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## The inflation-financial stability trade-off: the Fed at the crossroads

Ernesto Talvi | Senior Research Fellow, Elcano Royal Institute.

### Theme<sup>1</sup>

The recent events triggered by the collapse of the Silicon Valley Bank (SVB) have brought to the forefront a debate that was only hinted at: the dilemma faced by central banks between price stability and the stability of the financial system. Is there really such a dilemma?

### Summary

The two objectives, the fight against inflation and financial stability, do not come into conflict if the origin of the instability of the financial system is a liquidity crisis. In such a case, in principle, the temporary action of central banks as lenders of last resort providing liquidity to the financial system solves the problem.

The conflict between the two objectives may arise if the problems of financial institutions are solvency-related and systemic. In the event of a systemic solvency crisis, of which Latin America has vast experience, it is very difficult to mobilise capital and/or fiscal resources with the speed the situation requires. Nor is it realistic to intervene a significant number of financial institutions.

Without these tools at its disposal, the Fed can temporarily resort to liquidity injections to try to stabilise the financial system, using an instrument not designed to deal with a solvency crisis. Eventually, and in the face of a systemic crisis, the Fed may be forced to abandon its inflation target and allow a more gradual convergence towards the ultimate 2% target if the latter is not raised also.

### Analysis

The recent events triggered by [the collapse of the Silicon Valley Bank \(SVB\)](#) have brought to the forefront a debate that was only hinted at: the dilemma faced by central banks between price stability and the stability of the financial system.

The rapid rise in interest rates, the key instrument for combating the inflationary spiral that was triggered in mid-2021, led to sharp falls in fixed-income securities which, in the case of SVB, resulted in a total loss of its capital, precipitating a run on its deposits. The contagion affected other regional banks in the US and the shock waves were felt globally, with the 'fall' of Crédit Suisse being the most symbolic event.

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<sup>1</sup> I thank Pablo Ottonello and [José Pablo Martínez](#) for a stimulating discussion on the first version of this paper. Any remaining errors are the responsibility of the author.

Is there really such a dilemma? It depends on the nature of the problem.<sup>2</sup>

### Inflation targeting and liquidity crisis

If the aim is to solve a temporary liquidity problem, the dilemma, in principle, does not exist. The classic principle of the Dutch economist [Jan Tinbergen](#) applies here: for each policy objective an independent instrument is needed. Central banks can use the interest rate to achieve target inflation, and their existing or new lender of last resort facilities to intervene when liquidity crises occur.

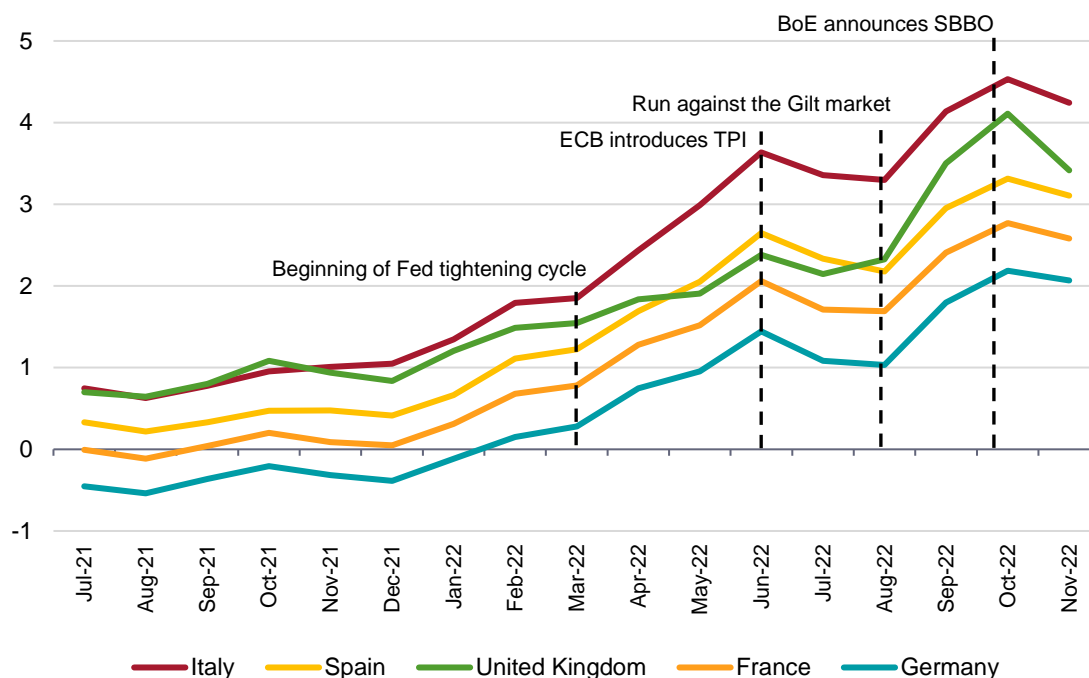
There are several recent examples of this *modus operandi*.

