

# Financial Crisis Cyclicity in Europe under the US Financial Disturbances’ Impact. A Logical Framework

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## Abstract

The cyclicity concept of the economic and financial crisis is well known and recurrently experienced by the Western world economies. Various triggers could be depicted for each of the crisis episodes, but some remain constant in the post-factum analyses. While political events (war/territorial disputes, energy crisis, fiscal and monetary policies) or calamities (pandemic) cannot be either anticipated or influenced, their effects, which shape each crisis (inflation rate, cost of living, supply shortages, bankruptcies) should be possible to anticipate, in order to mitigate crisis’ effects on population and businesses.

Looking for patterns of the last century crisis is the obvious line of defense so that early signs are captured and acted on for future occurrences. Despite global indicators being monitored and triggers being put in place, the cyclic crisis pattern is one that could not be broken.

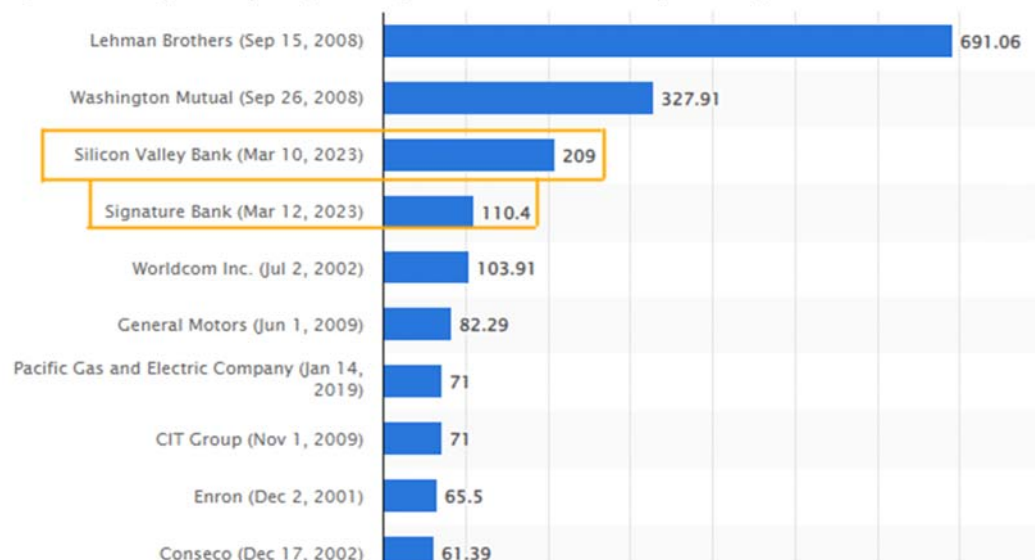
**Key words:** financial crisis, cyclicity, inflation

**J.E.L. classification:** E42, E5, E31

## 1. Introduction

The recent (March 2023) bankruptcies of Silicon Valley Bank and Signature Bank, two large banks that cater to the tech industry, have triggered a financial crisis in the U.S. and immediately raised fears of a global contagion. According to Statista [8], these crashes qualify as the second and third most significant bank collapses in the U.S. in the last 20 years, with assets in value of 209 billion and 110.4 billion U.S. dollars respectively [8].

Figure no. 1. Top 10 US failing banks by asset value at the time of the collapse



Source: Statista, 2023

Several circumstances, including a difficult time for technological businesses, relementation challenges, increased inflation rates, followed by rising interest rates, and bank runs that drove them to sell their bonds at a loss, contributed to the demise of these banks. The Federal Reserve launched a significant lending program, the Federal Deposit Insurance Corporation (FDIC) transferred all deposits from collapsed banks to other institutions, and the President in office reassured Americans that their funds are secure – in an effort that the government embarked to support the financial system. However, the impact of these bank failures is still unfolding and could have serious consequences for the economy and society at large.

Following the mentioned bank defeats, the three main federal bank regulators declared in a joint statement that special procedures would be put in place to guarantee that Silicon Valley and Signature Bank's deposits in their entirety – and not capped at the unusual ceilings - are to be honored [9]. One of the exceptional measures was put in place by The Federal Reserve (Fed), which implemented the Bank Term Funding Program (BTFP) to provide short term (less than 1 year) loans to qualified depository organisms in exchange for collateralized use of qualifying assets.

