those larger banks if the threshold had not been changed in the last five years. This also brings up another issue of moral hazard. Moral hazard is heads I win, tails you lose. And in this case, there was moral hazard with respect to the depositors. So one of the striking things that happened was that the FDIC, as I mentioned in the introduction, is supposed to only insure deposits up to $250,000. But then they came in and said, "well, we're going to make everybody whole." So there's no discipline from depositors, even from depositors who might be very sophisticated and have literally millions of dollars in the bank. Was it a mistake to make all the depositors whole? Should the people who had money above $250,000 not been able to get all of their money back as a consequence of this?

Scott Horsley:

Well, I think this is something that policymakers are definitely going to be wrestling with in the aftermath of this because there is now sort of an implicit guarantee for depositors at other banks that they could also have more than a quarter million dollars and they'll be protected in the event of a failure. Or if they're not, then there'll be a political blow back of why were these well-to-do Silicon Valley depositors protected, but the depositors at some community bank in Oklahoma were not, for example. So we've got an implicit guarantee, but it's not priced in to what the fees that the banks pay for that deposit insurance. I'm sure there'll be some people pushing to have the $250,000 cap raised, but should it be infinite? Can you put any amount of money in and it'll be covered? Where do we draw the line between a sophisticated investor and the person that just wants to put money in the bank and assume it's going to going to be there when they come for it?

Heather Long:

I'll jump in on this one too. I mean, this is definitely the most controversial thing that happened over the weekend, both politically and financially. Historically, you probably would've seen a situation where they would have gone above the $250,000 limit, but they wouldn't have protected a hundred percent. Now it's hard to pick. I mean, in hindsight, we got a lot more time sitting here even just a few days later to kind of debate what that right threshold would've been. But you wouldn't have done ... like you look at somebody like Peter Thiel admitting that he had $50 million sitting in Silicon Valley Bank. There's reasons to feel uneasy about the fact that he got made totally whole here.

But you can also sort of understand over the weekend when you're worried about contagion risk, why they did what they did. And it was interesting, I'm sure others on the panel here ... I've been able to sit in on a couple of some of the Wall Street types who've been giving various webinars all week to clients on this. And two interesting things that were flagged, to me in listening to some of these presentations, one is that Silicon Valley Bank is now reassuring a lot of its startup customers that they are the safest bank in America because all deposits are insured, which is basically true.

And the second thing that's kind of interesting is some of these high profile bankers will argue to you that while it is a de facto guarantee for all deposits right now across the entire financial and banking system, they would argue that the Fed backstop, what I like to call the "big bazooka", the big emergency lending fund that also came out simultaneously, really helps negate the likelihood that we're ever going to really have to insure a lot more deposits for other banks. We're preventing other banks from basically becoming insolvent. So while I'm uneasy with the blanket basically deposit situation, I think it is kind of unlikely that we're going to need to really tap it further.

Michael Klein:

The bazooka metaphor is from Hank Paulson back in 2008, that when you come with a big bazooka, not a small gun. Binyamin?

Binyamin Applebaum:

Yeah, and Hank Paulson said we weren't going to need to fire the bazooka, so it's a metaphor with a bit of a fraught history. Yeah, listen, I think that the reality is that we have as a society become increasingly uncomfortable with allowing banks to fail. There was implicitly a federal backstop here that was activated, and the one thing we weren't doing is pricing it. We weren't making banks pay for it, and we're still not making them pay for it. And so what you have is basically a system where depositors have confidence, almost a reckless degree of confidence, that the government is going to prevent their money from disappearing. This is particularly true of those big banks that we were talking about a moment ago, which everyone understands would never be allowed to fail in a crisis and they're not being forced to pay for it.

And so to my mind, we ought to sort of acknowledge the reality that became impossible to miss this weekend, which is that the government is not going to going to allow deposits to disappear from a bank of any size, and we ought to make sure that we are not ...that the right people are footing the bill for that reality, and that's where the focus of policy ought to be.

Greg Ip:

I find myself having been through a number of these episodes over the last 30 years, wanting to hold back my strongest opinions because we learn so much over time. And I want to give the folks who did the bailout a bit of the benefit of the doubt. I'm old enough to remember when they were ...we were ...folks were praised and high-fived for letting Lehman Brothers fail in October of 2008, and within a month or two that began to look like a terrible, terrible mistake because of the broader repercussions. The choice regulators always fail is do you teach a lesson, and about moral hazard...sorry, and not allow moral hazard and you accept the consequences? Or do you allow some moral hazard to take root and avoid those consequences? Which is the greater harm? And I don't think we know a priori how many other banks would've gone down from a rush on their uninsured deposits if Silicon Valley Bank had failed. I'm comfortable saying the number would've been large. So we don't know who would've been next, and the nature of bank panic is that ...the nature of a liquidity crisis is that banks that look solvent and healthy one day can fail the next because of the psychology that takes over.