In March 2022, at the onset of US monetary policy tightening and [Fed rate hikes](#), the interest rate on Italian debt and spreads on German Treasuries rose sharply (see Figure 1). In response, the ECB announced a new instrument, the [Transmission Protection Instrument](#) (TPI), which was activated to counter ‘unwarranted and disorderly market dynamics unrelated to the specific fundamentals of the country in question’. In plain English, the ECB would intervene by buying bonds, in this case sovereign bonds, when it interprets that the situation is not related to a solvency problem but to temporary illiquidity and contagion. Moreover, the TPI does not restrict *ex ante* the scale of interventions, which will depend on the severity of ‘the risks of fragmentation in the transmission of monetary policy’. A blank check to buy Italian debt (or any other in the same situation) at the ECB’s discretion and, unlike the *Outright Monetary Transactions* (OTM) mechanism, with a [much looser conditionality](#).

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<sup>2</sup> For an alternative perspective to the one presented in this analysis see Judith Arnal (2023), ‘Estabilidad financiera y estabilidad de precios: dos caras de la misma moneda’, ARI, Elcano Royal Institute, 10/IV/2023, <https://www.realinstitutoelcano.org/analisis/estabilidad-financiera-y-estabilidad-de-precios-dos-caras-de-la-misma-moneda/>.

Figure 1. European Interest rates (10-year bond yield, in %), 2021-22

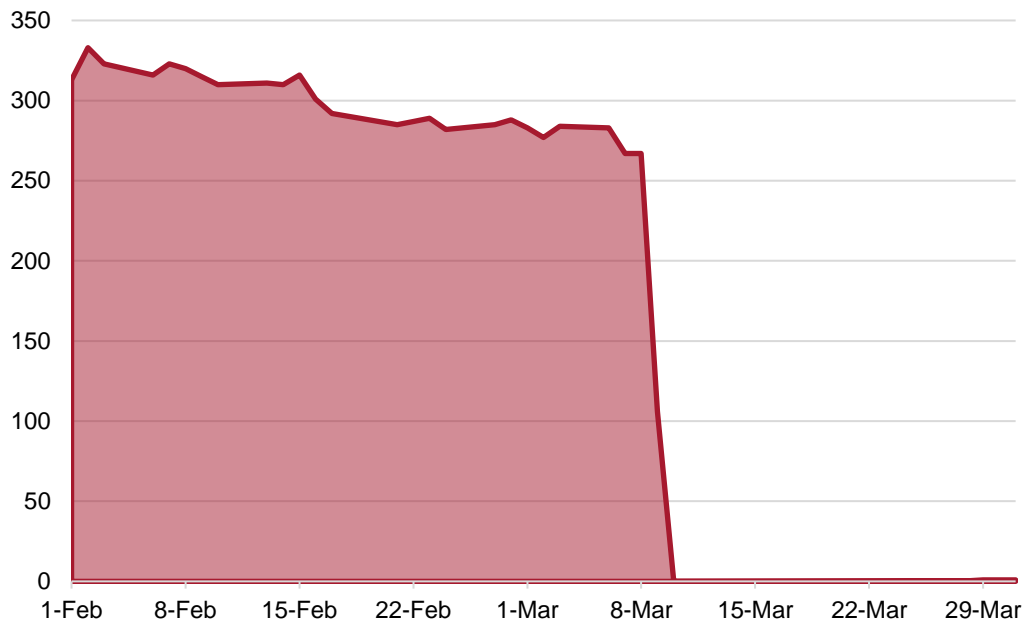


Source: Federal Reserve Bank of St Louis.