Global industry regulators like the European Central Bank, but also national regulators for the UK, Canada, Japan, and the Switzerland stepped in similarly, to endure exceptional liquidity flows in their respective systems, in order to stop the „desease” from spreading to more institutions. Major efforts to apease the banking crisis were mostly made in Switzerland, where Credit Suisse was taken in, thus salvaged by its main competitor UBS in March 2023, in an *entante* facilitated by the government. The agreement, welcomed by UBS and the Swiss government, was intended as a method to save Credit Suisse from collapsing and sparking a new banking system crisis. Credit Suisse is anyhow regarded as a systemically significant financial institution.

Quite rapidly, significant interbank fund transfers took place to support the banks' weakening balance sheets, and restless analysts started speculating about a potential wider (and recurring) U.S. banking crisis. Whithin a week after the liquidity crisis had hit the two banks in the U.S., various banks had borrowed about \$150 billion from the Federal Reserve's discount window liquidity facility.

The situation degenerated though two months later when another player on the US banking sector, the First Republic Bank, was closed on 1 May 2023 by a local bank regulator, DFPI. First Republic Bank continued to lose deposits, so FDIC announced that it had taken over the local bank. JP Morgan Chase then purchased the bank, taking over the majority of First Republic's assets amounting to \$175 billion in loans and \$30 billion in securities, plus all its \$92 billion in deposits. The FDIC predicted it would suffer a \$13 billion hit from the deal and will share losses on First Republic's loans. The auction for the First Republic has thus been won by JPMorgan Chase, which is already by a number of metrics the biggest bank in the United States. The failing bank's deposits will all be transferred to it, along with "a substantial majority of assets," according to the New York-based bank's declaration. The most significant bank failure since the 2008 financial crisis, when Washington Mutual collapsed, was caused by the seizure of the First Republic. The assets of the failed banks were at the time acquired by JPMorgan as well.

As per several official statements, the US banks and regulators are confident that First Republic Bank's rescue has put an end to the local banking crisis. Given the risk of contagion, markets are still doubtful that the crisis has been resolved, and speculators are eager to find the next prey. The effects on all asset classes, including currencies, will be significant. If stock prices continue to decline, the dollar will receive some defensive support. However, if the economy rapidly deteriorates and there are restrictions on further monetary expansion, the Federal Reserve will be in a quite vulnerable position. The US dollar will be exposed on international markets if the US economy falters.

## 2. Theoretical background

The total amount of money held in circulation or in reserves is called the monetary base. This applies only to highly liquid assets such as cash, coins, banknotes, i.e. materialized money. The monetary base is increased by an increase in bank reserves, which happens when the Federal Reserve creates new funds for the US dollar to buy commercial bank bonds. The monetary base is an uncommonly cited monetary aggregate that is distinct from the money supply. It includes the total amount of liquidities in use as well as the portion of commercial bank reserves that are kept on hold

at the central bank. As a result of its ability to be multiplied through the use of fractionary reserve banking, it is sometimes called "high-powered money." (Cagan, 1965, p.9)

The imbricated levels of the monetary base are typically listed as M0 through M3 or M4, each of which represents a different aspect of a defined economic space's assets. If M0 is essentially cash, M1 is a specific indicator of the money reservoir that takes both material money and reserves into account, marking the most liquid component of the monetary aggregates. For the U.S., M2 includes M1 plus savings under USD 100,000 and money market funds. M2 assets are liquid, meaning they can rapidly be converted into cash, but they are less liquid than M0 and M1's components and less suitable as trade instruments. M3 comprises M2 plus large, long-term deposits in banks.

One sovereign entity, typically a nation's central bank, is in charge of most monetary bases. Through open market transactions or monetary policy, this body can typically alter the monetary base and monitors it as its main business. Implementing expansionary or contractionary policies can achieve this. By purchasing and selling government bonds on the open market, the government of a given country can keep some degree of control over the monetary base.

