Shadow Banking and the Dynamics of Capitalism: Beyond the Crisis

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From Crisis Narrative to Persistence,

From regulatory dialectic and rule evasion to public-private co-production and monetary system design

Outline of the Talk

Introduction
The Mechanics of shadow banking
Narratives of its Foundation and its Growth
Transformation Post-crisis
Liquidity as a state-project

Introduction – Why Shadow Banking Matters

- **Core of financial markets**
- **Goal Today:** Justify its relevance for understanding:
  - Current capitalism
  - Empire (U.S. hegemony)
  - Factions of capital & their relationships to the different factions within the state

What is Shadow Banking?

- **Definition**: A system of credit production outside traditional banking regulation
- **Key Players**: Central Banks, commercial banks, hedge funds, insurers, and other financial institutions.
- **Paradox**:
  - Often associated with crisis and opacity.
  - Yet, it is now central to financialized capitalism.
- **Rebranding Attempt**:
  - FSB calls it "*Non-Bank Financial Intermediation*" to promote "*resilient market-based financing*."
  - But concerns remain among policymakers and analysts.

Analytical Task 1 – The Paradox of Non-Change

- *"Plus ça change, plus c'est la même chose"*: Crisis reforms masked deeper continuities, which have only become accentuated.
- **Challenge:**
  - Move from concrete (crisis and crisis-driven changes) to a longer, more historically driven narrative which showcases the continuities
  - Frustration: Enlightenment promise (critique → change) clashes with institutional inertia.
- **Key Question:** How to theorize the *lack* of transformation post-crisis?

Shadow Banking's Evolution – A Tripartite Nexus

- **Three Functions and their interlinkage shaping the System:**
- Public debt issuance
- Public liquidity provision (central banks)
- Private liquidity creation (markets)
- **Present Crisis:** This triangle's destabilization threatens U.S. imperial power (e.g., dollar hegemony).

Shadow Banking as Financial Statecraft

- **Argument**: Shadow banking is an outcome of **state-driven financial engineering**, not just market innovation.
  - Fed & Treasury played active roles through legal and regulatory creativity.
- **Technocratic Myopia**:
  - Failure to integrate shadow banking into monetary policy or regulate its instability.
- **Political Economy of Liquidity**:
  - A **"world-making"** process with winners and losers.
  - Central banks, private banks, and economists form a powerful **coalition of interests**.
- **Key Takeaway**:
  - Understanding shadow banking requires rethinking state-market boundaries and historical narratives.

Analytical Task 2 – The "End of History" Illusion

- **Current Consensus:** Shadow banking is now "stabilized" by central bank backstops.
- **But:** Institutional solutions exhaust themselves (cf. growth/accumulation regime literature).
- **Critical Lens:**
  - What contradictions are brewing beneath this "stability"?
  - How might the Fed's role become unsustainable?

The Normalization of Shadow Banking

- **Crisis-Driven Governance**:
  - Shadow banking persists due to repeated central bank bailouts (2008, 2019, 2020, 2025).
  - **"Socialization of risk, privatization of profit"**—public backstops private gains.
- **Failed Reforms**:
  - Post-2008 efforts to curb risk-taking were diluted.
- **Key Question**:
  - How did we move from post-crisis reform promises to today’s normalization?

The Duality of Capital

- **Two Logics in Tension:**
  - **Wealth-Securing Capital:** Seeks stability, provided through liquidity
  - **Volatility-Profiting Capital** (e.g., hedge funds): Exploits crises and acts as the "smart money" in the system (arbitrage)
- **Shadow Banking's Role:** Circuits linking these logics—systemically embedding fragility, with the central bank becoming the guarantor of shadow banking stability
- This in turn validates financial portfolios held by the wealthy 10%

Surplus Value Accumulation in Shadow Banking

- **Process:**
  - For cash pools: minor gains over direct cash-holding
  - Profits stemming from arbitrage trades for hedge funds and open-ended funds, loading up on tail risks which they get paid for but do not necessarily bear
  - Fed policies enable private profit under guise of stability.
- **Outcome:** Concentrated gains, socialized risks (central bank balance sheets).

