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# Global Trade in Crisis: What's Next?

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# Global Trade in Crisis: What's Next?

- The old open trade and investment order has been weakening.
- Undermined not just by the United States but also by China.
  - Have never really addressed the concerns of those hurt by trade.
  - Anger at mismanagement that led to Global Financial Crisis.
  - Is there place for two hegemons?

## Despite all the worries...

- Adverse effects are hard to see yet in the United States on either growth or inflation
  - Anticipation and policy uncertainty have delayed effects.
  - Range of policies and developments have complicated effects
    - The AI related construction boom.
    - The immigration crackdown.
    - The fiscal stimulus in the Big Beautiful Bill
- Government shutdown increases uncertainty about true situation.

## Is there anything else policymakers should worry about?

- Lots of uncertainty, yet financial markets are celebrating
  - Stock prices high
  - Credit spreads narrow
  - Speculative assets like crypto currencies buoyant
  - Merger boom
- Financial conditions have not tightened throughout the time the Fed raised rates
  - Excesses have not been squeezed out both during the pandemic (huge fiscal and monetary stimulus) and after.
  - Newer forms of credit, including private credit, have expanded.
  - Cracks emerging – Tricolor, First Brands...

## Do we know enough?

- The Fed is cutting into strong credit conditions...extrapolating labor market weakness but also government pressure.
- What have we learned about such situations?

## When Credit Bites Back: Jorda, Schularick, and Taylor (2013)

- Examine 154 business cycles in the 14 countries
- 35 coincide with financial crises
- Examine the effects of excess credit
  - higher credit/gdp growth relative to mean in expansions
- Findings
  - Financial crisis recessions worse
  - Closely related to credit intensity of expansion

# The effects of excess credit...

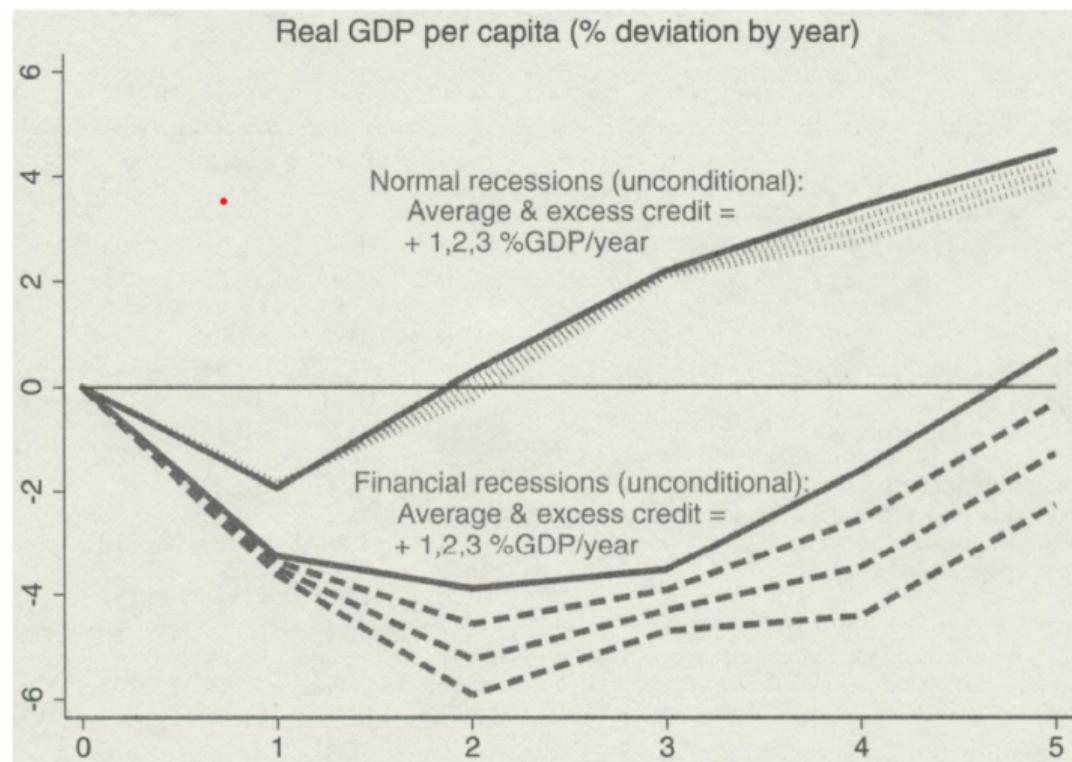


FIG. 1. Unconditional Paths under Continuous Excess Credit Treatment.