The percentage change in prices of goods and services from one year to the next is known as the inflation rate. It is one way of looking at the equation, in other words, we speak about inflation when a gradual, cumulative increase is manifested in the cost of the goods and services across an economic space, fact that determines a decline in the purchasing power per money unit. A persistent increase in the cost of finished products (consumer goods, capital goods) is referred to as inflation, sometimes known as currency devaluation (a decrease in the worth of money). These are classical definitions that can confuse the reader, by mixing in a same basket concepts like: purchasing power, price of goods and services and currency devaluation. Do they account for inflation triggers or rather unwanted consequences?

Methodologically, a basket of different goods and services that households have purchased over time is compared in value to determine inflation. The Consumer Price Index (CPI) and the Wholesale Price Index (WPI) are indexes that monitor inflation. *Demand-pull* inflation, which appears when total demand exceeds total supply, *cost-push* inflation, which happens when production costs rise, and *built-in* inflation, which happens when inflation expectations have an impact on wage and price setting, are typically cited as the causes of inflation. Again, we conglomerate concepts that – put together – could be encountered as consequences rather than causes of the phenomenon.

### **3. Research methodology**

The paper undergoes a classic qualitative approach of the studied phenomena, in an interlinked application of the monetary mass concepts (construct, components, influences, dynamics), inflation (triggers, misconceptions, dynamics) and financial crisis cyclicity.

It compares two cycles of financial crisis, one confirmed (2008) and one under possible formation (2023), by discussing their two main triggers: inflation and economic underperformance. We review undertaken measures to limit the new crisis formation and we assess the current outcomes.

The four components of the qualitative approach are: review of literature, phenomenological investigation, grounded theory and case report. The four components are attained in interrelation and in a sequential trail. The Cantillon effect is discussed and its continuous applicability over changing economic paradigm is emphasized.

### **4. Findings**

#### **4.1. Comparison of the 2023 upsurging crisis with the confirmed 2008 crisis**

According to FDIC data, the assets of all federally insured banks that failed in 2023 were greater than the assets of all 25 banks that failed in 2008, with inflation factored into the equation. The three banks' combined assets, according to the New York Times, were \$532 billion. When adjusted for inflation, that amount exceeds the \$526 billion held by the 25 banks that failed in 2008 during the height of the global financial crisis. Small bank failures typically go unnoticed on the larger market. For instance, more than 500 federally insured banks failed between 2008 and 2015. But among US banks ranked by assets, the three that collapsed in first half of 2023 made the top 30.

Up to \$250,000 is insured for US bank accounts. The vast majority of individual bank accounts are fully insured, according to the most recent data. However, due to the concentration of some very large accounts, particularly in the corporate sector, uninsured deposits have tripled since 2009 to \$7.7 trillion. Large amounts of uninsured deposits raise the risk of bank runs as businesses withdraw money from weaker banks. The FDIC released its most recent reform recommendations this week, taking into account three main alternatives. The first choice would be to keep things as they are, but doing so would make more failures likely. Another choice would be to insure all deposits and do away with the insurance ceiling entirely. The FDIC has significant concerns and noted that completely eliminating the cap could be expensive and could ultimately undermine financial stability because banks might take greater risks if their deposit bases are seen as more stable. It believes that implementing reforms with stronger protection for business accounts would be the most advantageous course of action. According to the FDIC, an insurance plan that would significantly increase or even provide unlimited coverage for such business accounts could improve financial stability by decreasing the likelihood that those depositors would flee a bank in large numbers.

Risk appetite is invariably reduced by concerns about the banking industry, particularly those related to contagion concerns and worries that rising interest rates will result in more casualties. As several analysts noted, it is difficult to assess where the next problem is going to manifest in a world where leverage has been very high because of very low-interest rates for a long period of time, while in the current situation, liquidity is not going to be as ample as before. US and international stock markets are likely to decline, and the US dollar also has a tendency to gain net support due to defensive factors.

Also, there are significant ramifications for the US economy as well. With the need to tighten lending standards and limit the amount of credit available in the economy, banks will inevitably be more cautious when making loans. Loans will be harder to obtain for businesses and people. Additionally, there is a chance that riskier loans made to businesses will be called in, increasing the chance of business failure. The commercial sector is particularly vulnerable to this threat. Before the end of 2025, more than \$1 trillion in commercial real estate loans will become due. As banks tighten their underwriting, many borrowers may find it difficult to refinance their debts.