Politicizing Monetary Policy

- **Technocratic Myth:** Fed as "neutral" optimizer vs. instability as "external."
- **Reality:** Fed is an *active agent* in shadow banking's evolution.
- **Key Move:** Expose how monetary policy *reinforces certain* factional capital interests and how technocratic officials fail to take this into account/overlay it with a general interest (technocratic myopia)

The Shadow Banking System: what it is and what it does

The rise of “Shadow Banking”

- Brought down the financial system in 2008
- Evolved since the late 1950s in US
- Spread since the late 1970s around the world
- Brings together banks and non-banks in the pursuit of capital markets activities based on money market funding
- Involves banking like operations where partially unregulated entities engage in maturity transformations

Map of the Shadow Banking System

What is shadow banking?

- Low margin, high volume activity outside of banking regulation
- «Money market borrowing for capital market lending», on or off-banks balance sheet
- Liquidity, maturity and credit transformation in a chain of financial intermediaries
- based on cash-equivalent money market instruments (Repurchase Agreements)

How a repurchasing agreement works

- Collateralized loan, masquerading as a Sale and a Repurchase

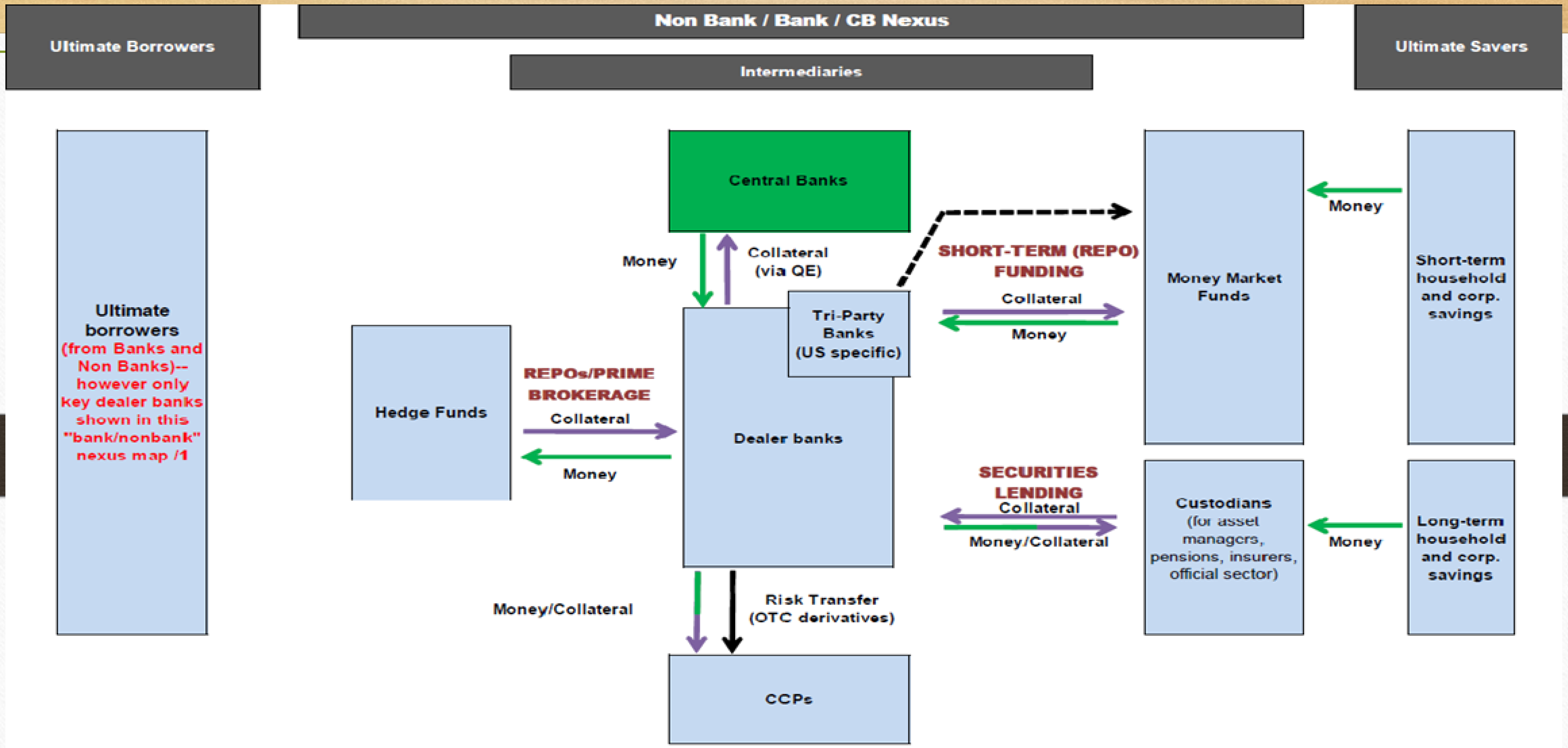
The role of cash-equivalent money market instruments

