An Interview on Banking Crisis with Paolo Pasquariello, Professor of Finance at the University of Michigan

Question 1:

Before the banking crisis, central banks have been fighting a war against inflation. Considering that, how do you assess the recent central banks' interventions?

Central bank interventions have both benefits and costs. The infusion of significant additional liquidity into the financial system may have inflationary effects --- especially now that inflationary worries are already in full swing. But I am less concerned than most about these costs. Letting banks fail would simply induce a protracted credit squeeze and a sudden recession while not having any immediate effect on inflation, thus leading to the stagflation (high unemployment and high inflation) that we all feared twelve months ago and has so far not materialized. Moreover, in absence of these actions, we ordinary citizens would be much worse: long lines to withdraw whatever is left of our deposits; unemployment; a depressed housing market; and less easy access to credit to fund economic activity. Most central banks seem to share my views, and have not hesitated to do what was necessary to extinguish those banking fires.

Question 2:

Many fear that central banks' broad interventions encourage financial institutions to take excessive risks. How do you analyse the risk associated with central banks' ever-broader interventions?

The notion that protective actions may lead protected agents to take excessive risks is known among academics and practitioners as "moral hazard". There is virtually no major event of distress in the last four decades in which some economists, politicians, investors, or simple observers did not invoke moral hazard to justify their opposition to rescue interventions. I strongly believe that this opposition, while occasionally well-meaning, is more often misguided.

I do recognize that moral hazard is indeed a present danger, however, policy-makers like central bankers have the obligation to undertake actions that benefit the most. The consequences of inaction can be exceedingly severe, way more severe than at least temporarily putting aside attributions of responsibility and moral hazard considerations. This is because all banks are intrinsically exposed to the same run risks experienced by SVB, and runs are both self-fulfilling and likely to spread as a domino from bank to bank --- especially since modern banks intensely lend to and borrow from each other both within and across national borders.

Question 3:

How do you assess the role played by technology in the current crisis, and what to do about that?

The last few decades have led to the development of a global economy in which depositors, borrowers, investors, intermediaries, corporations, governments, and central banks are all interconnected via complex nexuses that are both difficult to disentangle and nearly impossible to replace. Technology has certainly played a role in enhancing those interconnections and magnifying the speed through which shocks may reverberate within this complex system.

The sources of panic are not new; like in the past, a well-placed or mis-placed rumor is all that it takes for a hoard of depositors to run to the nearest branch to withdraw their money before others do - an individually rational response (as shown by last year's Nobel prize winners' research) yet one extremely deleterious for the community. Of course, Twitter feeds or Reddit threads these days are all it takes to spread these rumors faster and wider. This is no different than contemplating the effect of greater physical mobility across national borders for the latest pandemic.

None of this means that we are going to stop flying internationally, sending emails, or posting our thoughts on social media. It is policy-makers and politicians' responsibility to be aware of the heightened risks that these fabulous technologies pose, first and foremost magnifying the fragility of the global capital markets, and respond accordingly and adequately, instead of simply berating those technologies and wishing a return to the "good old times" of candlelights and telegraphs. Those times were not that good at all, and they all saw their fair shares of financial crises, as history teaches us.