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Rising Interest Rates and Financial Cracks

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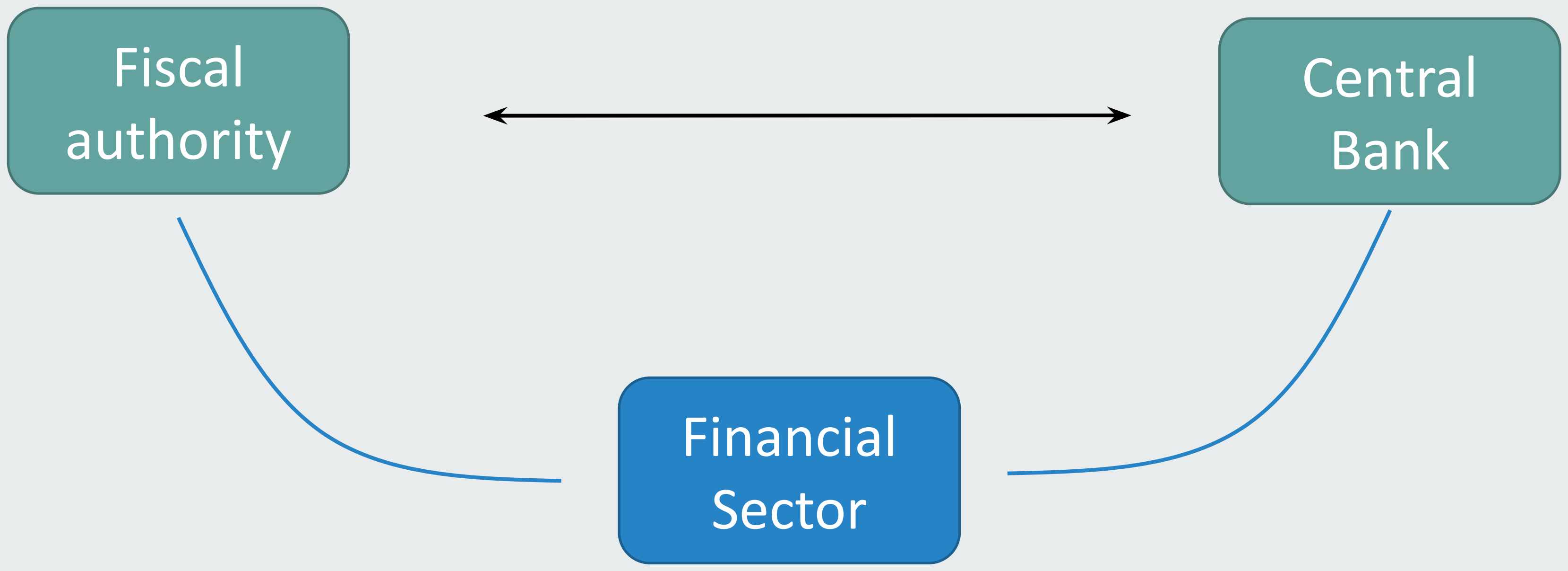
Fiscal, Monetary, and Financial Dominance

- **“3-sided” Game of Chicken**



- Monetary Dominance: *tighten*
- Financial Dominance: *loosen*
  - UK Pension funds: LDIs