-large scale issuance of private money claims for the funding of capital market assets

-characteristic: no nominal price risk with respect to money/cash, but offering a little uptick over cash→ of interest to cash rich agents, such as corporations who need to manage cash-flows: these are the risk-averse cash providers for the money market system

-on the other hand, there are risk-embracing investors who seek leverage/cheap cash to take leveraged bets (hedge funds)

-yet, how to link the two? the role of broker-dealers and collateral



/1 Figure 1 is a snapshot of "z" or the nonbank/bank nexus explained in the analytical framework. The dealer bank depicted above are active in the cross-border collateral intermediation. . So "zi" is important for dealer bank "i". The ultimate borrowers also borrow directly from commercial banks; however they are not shown in this figure as their interaction with nonbanks is minimal; hence "zi" is negligible.

Crisis dynamics surrounding liquidity

Shadow banking is based on a fragile system of funding, which links market and funding liquidity as well as the credibility of the collateral used with the stability of quasi-money

For the repo-market in particular, margins and haircuts are there to secure the risk averse lender that the money will be there in case it is needed (strong liquidity preference)

In case, the asset which is used for collateral for the repo experiences unexpected volatility, this will lead to a reduction in funding liquidity, as margins and haircuts increase

this can lead to a self-defeating liquidity crisis (negative liquidity spiral)

A negative liquidity Spiral

Chart 1

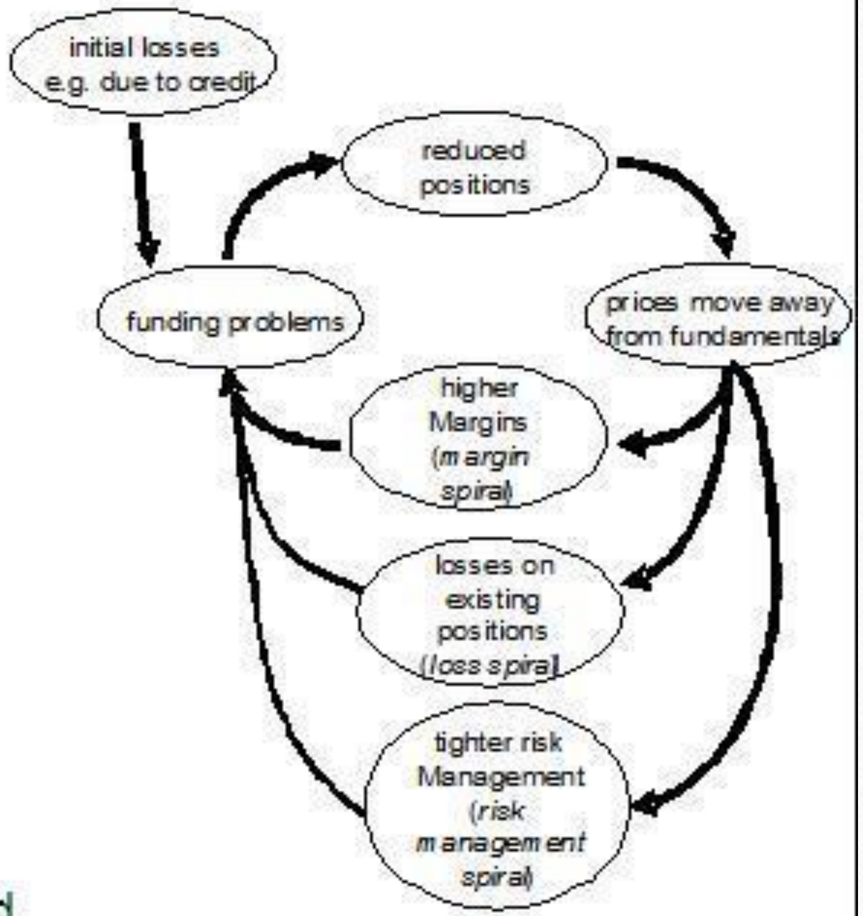
Some traders hit or near margin constraints (or risk limits) and reduce positions, which:

1. moves prices against them (and others with similar positions) leading to further losses, and
2. increases volatility and reduces market liquidity
3. increases margins and tightened risk management.

All of which lead to further funding problems.

This leads to reduced positions and the 3 cycles restart.

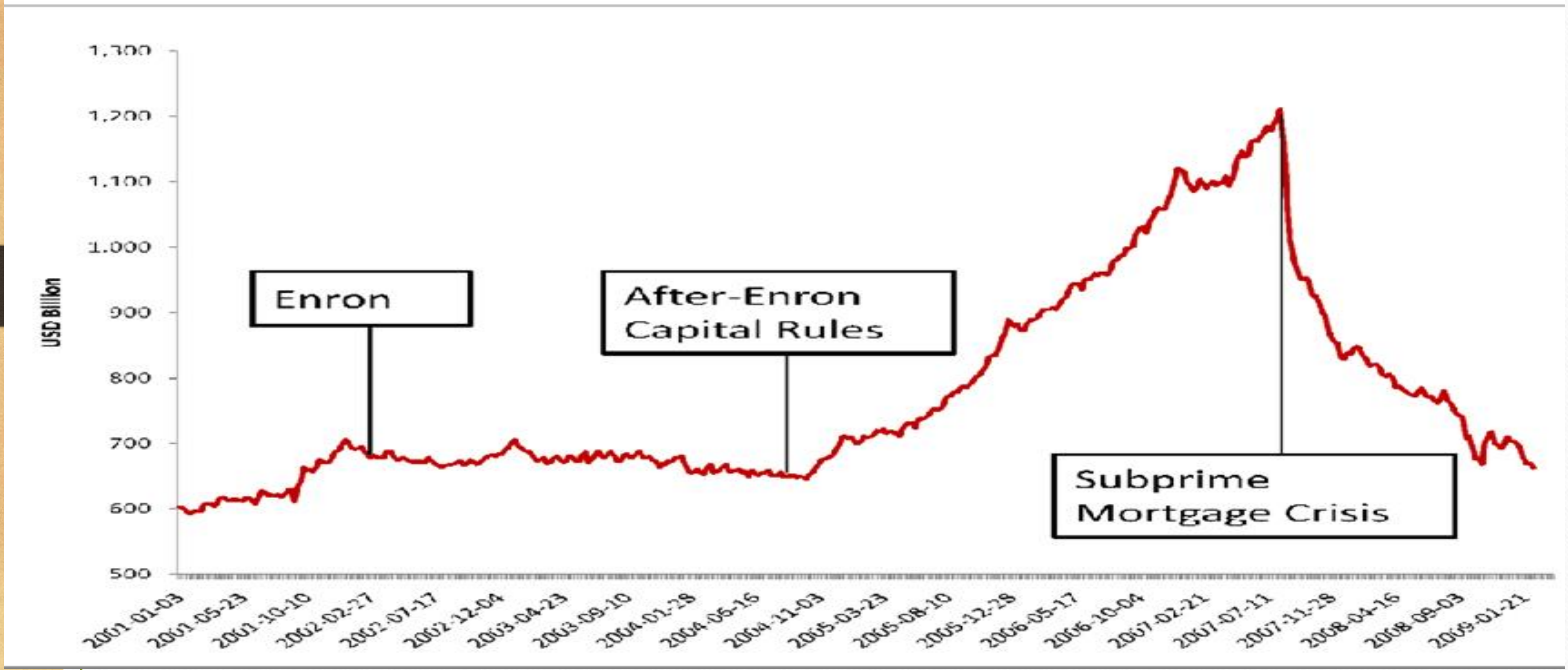
Continue until a new equilibrium is reached