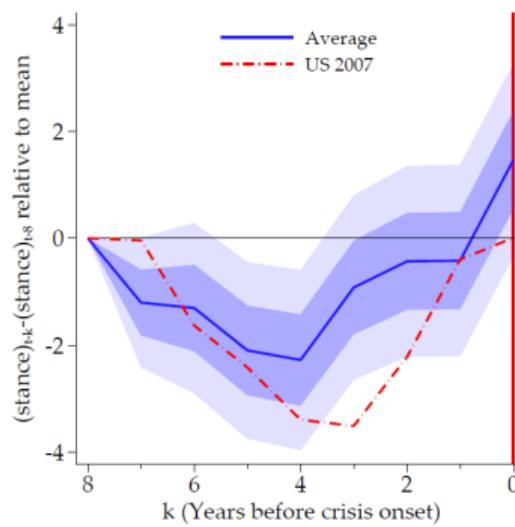
# Accommodative Monetary Policy and Financial Instability: Grimm, et al. (2023)

- Stance of monetary policy => real policy rate less a measure of real neutral rate

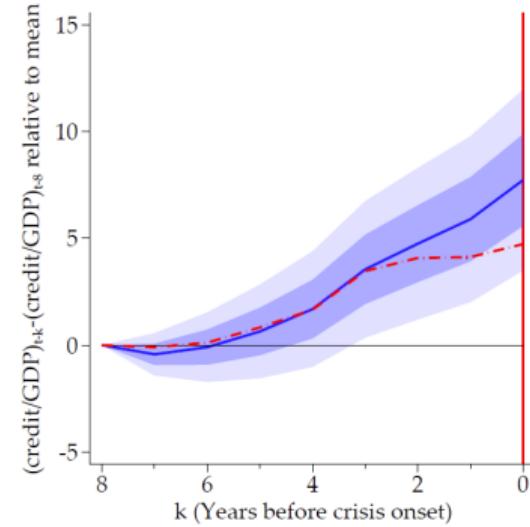
# Policy stance and credit growth before crisis

Figure 1: The stance of monetary policy and credit growth before financial crisis events.

(a) stance (pps)

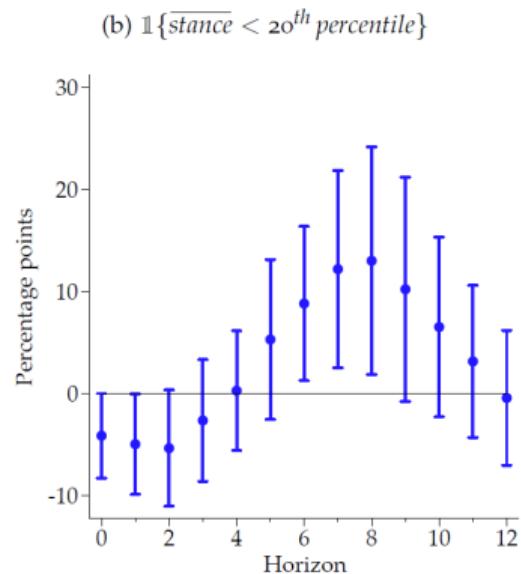
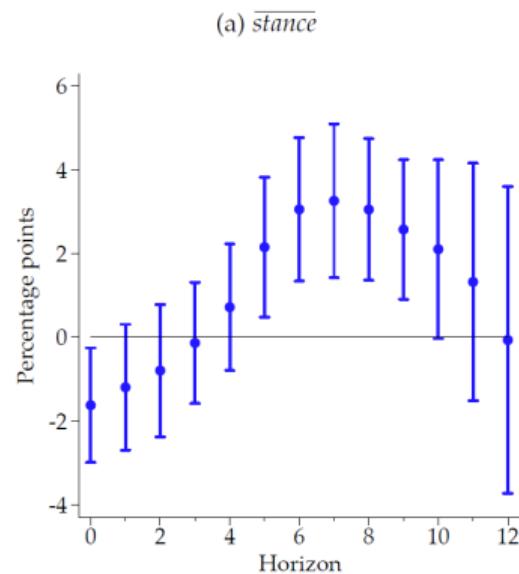