Poll

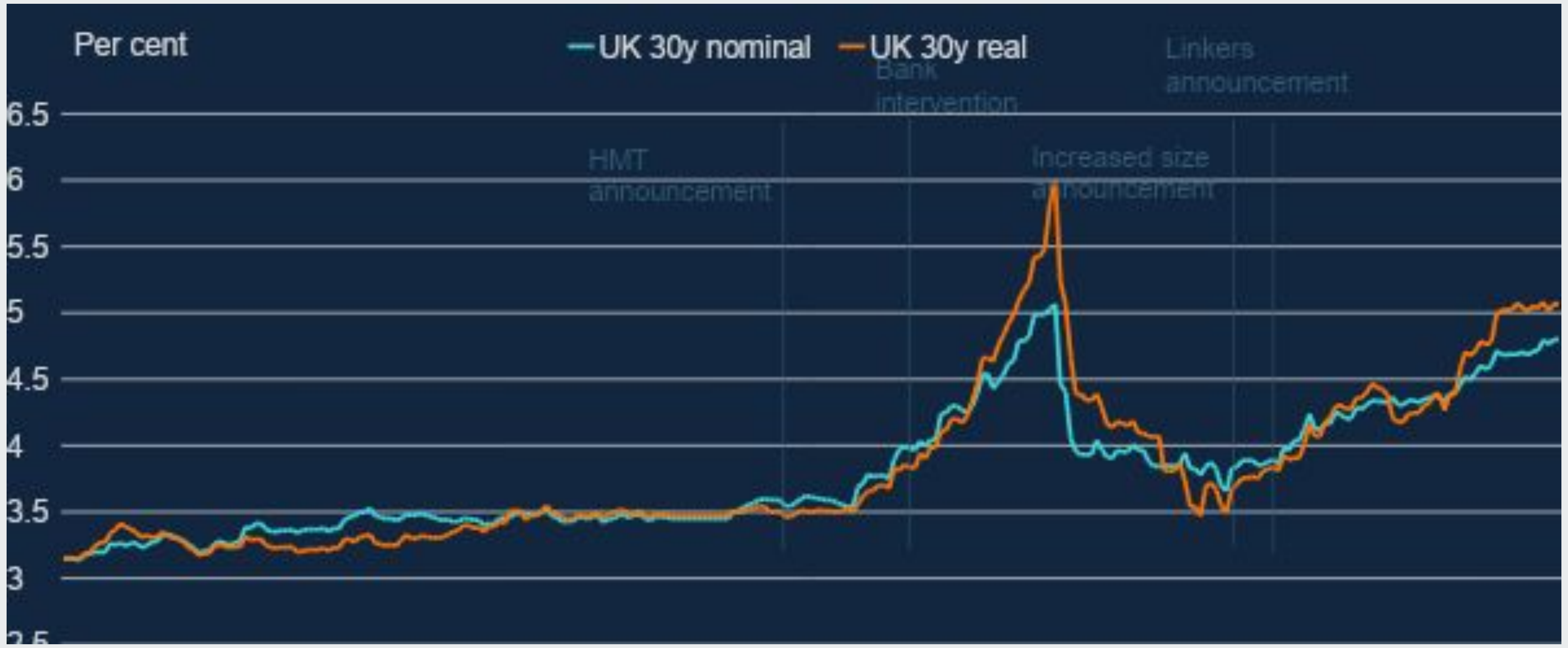
1. The **spike in** UK **yields** is **due to**
   a. Financial frictions (LDI) b. Solvency fears
   c. Loss of central bank credibility d. Others
2. Interest rate hikes will most likely reveal **cracks in**
   a. Traditional banks b. Shadow banks
   b. Other intermediaries d. Crypto assets

Can pick more than one

3. The **increases in interest rates** in the US will bring
   a. **inflation back** to target b/c Fed tolerate recession
   b. inflation back to target slower growth but no recession
   c. Not bring inflation back because Fed will stop hiking
4. Normalization of monetary policy will lead to
   a. Normalization of corporate default
   b. Excessive corporate defaults

