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  
   c. Other intermediaries  
   d. Crypto assets

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: \( \Rightarrow \) Repo for pension funds/LDIs
  - MMoLR: \( \Rightarrow \) 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 $\beta$
- 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
Rising Interest Rates and Financial Cracks

Markus Brunnermeier
Gilt Bid-Ask Spreads