(b) Credit-to-GDP ratio (pps)



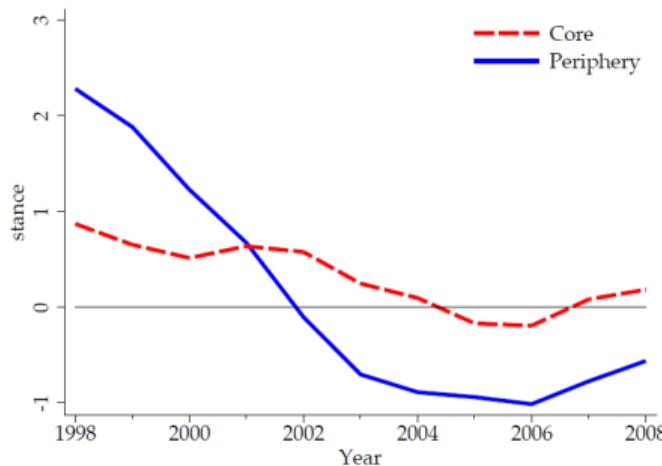
# ▽ Probability of crisis and 5 yr average stance (a) Lower by 1% (b) in lowest 20th percentile

Figure 3: The connection between loose monetary policy and financial crises.



# But isn't policy endogenous?

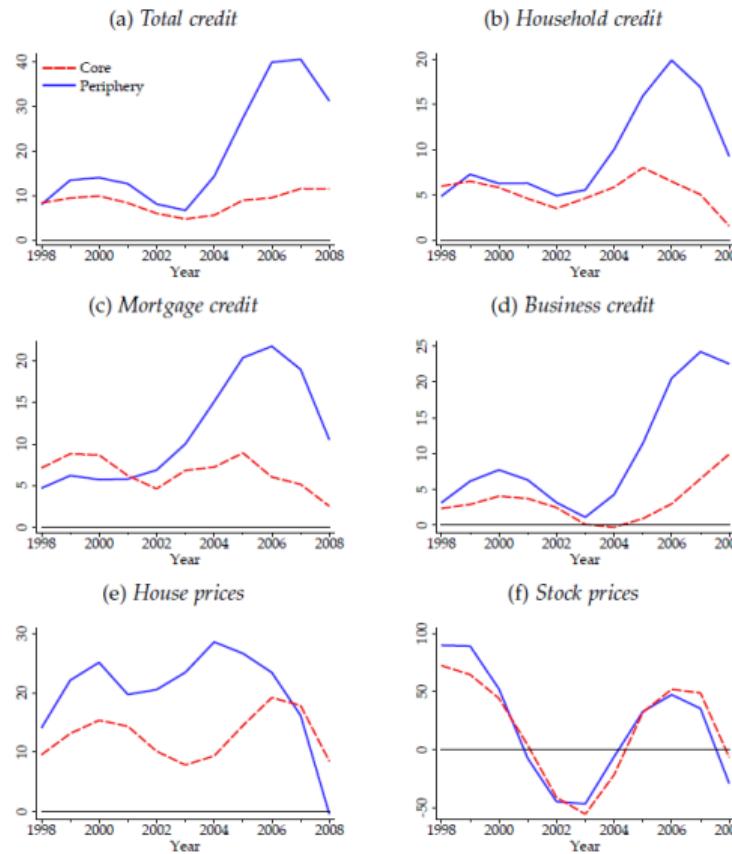
Figure 10: The stance of monetary policy in the eurozone before the Global Financial Crisis.



Notes: The figure shows the unweighted average of  $\overline{\text{stance}}$  as defined in equation (4) for the core countries (Belgium, Denmark, France, Germany, Netherlands) and for the periphery countries (Ireland, Italy, Portugal, Spain) of the eurozone.

# Effect of divergent policy on credit and asset prices

Figure 12: Credit and asset prices in the eurozone before the Global Financial Crisis.