The transformation of shadow banking pre- to post crisis

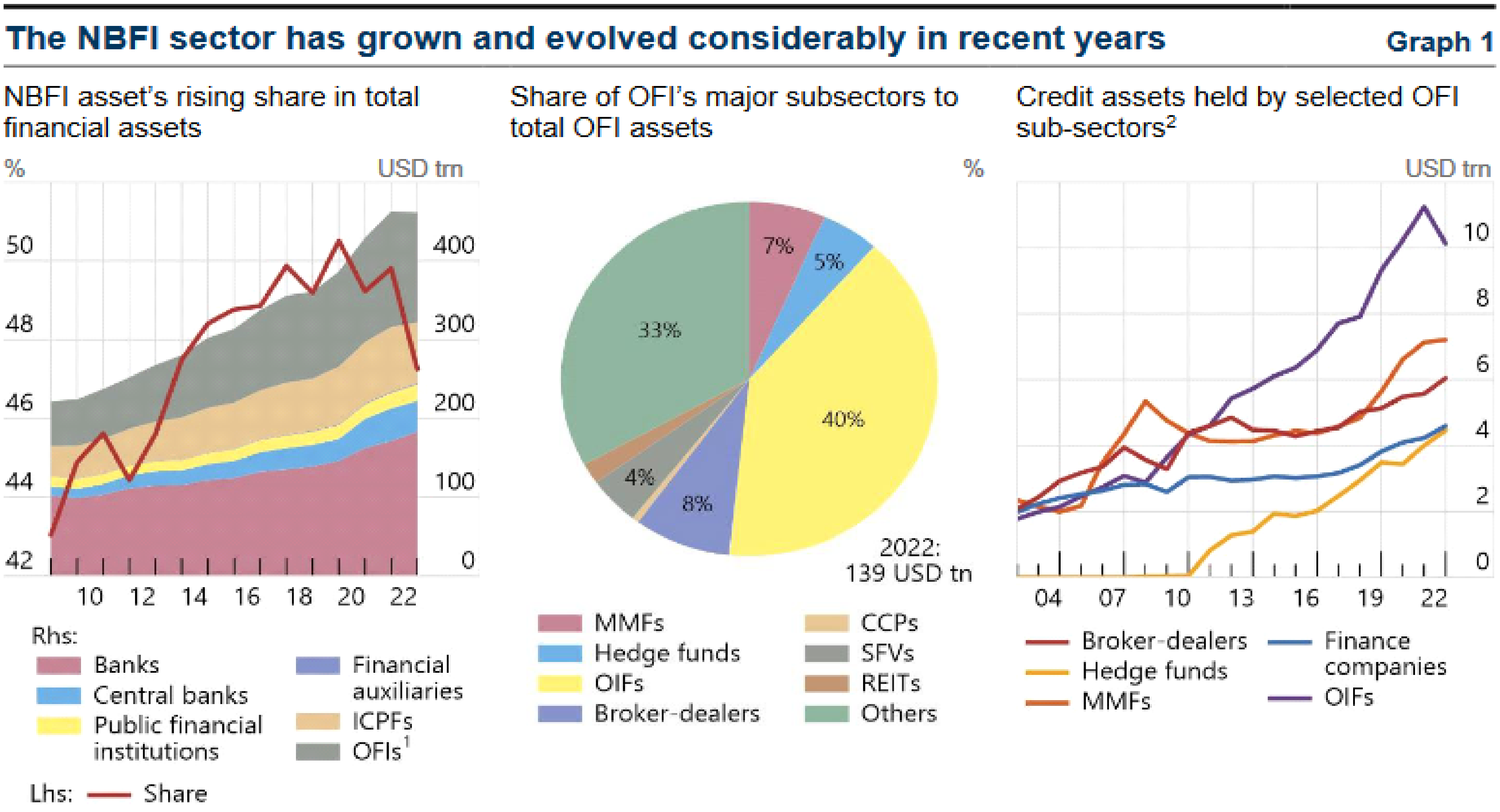
- Focus back then: « Internal Shadow Banking System » (Pozsar et al 2010)
- Post-Financial Crisis: Regulatory changes which closes certain loopholes (ABCP market but leaves other funding options untouched, e.g. Repo-market)--> from internal to external shadow banking system
- No fundamental change in the system itself, but instead transformation and growth…

