

Banks on the Brink? The Origins, Nature, and Trajectory of the Crisis

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The banking industry has been beset by a series of failures, government bailouts, and takeovers. The crisis in these banks has sent stock markets around the world into gyrations. What caused all of this? Is this a passing crisis? What impact will it have on the real economy? *Spectre's* Ashley Smith interviews Michael Roberts, asking him these and other questions about finance capital and global capitalism today.

Ashley Smith - What were the immediate causes of this run of bank failures?

Michael Roberts - The immediate cause of the recent bank failures, as always, was a loss of liquidity. What do we mean by that? Depositors at the Silicon Valley Bank (SVB) and at First Republic and also at the cryptocurrency bank, Signature, started to withdraw their cash big time, and these banks did not have the liquid cash to meet depositor demands.

Why was that? Two key reasons. First, much of the cash that had been deposited at these banks had been reinvested in assets that have hugely lost value in the last year or so. Second, many of the depositors at these banks, mainly small companies, had found that they were no longer making profits or getting extra funding from investors, but they still needed to pay their bills and staff. So, they started withdrawing cash rather than building it up.

Why did the assets of the banks lose value? It comes down to the rise in interest rates across the board in the financial sector, driven up by the actions of the Federal Reserve to raise its basic policy rate sharply and quickly supposedly to control inflation. How does that work?

Well, to make money, say banks offer depositors 2 percent a year interest on their deposits. They must cover that interest, either by making loans at a higher rate to customers, or by investing the depositors' cash in other assets that earn a higher rate of interest. Banks can get that higher rate if they purchase financial assets that pay more interest or that they could sell at a profit (but might be riskier), like corporate, mortgage bonds, or stocks.

Banks can buy bonds, which are safer because banks get their money back in full at the end of maturity of the bond – say five years. And each year the bank receives a higher fixed rate of interest than the 2 percent its depositors are getting. It gets a higher rate because it cannot have its money back instantly but must wait, even for years.

The safest bonds to buy are government bonds because Uncle Sam is (probably) not going to default on redeeming the bond after five years. So SVB managers thought they were being very prudent by purchasing government bonds. But here is the problem. If you buy a government bond for \$1000 that “matures” in five years (i.e., you get your investment back in full in five years), which pays interest at, say, 4 percent a year, then if your deposit customers get only 2 percent a year, you are making money.

But if the Federal Reserve hikes its policy rate by 1 percent, the banks must also raise their deposit rates accordingly or lose customers. The bank's profit is reduced. But worse, the price of your existing \$1000 bond in the secondary bond market (which is like a secondhand car market) falls. Why? Because, although your government bond still pays 4 percent every year, the differential between your bond interest and the going interest for cash or other short-term assets has narrowed.

If you need to sell your bond in the secondary market, any potential purchaser of your bond will not be willing to pay \$1000 for it but say only \$900. That's because the purchaser, by paying only \$900 and getting the 4 percent interest, can now get an interest yield of $4/900$ or 4.4 percent, making it more worthwhile to buy. SVB had a load of bonds that it bought "at par" (\$1000) but worth less in the secondary market (\$900). It had "unrealized losses" on its books.

But why does that matter if it does not have to sell them? SVB could wait until the bonds mature, and then it gets all its investment money back plus interest over five years. But here is the second part of the problem for SVB. With the Fed hiking rates and the economy slowing down towards recession, particularly in the start-up tech sector in which SVB specialized, its customers were losing profits and so were forced to burn more cash and run down their deposits at SVB.

Eventually, SVB did not have enough liquid cash to meet withdrawals; instead, it had a lot of bonds that had not matured. When this became obvious to depositors, those that were not covered by state deposit insurance (anything over \$250,000) panicked and there was a run on the bank. This became obvious when SVB announced that it would have to sell much of its bond holdings at a loss to cover withdrawals. The losses appeared to be so great that nobody would put new money into the bank and SVB declared bankruptcy.

So, a lack of liquidity turned into insolvency - as it always does. How many small companies find that if only they had gotten a little more from their bank or an investor, they could have ridden out a shortage of liquidity to stay in business? Instead, if they get no further help, they have to fold. That is basically what happened at SVB, and at Signature, the cryptocurrency deposit bank, and now at First Republic, a bank for medium-size businesses and rich people in New York.

What have the US and other states done to stop the financial crisis? Will this work to prevent other bank failures and calm down stock markets?

There are two things that the government, the Fed, and the large banks have done. First, they have offered funds in order to meet depositors demand for their cash. Although in the US, any cash deposits over \$250,000 are not covered by the government, the government has waived that threshold and said that it will cover all deposits as an emergency measure.

Second, the Fed has set up a special lending instrument called the Bank Term Funding Program where banks can obtain loans for one year, using the bonds as collateral at par to get cash to meet depositor withdrawals. So, they don't have to sell their bonds below par. These measures are aimed stopping the "panic" run on banks. But of course, they do not resolve the underlying problems that the banks are in because of rising interest rates and falling profits for the companies using these banks.