The other thing that I find really striking is that the whole theory of moral hazard is that if the government promises not to bail out somebody like an uninsured depositor, then those people will be more careful with their money. They themselves will exercise oversight over the bank that has their money, and that counterparty discipline will itself prevent failure. There was absolutely zero evidence that people who had staggering amounts of money on deposit in Silicon Valley Bank were exercising any sort of counterparty scrutiny of this bank.

What in the world was a crypto company doing with $3 billion on deposit at this bank? What was Roku doing with more than $400 million on deposit at this bank? Somehow I don't think they were thinking, "oh, we'll get bailed out." I'm open to the possibility that we'll discover that yes, in fact they were assuming they'd get bailed out. I think they just thought that this was a safe bank because their friends told them it was a safe bank. Their venture capital sponsors told them it was a safe bank. Moody's said it was, or the rating agencies said it was a safe bank, and the regulators said it was a safe bank.

We're now in this situation now, I think, and this is the hard question I think we're going to have to be asking is whether banks of this size only survive with some kind of like massive, possibly blanket guarantee of their liabilities, or they all have to basically end up merging into one gigantic super bank that we acknowledge is too big to fail and must hold 100% capital. I realize these are somewhat hypothetical blue sky scenarios I'm raising here, but I think they're sort of questions that we'll be grappling with in the coming months.

Binyamin Applebaum:

I'm just curious, in your lifetime, can you imagine policy makers again running the Lehman experiment? Do you still regard that as an open question?

Greg Ip:

I think that the problem is they keep being presented with a different scenario. If they were presented with Lehman, no, but I don't think, again, a priori, if they said a bank with $200 billion in liabilities, would you let it fail? Well, sure we'd let it fail. That's not systemic. You know what I mean? Until they actually realize what's happening. So I don't know, it's a good question, Binyamin, but it certainly looks like the answer is no, doesn't it?

Michael Klein:

Part of the thing with Lehman was the opacity that people didn't know who owed what to whom, or who owed what to whom, who owed what to whom, and so on. So that's one issue. Another issue I think is that there are different sources of moral hazard. So the depositors were made whole, but the shareholders weren't. The people who held the bonds in the bank weren't. The executives of the bank weren't. So those are the people who should have had more discipline over the actions of the bank. And I don't know if this will cause people who are shareholders or bond holders or executives to be a little bit more careful or not, but there wasn't moral hazard with respect to them.

I'd like to pivot it a little bit now, although maybe it's not a pivot. All of this complicates the Federal Reserve's fight against inflation. Higher interest rates made the Silicon Valley Bank more vulnerable and it could also make other banks and financial institutions vulnerable as well. So while inflation has come down a bit, it still remains high as compared to what we've seen in the decades before the pandemic. Greg, in our last conversation, you pointed out that there's not a single measure of inflation, but many of them. What do we see now with these different measures, and are they all pointing in the same direction or are we getting mixed messages?

Greg Ip:

Well, you're right, there's a lot of different inflation measures. There's the headline inflation number. There's a core number from which we remove energy and food. Now there's a variety of core core measures, or super core measures, where you take other things like shelter and cars, which seem to have been distorted by pandemic behavior. When you do that, you find that the inflation rate is 4% or 5%, which is pretty high. That's higher than it's been in 30 or 40 years, and it's double the Federal Reserve's 2% target. So on that basis alone, the Fed's got a lot of work to do, and as you say, this does put them in a very difficult situation because it essentially requires them to keep raising interest rates knowing that doing so aggravates exactly the type of market dynamics that brought down Silicon Valley Bank.

There's a couple of positive things out there though, and I think you'd say the first positive thing I would look to is wages. So even though unemployment is still close to a 40 or 50 year low, we're starting to see the rate of wage growth slow down. It's still a bit high relative...a bit higher than the Fed thinks is necessary to get back to a 2% target, but it seems to be coming down. That suggests that we're not in wage price spiral world, which tells you that you more or less have a much more persistent inflation problem.