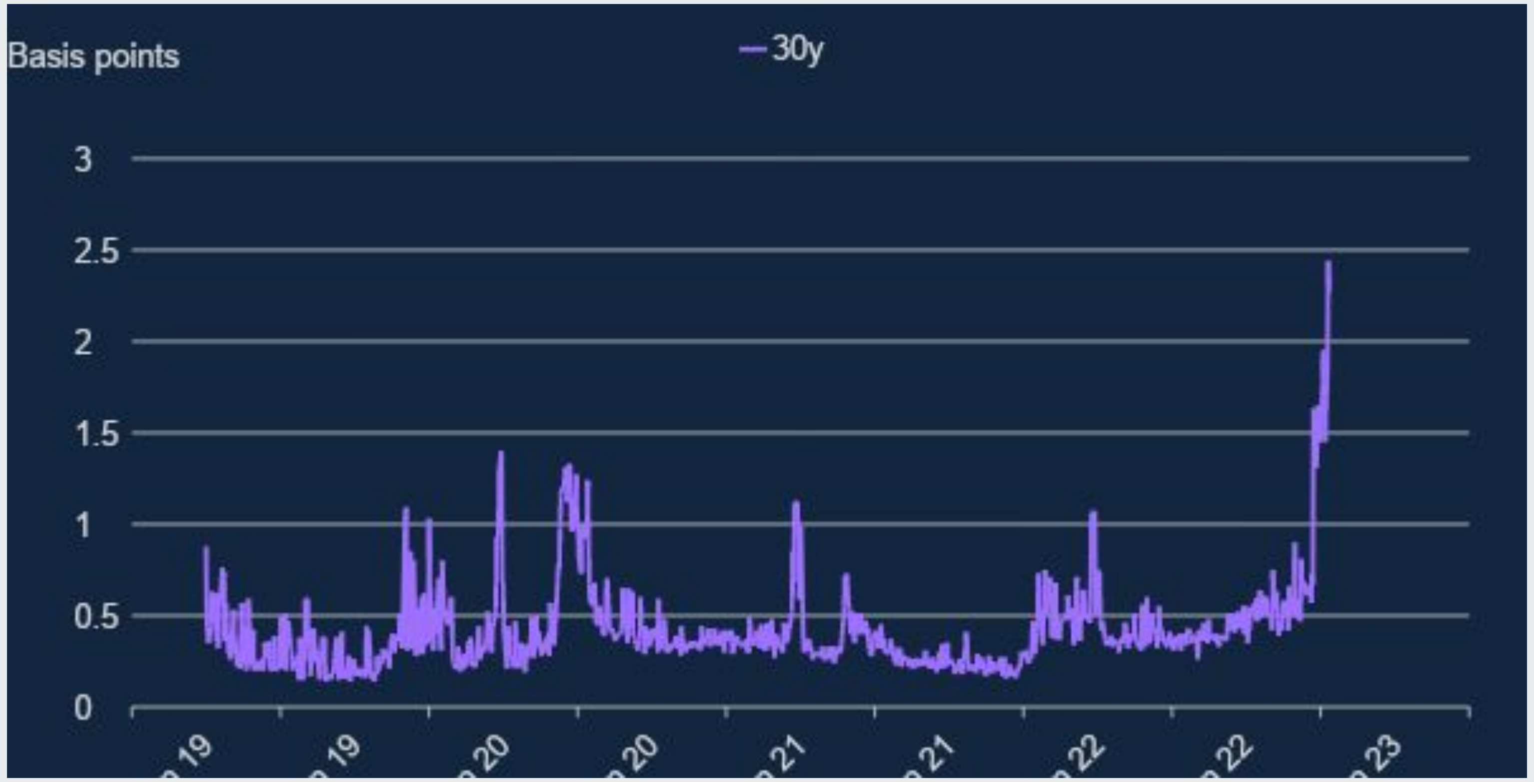
5. **Japan** will be spared from high inflation: Yes or No

Government Bond Interest Rate: Nominal & Real



Lender vs. Market Maker of Last Resort

- Intervention:
  - LoLR: ⇒ Repo for pension funds/LDIs
  - MMoLR: ⇒ purchases (temporary)
    price, volatility, **bid-ask spread**



Runs: Banks and Shadow Banks

- Banks' vulnerability & inflation
  - Stagflation

- Pension funds, LDI,
- Insurance companies
- CLO structures
- ETFs with hidden leverage
- Open-ended mutual funds

Default Risk

- CDS spreads
- Corporations
- Bonds and negative β
- Correlation btw bonds and stocks