In the run on UK government bonds (better known as gilts) in September-October 2022 (see Figure 1), the Bank of England did not need verbal twists and turns to act decisively: it halted its Quantitative Tightening (QT) programme and announced a [Special Bond Buying Operation \(SBBO\)](#) of up to £65 billion for a two-week period to calm the markets in order to mitigate 'significant risks to UK financial stability'.

At the time of [the run on SVB](#), the Fed put in place a new lending facility for non-systemic banks to ensure that they could meet depositor withdrawals. The Fed's [Bank Term Funding Program \(BTFP\)](#) provided liquidity lines of up to one year and US\$25 billion, taking government-backed bonds as collateral and pricing the bonds at par, an unprecedented move. Independently of the BTFP, in the days that followed the outbreak of the SVB crisis, US banks drew on the Fed's primary credit facility (a lending programme available to depository institutions that are in a generally sound financial condition) more heavily than during the 2008 crisis (see Figures 2 and 3).

**Figure 2. SVB stock price (US\$/share)**



Source: Investing.com.

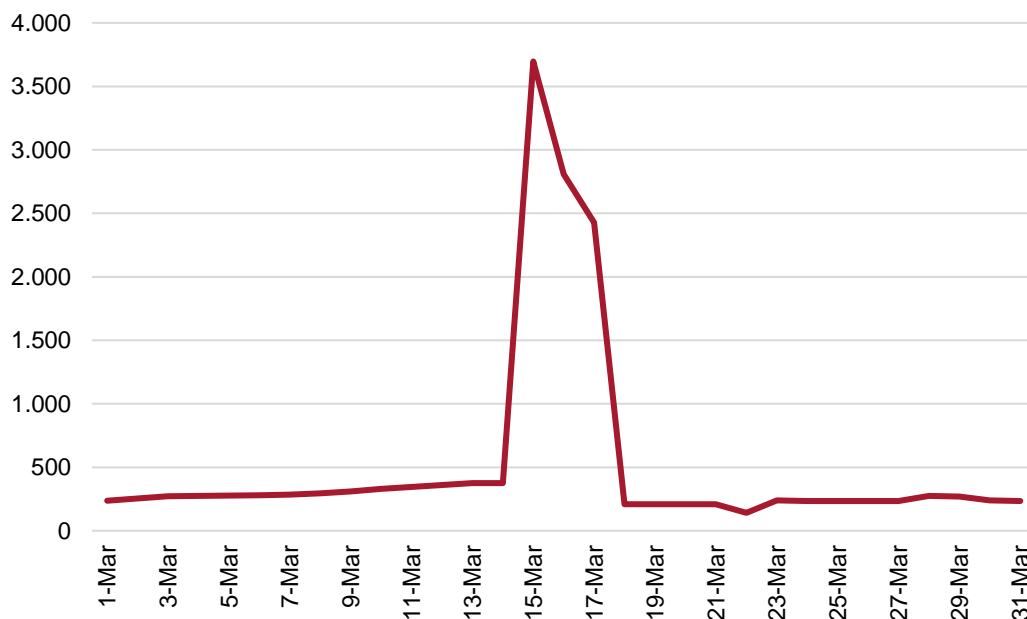
**Figure 3. Fed primary credit facility (US\$ mn)**



Source: Federal Reserve Bank of St Louis.