The other thing is that I think that one thing that the Silicon Valley Bank situation reminds us of is that there's this old saying on Wall Street, 'the Fed tightens until something breaks.' Which basically means that high interest rates somewhere, somehow tend to play havoc with some piece of the financial system, and the consequences of that chaos themselves tend to cause people to pull back on spending and borrowing and risk-taking. So the chaos in the banking system this week might be a powerful signal that

the Fed tightening over the last year is starting to get some traction on the economy, and we could see a more pronounced slowing, and with it, an ease of inflation pressure in the next year or so.

Heather Long:

I'll just jump in and say that I'll be interested in what my colleagues on this call have to say, but I personally, it's a really tricky decision for the Fed, but I think ...I really hope that they pause on Wednesday at their March meeting and just give a little bit of time for the dust to settle. I think Greg said it well early in this conversation, we really don't know how a lot of this is still going to play out with these regional banks. There's still dozens of them that are heavily under pressure at the moment. We also don't know how much this is going to really put a damper on lending and kind of business activity.

I've been on a few calls with people who are like, there is no appetite to be lending or to be funding activities right now. And so to me, even though inflation remains a stubborn problem, it's clear it's a problem, there's another meeting coming in six weeks in May, early May. I personally hope that the Fed just gives a minute to pause, and can signal through the dot plot and through Chair Powell's comments that they still are watching inflation and fighting inflation, but the main overriding goal right now has to be to restore confidence and trust in the financial system. That's my view.

Binyamin Applebaum:

I think it's a tricky moment for the Fed because coming through the fall, they really felt like they were making progress. They felt like they had finally put policy on a trajectory that was working and that they probably didn't have all that much further to go maybe. And then for the last couple months, I think they've been reconsidering that premise and looking at the data and saying, hey, this last part of the journey is not going as well as we hoped. Maybe it's not as easy as we hoped. Maybe we need to go a little further, we haven't gone far enough yet. And I think there was a real inclination to press ahead with this assault on inflation, to keep squeezing, as Greg said, until things started breaking.

And I don't know that this by itself is going to seem to them a sufficient amount of breakage, if you like. But that said, that's I think a very different question from whether you keep squeezing at this next meeting when you're in the midst of a lot of uncertainty. And I do think that there's a good argument for waiting a little while to get a little more information before you decide what your next steps are. But I think this would've been an easier call if they weren't worried right now about falling behind the curve or letting go of the progress that they think they've made.

Michael Klein:

Yeah, it's really interesting that this meeting is coming right on the heels of the crisis. If the crisis occurred two weeks later, it would've been in the wake of that meeting.

So as we're worried about inflation, unemployment, as Greg mentioned, is still very low. Heather, you had a column a few weeks ago called 'One Plausible Explanation for this Too Good to Be True Economy'. Maybe it's not too good to be true anymore, but it is striking that unemployment has stayed as low as it has. Why has the economy, at least up until this point, been so robust, Heather?

Heather Long:

Well, I'll be curious what my colleagues here have to say, but I do think Lael Brainard kind of put forward this thesis last year when she was at the Fed and now is at the National Economic Council, that basically things were so good last year, part of record ...profit levels best since decades, that you had this situation normally when you start to see profit margins coming down in a company, the first instinct is to immediately start chopping some heads. Let's let go of some people. Let's see the unemployment rise. But there's a case to be made that things were just so good and juiced a lot by the various stimulus programs,

that executives sort of knew it was too good to be true and it wasn't going to last. And so that's why you don't see, at least yet, a bunch of mass layoffs across the economy except in sectors that had heavily hired.

I think the other unique situation going on is there's sort of two economies. There's sort of the ones that over hired like tech and warehouses during the pandemic, and you see a little bit of slowing down or letting go in those sectors. But there's others that are still catching up. And a lot of the hiring has been particularly strong in recent months in the hospitality sector and education, particularly public schools, and services broadly, and healthcare, and places that were really struggling to...lost so much during the pandemic and are still struggling. So it's a little bit different calculation for them when they currently could actually do more business if they had a few more waiters and could actually serve a few more tables, and do a few more takeout orders right now. So those are some of the things that just started to make a little bit more sense to me as I thought about it.

Michael Klein:

Thank you all very much for joining me today, at as I said, sort of an opportune time for this conversation, but perhaps a less opportune time for the economy as a whole. But we'll see what happens, and I hope that we get a chance to talk again in a month or two, and can revisit these episodes with a little bit more information. So thanks again very much for joining me.

Binyamin Applebaum:

Thank you.

Heather Long:

Thanks, Michael.

Scott Horsley:

Thank you, Michael.

Michael Klein:

This has been an EconoFact Chats. To learn more about a EconoFact and to see the work on our site, you can log into www.econofact.org. EconoFact is a publication of the Fletcher School at Tufts University. Thanks for listening.