Some argue that SVB and the other banks are small fry and rather specialist. So, they do not reflect wider systemic problems. But that is to be doubted. First, SVB was not a small bank, even it specialized in the tech sector - it was the 16th largest in the US and its downfall was the second biggest in US financial history. Moreover, a recent Federal Deposit Insurance Corporation report shows that SVB is not alone in have huge "unrealized losses" on its books. The total for all banks is currently \$620 billion, or 2.7 percent of US GDP. That's the potential hit to the banks or the

economy if these losses are realized.

Indeed, 10 percent of banks have larger unrecognized losses than those at SVB. Nor was SVB the worst capitalized bank, with 10 percent of banks having lower capitalization than SVB. A recent study found that the banking system's market value of assets is \$2 trillion lower than suggested by their book value of assets accounting for loan portfolios held to maturity.

Marked-to-market bank assets have declined by an average of 10 percent across all the banks, with the bottom 5th percentile experiencing a decline of 20 percent. Worse, if the Fed continues to raise interest rates, bond prices will fall further, and the unrealized losses will increase, and more banks will face a lack of liquidity.

So, the emergency measures may well not be enough. The current claim is that extra liquidity can be financed by larger and stronger banks taking over the weak and restoring financial stability with no hit to working people. This is the market solution where the big vultures cannibalize the dead carrion - for example, the UK's SVB arm has been bought by HSBC for £1. In the case of Credit Suisse, the Swiss authorities are trying to force through a takeover by the larger UBS bank for a price one-fifth of CS's current market value.

However, if the current crisis becomes systemic, as it did in 2008, that will not be enough. Instead, there would have been socialization of the losses suffered by the banking elite through government bailouts, driving up public sector debts (already at record highs), to be serviced at the expense of the rest of us through increased taxation and yet more austerity in public welfare spending and services.

Will the Federal Reserve and other central banks continue to raise interest rates to combat inflation, or will they back off to prevent further banking crises?

It seems very likely that central banks will continue to raise interest rates in their impossible quest to control inflation. They will only stop if there are a further series of banking crashes. Then they may even be forced to reverse their monetary tightening policies in order to save the banking sector.

But, at the moment, they are putting on a brave face and claiming the banking system is very "resilient" and in much better shape than in 2008. To reverse monetary tightening would be disastrous for the credibility of central banks, as it would expose the fact that central banks do not control the money supply or interest rates or banking activity - on the contrary.

What are deeper causes of inflation and financial instability today?

Let's take financial instability first. Capitalism is a money or monetary economy. Production is not for direct consumption at the point of use. Production of commodities is for sale on a market to be exchanged for money. And money is necessary to purchase commodities.

Money and commodities are not the same thing, so the circulation of money and commodities is inherently subject to breakdown. At any time, the holders of cash may not decide to purchase commodities at going prices and instead hoard it. Then those selling commodities must cut prices or even go bust. Many things can trigger this breakdown in the exchange of money and commodities, or money for financial assets like bonds or stocks - fictitious capital, Marx called it. And it can happen suddenly.

But the main underlying cause will be the overaccumulation of capital in the productive sectors of the economy or, in other words, falling profitability of investment and production. The tech companies' customers at SVB had begun to lose profits and were suffering a loss of funding from so-

called venture capitalists (investors in start-ups) because the investors could see profits falling. So that's why the techs had to run down their cash deposits. This destroyed SVB's liquidity and forced it to announce a fire sale of its bond assets.

In the financial crash of 2008, the liquidity crisis was caused by the collapse of the real estate market - not tech as now. It left many lenders with severe losses in mortgage bonds, and the derivatives of those bonds multiplied the effect across the financial sector and internationally. But the collapse of the housing market itself was due to a downturn in the profitability of the productive sectors of the economy from 2005-6 onwards that eventually caused an outright fall in total profits which encompassed the real estate sector.

This time the monetary breakdown has been triggered by the inflationary spike globally since the COVID pandemic ended. This was driven mostly by huge rises in energy and food costs due international supply chains breaking down during COVID and not recovering.

Reopening companies found that they could not match revived demand; they could not get ships, containers, ports, oil rigs working properly again. Food and energy supplies dried up and prices rose, even before the Russia-Ukraine war intensified the supply chain collapse in key commodities. Beyond food and energy, underlying inflation accelerated because of generally low productivity growth in the major economies: capitalist companies could not find enough skilled staff after COVID and had not invested in new capacity, so labor productivity growth was insufficient to match revived demand.

What is clear is that accelerating inflation was not caused by higher labor costs (i.e., rising wages); on the contrary, workers were (and are) way behind the inflationary spiral in getting wages to compensate. Instead, rising raw material costs and shortages allowed companies with pricing power, i.e., big multinationals, to hike prices and boost profit margins to record highs, particularly for energy and food companies. It was a profit-price spiral.

Despite that, the monetary authorities everywhere have ignored or denied that accelerating inflation was a supply-side problem (as it usually is under the capitalist mode of production). Instead, they claimed it was due to excessive demand inducing a wage-price spiral. So, their answer was to raise interest rates, reverse their previous policies of quantitative easing (QE) with quantitative tightening (QT) and reduce liquidity (cheap cash and credit). So, the cost of borrowing for firms to invest or households to pay mortgages and so forth has risen sharply and has now fractured the banking system.