Rise and collapse of global ABCP market



Source: Acharya and Schnabel 2010

Growth of shadow banking post-crisis (FSB)



The Notion of Crisis and the fact of non-change

Analytically speaking, the notion of crisis evokes a moment of bifurcation: either recovery or decline/death (Roitman 2014)

As such, the initial framing of shadow banking in the framework of crisis analysis led to an assumption of fundamental change which would right the wrongs and place the patient on the pathway to recovery

Metaphor of "cutting arm rather than removing the cause for cancer" (Pozsar 2015)

What is it that we are facing analytically and how can we best understand its evolution? Which implications does it have for our understanding of the system evolution inside of the United States as a growth regime and beyond?

Perceptions of the shadow banking system: Phase 1

Initially seen as the outcome of a regulatory cat and mouse game (cunning investment bankers), which subsequently had to be consolidated and confirmed/approved by interventions of the central bank (notions of cognitive and regulatory capture)

This perception was put into question after the financial crisis, with these rule circumvention being exposed, and indeed, much work has been devoted to showing that this is a misperception: central bankers and others knew, what was going on and how banks played the leverage game (BIS 1988)

Instead of an act of cunning, an act of public-private co-production, with literature focussing in particular on the Eurozone and the installation of the repo-market there (Gabor 2016, Gabor and Ban 2016, Braun 2020)

-a state project pursued within the Fed centered around the money market, based on the idea of credit growth as driver of economic growth, coupled with need for liquidity protection (Ozgode 2022)

Much changed role for central banks

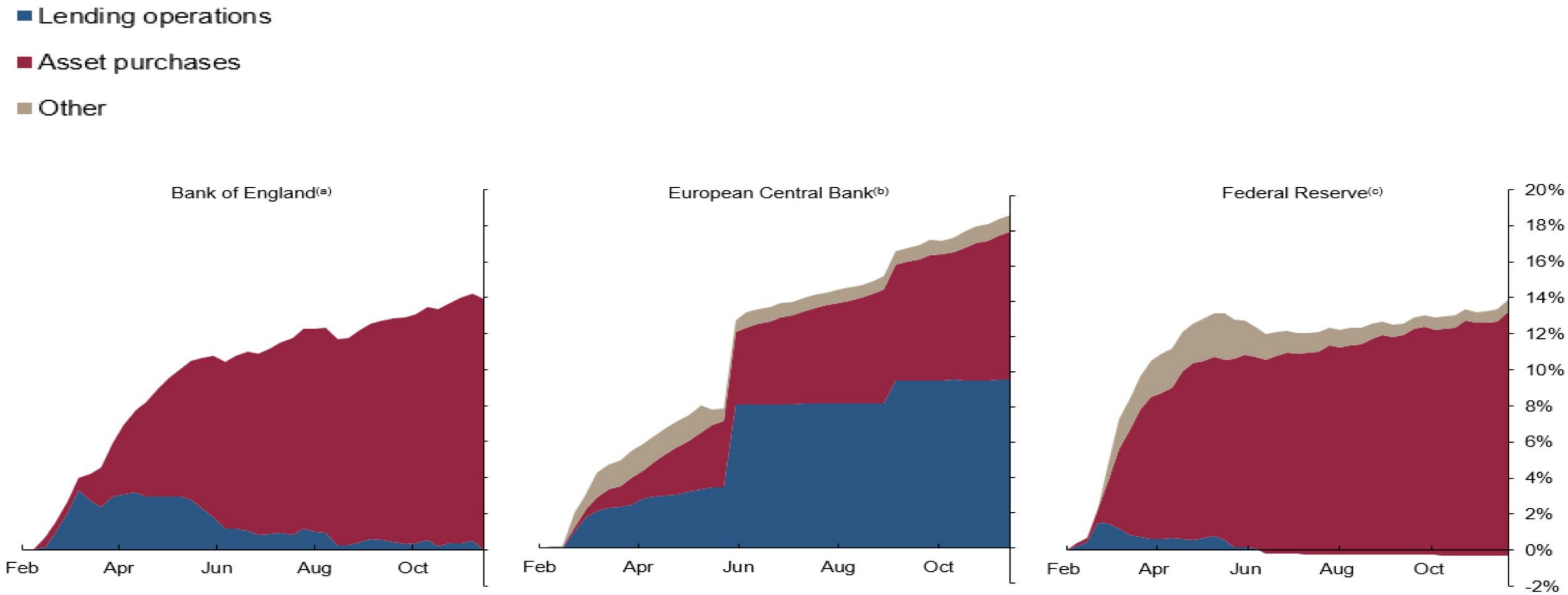
Central Bank Backstop from implicit to explicit: from 1970's crisis, where acting as liquidity backstop to banks' suffering from bank runs in the shadow banking system was initially kept a secret (Fink 2023) to a now openly assumed role of Market-Maker of Last Resort (Carney 2013)