The economy could be impacted by the tightening of credit standards, which will also have a significant impact on financial conditions. The Federal Reserve will find it much harder to defend any additional interest rate increases in this situation. Is this situation going to potentially create stirring conditions for the next financial tornado? Almost certainly yes, in a globalized economy where many States take the US Dollar as a currency choice for the national reserve. We note though that the preference for the US Dollar as a global reserve decreased from 72% to 58% between 2000 and 2022 [IMF data, 2023]. The same dataset speaks about financial fragmentation under increased geopolitical volatility.

#### **4.2. Monetary mass and inflation**

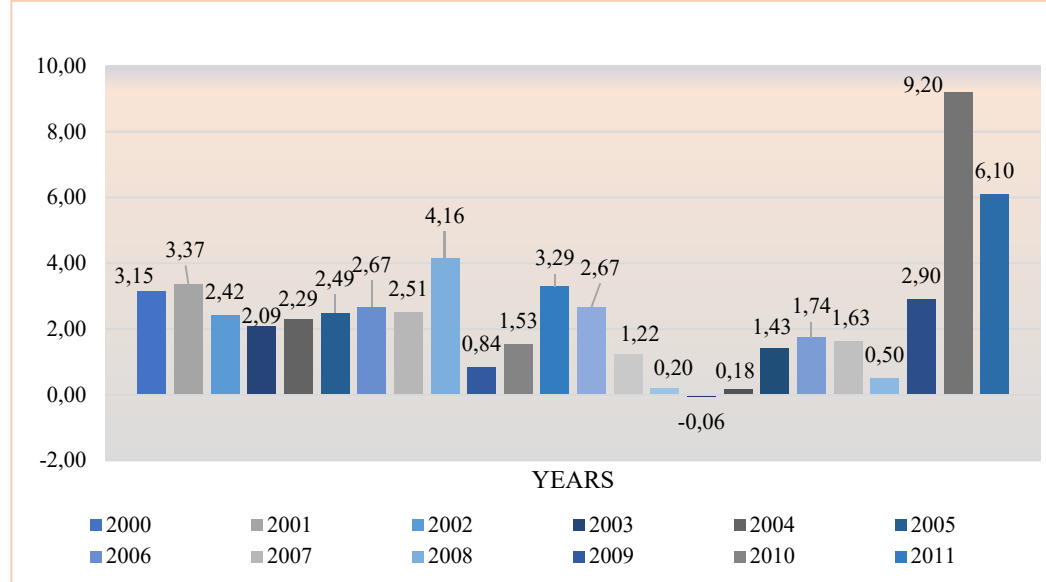
Depending on the rate and the perspective, inflation can have either good or negative consequences on the economy. According to economists, moderate inflation can promote economic expansion and consumer spending, whereas severe inflation can erode purchasing power and deplete savings. The European Central Bank (ECB) tries to keep inflation at or below 2% over the medium term in order to ensure price stability. Examples of demand-pull inflation include the 2006 increase in US housing prices. This resulted from a new insurance product that enhanced demand for asset-based securities and created a housing bubble by guaranteeing against mortgage and other loan defaults. Also, the inflation and economic development in the UK since 1980 resulted from declining interest rates, income tax rates, growing home prices, and increased consumer confidence, all of which increased aggregate demand and consumer expenditure.

Along the same line, a decline in the value of the local currency can lead to a demand-pull inflation scenario by lowering export prices and raising import prices, which raises home demand and lowers international competition.

Despite all these well known, recurring scenarios that we can enumerate, what we can clearly see are the unwanted consequences of the inflated money, which find their primary source in the same old, simple and tempting maneuver that all administrations tend to recur to: printing money.

The money, as main exchange instrument, is not sensitive in nature, in the absence of the governments' intervention. With the development of the human society, also developed artificial ways in which natural phenomena (demand, offer, equilibriums, consumption, prices, etc.) are detoured and manoeuvred to obtain specific configurations and effects in certain moments by the governments in place. For insignificant and volatile advantages (for example illusion of prosperity for the voters), the administrations ruin well established equilibriums and postpone natural adjustments which would be applicable to correct or integrate misperformance.