# Why do low rates precipitate risk taking?

## Households

- Low risk free rates increase investment in risky assets (Lian, Ma, and Wang (2018))
  - Reference point
  - Salience
- Search for yield to cover fixed savings needs

## Financial intermediaries

- Search for yield to cover fixed liabilities or fixed costs (Rajan (2005), Drechsler, Savov, and Schnabl (2018))
- Inflows burning a hole in your pocket (Granja, Leuz, and Rajan (2022))
- Exacerbated by herd behavior or FOMO (Stein (1989), Rajan (1994))

## Another instrument? Liquidity expansion and contraction

- Central bank balance sheet expansion injects liquid central bank reserves into banks: Quantitative Easing (QE)
  - Free extra instrument?
- Used to
  - Stabilize financial markets
  - As a monetary policy instrument when central bank faced with the zero lower bound
- Should flooding the market with liquidity not reduce liquidity shocks (periods when liquidity seems to evaporate from markets)?
  - However, September 2019, Mar 2020, Mar 2023, April 2025

## Sustained liquidity infusion encourages liquidity use, dependence

- Liquidity is like a drug, induces dependence (Acharya and Rajan (2022))
- It is costly for banks to simply hold liquid central bank reserves. Therefore they “use” them and become vulnerable to shortfalls (heightened in time of quantitative tightening (QT))
- Evidence in Acharya, Chauhan, Rajan, and Steffen (2024)): Against reserve holdings acquired in QE,
  - US banks issued “cheap” uninsured demand deposits. Also ran down time deposits.
  - Banks wrote lines of credit to all who might need liquidity.
  - Banks funded levered speculation, e.g., bond basis trade.
- Each action created claims to some portion of the bank-held central bank reserves.

- Liquidity supply creates its own demand, leaving little spare.
  - This is why the Fed is stopping QT when bank reserves are twice what they were when it started QE in 2020.
  - But leaves the system yet more extended.

## Central bank intervention is beneficial in the short term...

- Illiquidity, fire sales, and bank runs are inefficient ex post.
  - Central bank intervention can reduce or eliminate them.
- One policy response might be
  - While the Fed cannot recognize or prevent asset price booms, it can “mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion.”  
Greenspan (2004)
- Fed put (interest rate, special facilities, liquidity)

- Intervention can undermine the disciplinary role of deposit contract (Diamond and Rajan (2001)), exacerbating moral hazard.
- Bagehot Rule: Lend freely against good collateral at a high rate.
- What rate? The rate that would prevail in the private market absent intervention (Acharya, Rajan, and Shu (2025))
  - Hard for central bank to charge that rate ex post in the midst of turmoil
    - Fed facility in 2023
  - Hard to charge that rate ex ante as insurance premia build up
    - Pre-committed facilities (King (2016))
    - Deposit insurance

# The Safety Net: Central Bank Balance Sheets and Financial Crises, 1587-2020 (Ferguson, et al. (2023))

- Central bank intervention turbo-charges incentive effects of accommodative policy.
- Does intervention sow the seeds of the next crisis (Ferguson, et al. (2023))?
- Authors find that liquidity support during financial crises
  - ensures crises are less severe
  - however, raises the probability of future boom-bust episodes.

## Should central banks be cautious?

Even as they navigate between a slowing and reaccelerating economy, central banks should worry about financial stability.

- Macro-prudential measures?
  - Using prudential measures alone is like trying to stop a car by waving outside the window while monetary policy is jamming on accelerator.
- Leads to asymmetric monetary policy
  - In normal times, no attempt to rein in risk taking from the monetary side
  - Let the supervisors take care of it!
- In times of stress, intervene to save the system
  - The supervisors were asleep at the wheel, we are the only game in town
- Boom to bust to boom again

The world cannot afford another financial crisis.

- Might a bust be too big for even the central bank – more likely today when many governments fiscally constrained.
  - While supervisory and macro prudential tools should be used fully, they will likely be insufficient in the modern financial system.
- Monetary policy should also take the likelihood of heightened leverage and credit market overheating into account (BIS (various), Borio and Lowe (2002)).

Can talk about other implications in the discussion.

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