Central banks since the GFC have developed a security apparatus to ensure that any market jitters do not translate into full-blown runs on the shadow banking system (Gabor and Braun 2020, Wullweber 2021)

2008 as a test-run of this emergency apparatus, afterwards repeated in a much faster fashion and on a much larger scale (2019, 2020)

Chart 4: Central bank balance sheet responses to the Covid-19 shock during 2020

Changes in components of central bank balance sheets since end-Feb 2020 (as % of 2019 nominal GDP)



Sources: Bank of England, Bureau of Economic Analysis, European Central Bank, Eurostat, Federal Reserve Board, ONS and Bank calculations.

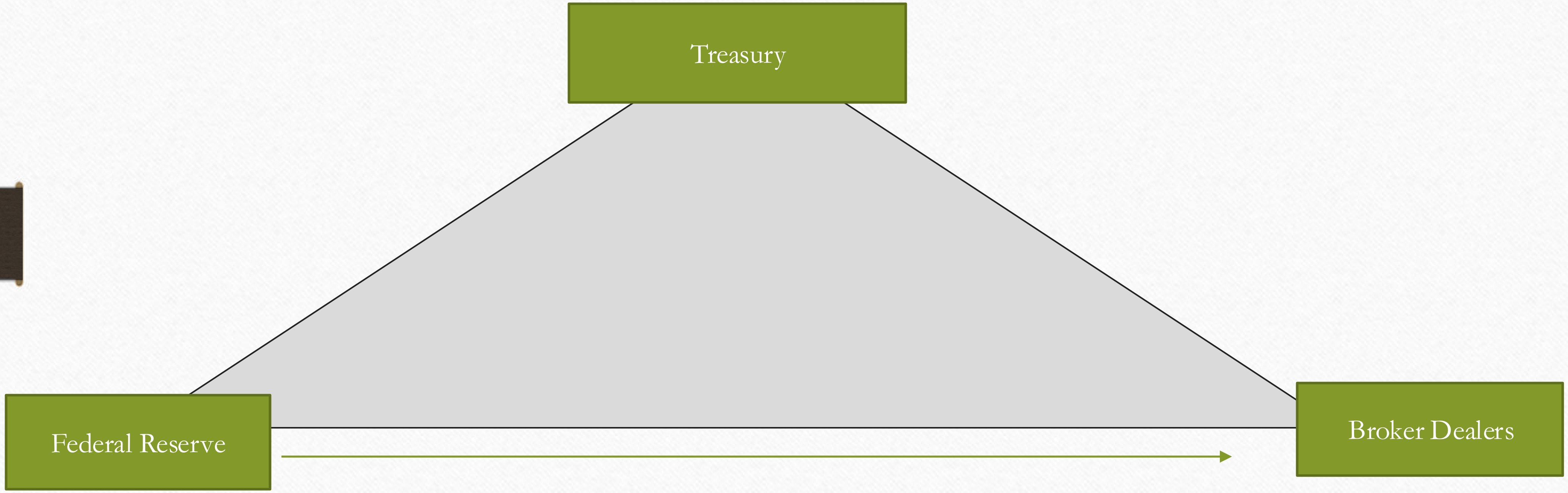
(a) Bank of England lending operations shown here: Indexed long-term repo, Contingent term repo facility, US dollar repo operations, Liquidity Facility in Euros, Term Funding Scheme and Term Funding Scheme with additional incentives for SMEs. Bank of England asset purchases shown here: Asset Purchase Facility and Covid Corporate Financing Facility.