Figure no. 2. Dynamics of the annual inflation rate in the Euro zone between Dec 2000 and May 2023 (%)



Source: World Bank, 2003

In the small consumer unit, the money creation process starts with a client defining a project. Sources of funding for the project are immediately sought, and a bank is chosen to finance it, after checking, variably thoroughly, on the client's solvability. It might be small projects, like buying a house or a car, refinancing an older credit, sending a child to college, or for medical expenses.

It is said that the commercial banks are in the business of transforming the duration. They attract short-term deposits and give out medium or long-term credits thus transforming the short-term liabilities into long-term assets. A part of the deposits is kept at the central bank or the Fed as compulsory reserves earning little or nothing at all. In fact, when a prospective client requests a loan, the bank is issuing a security with a face value equal to the loan plus costs and provisions. The Fed or the central bank like ECB is buying these securities by crediting the bank's account with new currency (asset purchase program). This stage is where the monetary mass increases, new money is pumped into the system.

The maturity of the security should be the same with the maturity of the loan so, at the end of the contract, the bank is redeeming the security and cancelling it. In fact, the existence of the secondary market requires that the securities remain valid and in circulation. They are different from the shares although they might pay a coupon as well. It appears that the value of the security is given by the quality of the loan collateral with all its fluctuations, but as too often seen, there could be securities not backed by any assets.

Another way to increase the money supply is a straightforward loan extended to the commercial banks. The third way is to manipulate the required reserves that the banks must maintain at the central bank. These reserves were reduced to zero by several central banks during the Covid'19 pandemic. No precautionary systemic measures were put in place, as force majeure could be invoked. The other banks whose assets do not qualify to the asset purchase programs, can still borrow, and extend loans in the fractional reserve system.

## 5. Conclusions

Between 2000 and 2021 the average inflation rate in the Eurozone was remarkably steady with a minor peak at 4.16% in 2008, thus not very shaken by the turmoil over the ocean, on the Dollar (see Fig. 2). Should it be linked to the fact that subprime crisis is more an American style of crisis or that the over-regulation on the Euro had favorable effects for once. Many were the circumstances, but the fact remains. Euro continued less traumatized by the American financial crisis, which contracted economies globally, and that despite its numerous objectionable components, given by its very aggregated, artificial nature.

At the same time, while a certain turmoil was forming, financially, around the post-pandemics' new context, the inflation rate on Euro jumps from 2,90% to 9,20% in 2022 as compared to the previous year. As mentioned, significant, unpredictable triggers such as pandemics and the war in Ukraine have set the scene for the monetary skid and these are certainly most authentic reasons that could cause inflation and financial crisis. Energy crisis, gas prices bouncing up, boycott to the Russian energy sources can also strain the monetary aspects of the Euro zone.

Additional aspects such as climate awareness determine costly choices for economies that already suffer the pressure of under-performing due to uncontrollable, exogenous factors but also due to erroneous management decisions. Still, in a visibly forming crisis, the governments' response for additional sources of financing deficits and under-performance remains the same solution: money printing. The cheapest answer to years of self-indulgence, lack of economic vision and of realistic economic measures.

There are several distortions that such mechanisms are introducing in the economy. First, the choice made by the central bank on which assets to buy and how much to change the required reserves is political in nature: no economic free will, no natural formation of phenomena. Political decisions are not economic in substance, they do not take into consideration the logic of economics, in other words they tend to be less efficient thus leading to malinvestment. Free will exists in the economy for a reason: against imposition of exogenous factors and policies, which – even with best intentions – will introduce distortions of phenomena. Secondly, the issuance of additional money against securities has a huge potential to be inflationary if its rate is higher than the productivity increase; in other words, more money will chase less merchandise and services. The Cantillon effect, which disrupts relative pricing of products and services, promotes redistribution of purchasing power among individuals, and causes the misallocation of limited resources, is still very much in evidence.

When there are no productivity questions, no natural adjustment to the cyclical contraction or the evident crisis triggers, the stirring-down of the economy is ensured. As per the known paradigm, when from the same actions governments expect different outcomes, the economic pathology can only be the same.

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