- Sovereigns (EME)
  - G20 common framework

Japan

- Yield curve control
- FX intervention

- CIP violations (bond basis)

Financial Innovation

- Hidden risk taking
- Crypto and Inflation

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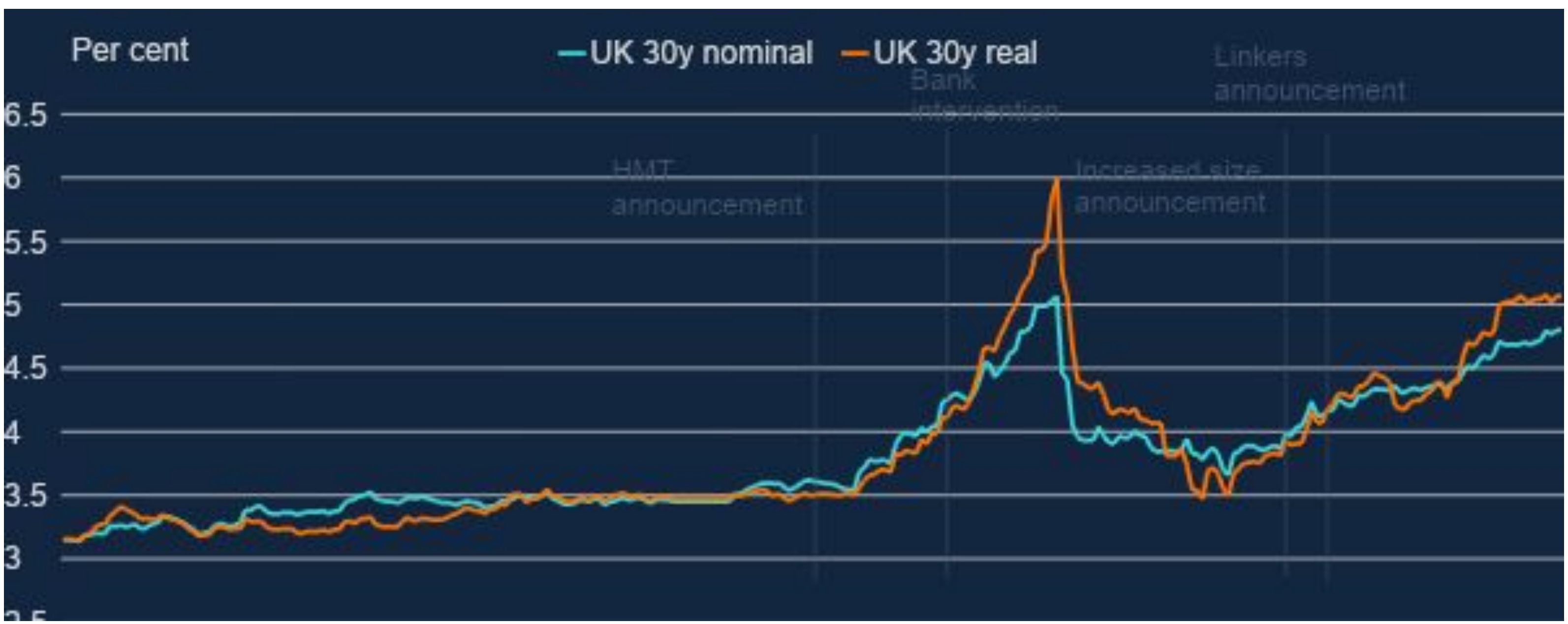
Markus Brunnermeier


Basis point change since 1 September
UK 30y
US 30y
EA 30y
Bank intervention
Linkers announcement
Fiscal event
Increased size announcement
250
200
150
100
50
0
-50


Per cent
UK 30y nominal
UK 30y real
Bank intervention
Linkers announcement
HMT announcement
Increased size announcement
6.5
6
5.5
5
4.5
4
3.5
3

Gilt Bid-Ask Spreads