(b) ECB lending operations: Lending to euro-area credit institutions related to monetary policy operations denominated in euro. ECB asset purchases: Securities held for monetary policy and other purposes.

(c) Federal Reserve lending operations: Repurchase agreements, Loans and Net portfolio holdings of TALF II LLC. Federal Reserve asset purchases: Securities held outright. Section of chart lying below the zero line from mid-2020 reflects a decline in repo outstanding relative to end-February.

What these Shadow Banking Crises Bring to the Fore

The liquidity triangle: the Fed, Broker Dealers and Treasury



Providing Public Liquidity Put for Private Liquidity Provision (Broker-Dealers) for Treasury Funding

The provision of liquidity as an act of conscious rule evasion from above

Fed not supposed to provide loans to non-banks→ Repos and reverse repos framed as non-loan interactions, but as sales and repurchase agreements

Alignment of interests between the three actors to bring about this change in the 1950s («Creative Lawyering »)

Fuel of expansion resides in this initial act of commission which then spreads: spread of this repo-practice from non-bank central bank interaction to non-bank bank, non-bank-non-bank and bank-bank interaction

A state project for the expansion of liquidity: Political Economy of Liquidity

Liquidity is needed for central bank in order to transmit its monetary policy transmission

Liquidity is needed for Treasury in order to keep funding costs low

Liquidity is needed for broker-dealers in order to engage in an all-encompassing web of risk transfer and risk exchange, of market making and commensuration, which in turn leads to the expansion of private credit in the US

A state project which unites all three actors in the pursuit of liquidity: dialectical unity of state and private actors in this pursuit

Effects of this state project

This state project interacts with given institutional constraints and dynamics, it produces intended and unintended consequences

Intended: financialization (growth of credit), establishment of Fed as the macro-economic manager of the US economy and an expansion of demand for the Treasury Bills and Bonds

Unintended: expansion of hedge funds and asset-management industry (1940 Investment Act) based on liquidity put of the central bank

No control over these actors by the Fed, but need to bail them out due to the risks to the entire financial system/ the monetary apparatus

Exhaustion of the system

New Role of Central Banks as MMLR as answer to the problem of system stability (2008, 2019, 2020, 2025)

Problem of Balance sheet built up of Fed (QE and liquidity interventions), coupled with losses since 2023 (currently dealt with through deferred accounting)

Yet, repeated need for intervention in Treasury Market by Fed allows no Quantitative Tightening→ ever-greater accumulation of losses?

Inflationary system which validates risk-taking of financial actors, which have taken these risks knowing that they would be bailed out in case of the realization of tail-risks

Monetary System Design and Justice

Monetary system design questions have recently been placed at the center of the political theory debate (Ricks 2016, Eich 2022, Downey 2025): need to open it up to democratic debate

Need to bring in shadow banking and the question of justice: risk taking, quasi-money production and the politics of bail-out

Being baked into the system of money and credit production, can the system internally be transformed? Can the Fed move outside of an asymmetric system, in which it has limited control over system expansion, but must back it up?

Question of Monetary System Design: how to make the control over the systems' risk taking equivalent to the backstop: no backstop without regulatory control

Conclusions

The expansion of credit, both public and private in the US is anchored in the production of liquidity in financial markets (here, a state project and the imaginary of financial economics meet)

This is a public-private partnership which in its most profound sense should not be understood as an opposition, but as a "dialectical unity" of public and private actors with unforeseen consequences

Its outgrowth and recent permutations (from broker-dealers to hedge funds) feed back on the systemic stability of this triangle and the political stability of the US at large

Understanding the liquidity triangle and its evolutions allows for an understanding of the evolution of financialized capitalism from its core

From «Serendipity » to the conscious co-production of liquidity

Central banks and the rise of the shadow banking system