What's after the Silicon Valley Bank bailout?

A crisis in the banking system wreaks havoc on the economy. Bank runs and bank insolvencies caused both the Great Depression (which began in 1929) and the Great Recession (which began in 2008). In both cases, the economy performed poorly for years, taking an abnormally long time to recover. It is too early to tell how widespread problems are in today's banking sector. Certainly, some economists worry that the run on the Silicon Valley Bank is just the first visible spark in what will become a forest fire of bad news.

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Some news reports may alleviate their worry. These reports note that the Silicon Valley Bank's Board of Directors were mostly political operatives rather than titans in the banking industry. This narrative comforts many since it implies that the bank's troubles may be caused by its distinctive failings and not by an economy-wide problem that will soon become apparent when more banks fail.

Certainly, some of Silicon Valley Bank's problems seem unique. In just a few months after the start of Covid-19, the bank's deposits tripled (according to CNN Business). It received most of its deposits from tech companies and these companies had a lot of money to deposit since tech businesses were booming during the pandemic. The Silicon Valley Bank had more money than it knew what to do with. In the end, it decided to buy U.S. Treasury Notes, which are usually considered to be pretty safe investments. However, the short-term interest rates were so low that the bank did not consider buying short-term treasuries. Instead, the bank bought long-term securities. For instance, they bought 10-year treasury notes that made fixed payments twice a year. These payments were determined by the interest rate when the note was issued. But unfortunately for the bank, the Federal Reserve's actions caused the interest rates to rise rapidly. As a result, the fixed payments made by the treasury notes decreased in value since investors could obtain these same payments by buying lower-priced securities – now that interest rates were higher. When the bank's treasury notes dropped in value, the bank became vulnerable. Rumors of the bank's trouble circulated and depositors withdrew their money. To meet these withdrawal demands, the bank had to sell its treasury notes at a loss. The losses were so large that it looked like the bank would fail, so the government bailed it out.

Unfortunately, other banks share a business environment that is similar to the one Silicon Valley Bank found itself in. First, these other banks received a lot of deposits in a short period of time. These deposits began to grow rapidly when the Biden Administration sent large checks to people and the Federal Reserve printed money to pay for this government largess. Second, these other banks did not have attractive short-term investments available since the interest rates were so low. If these other banks invested in long-term securities, like the Silicon Valley Bank did, their investments dropped in value and put the banks at risk.

Personally, I am worried that this might be the case. The interest rate shot up quickly and some banks may not have foreseen this change. As a result, they will take losses on their long-term securities and be vulnerable, just like the Silicon Valley Bank was vulnerable. If this scenario occurs, I am not inclined to exclusively blame poor bank management for the emergent problems in the banking industry. Government policymakers should share some of the blame.

I would start by directing some of the blame toward the Federal Reserve. It expanded the money supply, which led to our persistently high inflation rates. Eventually, the Fed realized its mistake and began to rapidly shrink the money supply, which led to rapid increases in the interest rates. The quickly changing interest rates surprised some bankers and some of their previous investments began to lose money. In short, the Federal Reserve ended up adopting an unpredictable policy. Bankers did not know how much the Fed would seek to alter interest rates, so some banks made bad decisions. Bankers do better when the business climate is predictable. If the Fed needs to alter the money supply to increase the interest rate, it should do so over a long period of time in a predictable, pre-announced manner. This is the opposite of what the Fed did and the result is currently apparent in the banking sector.

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