The irony is that hiking rates will continue to have little direct effect on inflation rates; instead, the policy is squeezing profits and wages and so accelerating the slowing economies into a slump - just as happened under the Volcker Fed regime in the late 1970s and early 1980s, which led to very deep slump from 1980-2.

How is this crisis different than the 2008 crisis and Great Recession? What restored growth then? Are those means available to capitalists and their states today?

Capitalist production and investment suffer from regular and recurring slumps. These are a necessary corrective to the tendency for profitability to fall over time. Slumps clear out the deadwood and let the stronger take over the markets of the weak, reducing labor costs through higher unemployment and so laying the basis for higher profitability and economic recovery. This process has been called "creative destruction."

The 2008-9 Great Recession achieved that to some extent - but only to *some* extent. Profitability of

capital in the major economies stayed below levels seen in the late 1990s. This has kept investment in productive sectors weak. Companies have depended on cheap or near zero credit to keep going – the share of “zombie companies” that survive by just getting more debt has now reached around 20 percent. The 2020 pandemic slump showed that a depressed and stagnating capitalism has not recovered – no creative destruction yet.

What solutions does the capitalist establishment offer today? Will they work?

The mainstream solution to banking crashes is always the same: better regulation. Even the most radical mainstream economists like Joseph Stiglitz, or politicians like Bernie Sanders or Elizabeth Warren, push this solution. And yet the regulation of an inherently unstable and speculative financial sector just does not work.

The history of regulation is a history of ignorance, avoidance, and lies. Take SVB: the regulators failed to pick up on the interest-rate risk that the SVB board was taking in purchasing so many bonds, despite warnings from various sources. And over and over again, banking scandals have surfaced which regulators have missed.

Instead of regulation, what is needed is to bring into public ownership the major banking and financial institutions, to be democratically run and supervised by workers in those institutions and in the wider economy. We need to close down speculative investment banks like Goldman Sachs or investment megaliths like BlackRock. We need to end the grotesque salaries and bonuses of the bank executives and traders in investment banking.

Banking should be a public service like education or garbage clearance, not a center for betting in the financial casino with our money. Ah, some say, even if the state banks just took deposits and then lent to businesses to invest and households by buy big ticket items, you could still get a run on them by depositors.

Yes, maybe. But that is very unlikely if depositors know that their money is safe because the state is behind the bank, and banks no longer speculate, and they are run democratically and transparently. If interest rates rise and it leads to state-owned banks suffering losses on their government bond holdings, those losses would be shared by society throughout equally and not by working people to save rich depositors and companies at the expense of the rest of us. But public ownership of banking is taboo across all varieties of opinion, even socialist.

What is the likely trajectory of global capitalism?

The first two decades of this century have shown that capitalism has passed its use-by date. Economic growth has slowed to a trickle; economies have suffered two major slumps (2008-9 and 2020), including the biggest financial crash in history. Investment in value-creating sectors that could raise incomes and lower working hours have not taken place.

Global warming and climate change has not been curbed, and we are heading for an existential disaster. Poverty in the so-called Global South is worsening, and inequality of incomes and wealth is rising everywhere. Capitalism is locked into a long stagnation or depression.

This will only be overcome (and then only temporarily) if capital destroys workers' living standards sufficiently to raise profitability and restore investment growth. But any attempt to do that could provoke unprecedented class conflict. So, the strategists of capital have so far opted instead to crawl along and not grasp the nettle of liquidation and creative destruction. But there are forces out there that are increasingly wanting to do that.

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Be sure to catch Roberts, along with *Spectre* editor David McNally and author Hadas Thier, at our upcoming *Spectre Live!* event, March 28th at 4pm ET. You can register [here](#).

The collapse of Silicon Valley Bank and Signature Bank followed by runs on First Republic Bank and Credit Suisse triggered panic in financial and stock markets throughout the world. Just as they did in the Great Financial Crisis of 2008, the U.S. and other states bailed the banks out. Where is this banking crisis headed? What does it mean for the real economy? Join Hadas Thier, David McNally, and Michael Roberts to address these and other questions about capitalism and its global slump.

Hadas Thier, author of a *People's Guide to Capitalism: An Introduction to Marxist Economics*

David McNally, author of *Global Slump* and *Blood and Money*

Michael Roberts, author of *The Long Depression* and *Capitalism in the 21st Century*

P.S.

• Spectre. March 20, 2023:

<https://spectrejournal.com/banks-on-the-brink-the-origins-nature-and-trajectory-of-the-crisis/>

• Ashley Smith is a socialist writer and activist in Burlington, Vermont. He has written in numerous publications including Truthout, International Socialist Review, Socialist Worker, ZNet, Jacobin, New Politics, Harpers, and many other online and print publications. He is currently working on a book for Haymarket entitled *Socialism and Anti-Imperialism*.