When the major European banks were hit by the SVB crisis, and once it became known that a key [Crédit Suisse](#) shareholder was refusing to inject capital and Credit Default Swaps (CDS), spreads skyrocketed, the [Swiss National Bank](#) granted [Crédit Suisse](#) a liquidity line of up to CHF100 billion (see Figure 4).

**Figure 4. CDS Crédit Suisse (1 year, in basis points)**



Source: Investing.com.

In all these cases, central banks acted decisively as lenders of last resort in the face of a liquidity crisis to stabilise the financial system. And they did so without affecting the dynamics of the instrument used in the fight against inflation. Both the ECB and the Fed raised interest rates amid the SVB storm, sending a clear signal as to how they would use the various instruments at their disposal. Nor did the Bank of England resort to interest-rate cuts when the run on gilts broke out.

Two instruments for two objectives: if the run stops, as it did in the cases described above, the monetary expansion implied by central bank interventions as the lenders of last resort are temporary, and do not conflict with interest rate policy and the inflation target.

### **Inflation targeting and solvency crisis**

This conflict could arise if the crisis of the financial system is solvency-related and systemic.

In the event of a solvency crisis in an individual banking institution, what is needed is to recapitalise it, by means of a capital injection from its shareholders, or by the absorption of the insolvent bank by other financial institutions. If neither of these options is available, there is always the possibility for the authorities to intervene the bank and proceed to an orderly transition or liquidation.

The latter is [what happened with SVB](#). The FDIC took control of the bank, removed its top management and almost simultaneously announced a full guarantee for all deposits held at SVB, including uninsured deposits, which could eventually involve fiscal

resources. In fact, the full deposit guarantee was extended to all systemically relevant banks.

In the case of *Crédit Suisse*, and despite the irregularity of a process in which the holders of contingent convertible bonds (CoCos) lost their entire investment and the shareholders were not consulted, the Swiss economic authorities essentially forced the [absorption of \*Crédit Suisse\* by UBS](#).

These specific cases were resolved according to the manual. Liquidity assistance was made available to solvent banks affected by contagion, and insolvent banks were quickly encapsulated, recapitalised and absorbed in one case or intervened in the other.

The conflict between inflation targeting and financial stability may arise if the solvency crisis takes on systemic proportions. In the current circumstances, this is not a minor issue as the rise in interest rates has generated considerable losses in the fixed income assets of financial institutions, affecting their capital base. [According to the Fed](#), US banks had US\$620.4 billion in unrealised losses in their bond portfolios alone, almost 30% of their capital. Other fixed-income assets –such as residential real estate or commercial loans– are currently in the focus of central banks.

In the event of a systemic solvency crisis, of which Latin America has vast experience, it is very difficult to mobilise capital and/or fiscal resources with the speed the situation requires. Nor is it realistic to intervene a significant number of financial institutions.

Without these tools at its disposal, the Fed can temporarily resort to liquidity injections to try to stabilise the financial system, using an instrument not designed to deal with a solvency crisis. Eventually, and in the face of a systemic crisis, the Fed may be forced to abandon its inflation target and allow a more gradual convergence towards the ultimate 2% target if the latter is not also raised. This action would be consistent with what is observed in episodes where inflation rises significantly, as recently documented by [Blanco, Ottonello & Ranosova \(2023\)](#): episodes of accelerating inflation tend to be persistent, with a duration of disinflation three times longer than the initial rise in inflation.

As we argued in our [Project Syndicate article last September](#):

‘Faced with the choice of allowing inflation to exceed its target or raising interest rates substantially above current inflation levels, the Fed will opt for the former. The reason is simple: choosing the latter could trigger a financial and economic crisis.’

We still think so.

## Conclusion

The two objectives, the fight against inflation and financial stability, do not conflict if the origin of the instability of the financial system is a liquidity crisis. In such a case, in principle, the temporary action of central banks as lenders of last resort providing liquidity to the financial system solves the problem.

The conflict between the two objectives may arise if the problems of financial institutions are solvency-related and systemic. In such a case the Fed may be forced to abandon its inflation target and allow a more gradual convergence to the ultimate 2% target if the latter is not also raised.