April 2023

Beware the Ides of March

Vincent Reinhart | Chief Economist & Macro Strategist

BNY MELLON | INVESTMENT MANAGEMENT

MELLON

The current market environment raises a series of questions, and unsurprisingly, the turmoil in banking and sharp market swings has unnerved investors. From the impact on credit conditions and economic activity to the future path for Federal Reserve (Fed) policy and global implications, we share our analysis of the developments in finance and the economy with a sampling of questions and provisional answers, which, of course, are a work in progress as events continue to unfold.

For now, we expect financial contagion to be contained given the underlying health of the banking system and vigorous official action against the backdrop of robust momentum in aggregate demand. Said differently, this will be recorded in history books as a financial crisis, but not a systemic one. The modest crimp from tighter credit on spending helps the Fed's current task of slowing the economic expansion to a more manageable pace given taut resources and above-goal inflation. The Fed is understandably watchful about spillovers from finance into economic activity but is leaning toward more policy firming. We expect one more quarter-point hike in the policy rate at the May meeting of the Federal Open Market Committee (FOMC). This is clearly at odds with current market pricing, but we, as at the Fed, expect this gap to narrow on the release of strong economic data and as evidence accumulates that the damage from the woes in the banking sector is limited.

How Much Will Recent Events Crimp Credit and Economic Activity?

The sharp rise in central bank policy rates in the past year, after more than a decade of being held low, triggered the public exposure of weaknesses in the balance sheets of some banks. Because modern financial institutions are complex and opaque and the extent of official support is unclear, risk-averse depositors shifted away from regional banks toward ones where government support is more explicit (namely those classified as global systemically important banks or G-SIBs by the Financial Stability Board) or out-of-bank products, such as money market funds. However, the banking system as a whole is well capitalized, the official response has been vigorous, and central banks are nearing the end of their tightening cycles. As a result, much of the adjustment has probably run its course, and the net effect will be a modest crimp in credit availability, consistent with the aim of most central banks to slow the expansion of aggregate demand to return inflation to goal.

True, deposits in the banking system have run off in the past few weeks, especially at smaller institutions (as shown in the table on the following page), in light of heightened uncertainties about private-sector balance sheets and public support. The level of deposits, however, remains high (as in the upper left panel of the chart on page 4) as recipients of federal fiscal largesse in 2020 and 2021 parked a goodly portion in a convenient place when the opportunity cost (the short-term market interest rate) was low. Those funds are now being tapped to support spending and redirected to more attractive, market-rate-sensitive products. On the way up, banks used those deposits to fund security purchases and only more slowly built up their loan books (the bottom panels). As a result, further runoffs of securities should temper an adverse effect on the availability of loans to support economic activity.

Assets and Liabilities of Commercial Banks in the United States

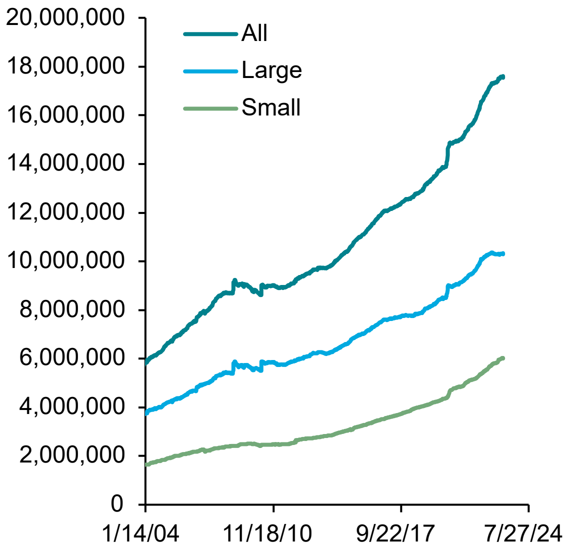
	Bank Credit	Securities			Loans & Leases				Assets		Deposits		
		All	Treasuries & Agencies	MBS	All	C&I Loans	Residential Real Estate	Consumer	Cash	Total	All	Large Time	Other
ALL BANKS													
Levels, millions of dollars													
3/15/2023	17,626,150	5,458,072	4,358,019	2,735,101	12,168,078	2,825,948	2,520,277	1,867,089	3,363,685	23,244,490	17,502,923	1,820,725	15,682,198
Change over previous period, %													
Annually													
2021/2020	6.83	25.06	26.43	24.35	-0.15	2.29	-3.50	-5.04	85.13	12.67	21.52	-16.83	27.13
2022/2021	9.50	17.13	17.37	10.58	5.85	-1.95	3.13	11.08	-0.12	7.76	8.28	-4.57	9.51
2023/2022	4.86	-6.35	-6.88	-7.85	10.82	11.22	9.92	9.59	-9.12	2.41	-3.33	30.50	-6.15
Weekly													
3/8/2023	-0.08	-0.37	-0.35	-0.24	0.06	0.15	-0.12	0.37	-1.93	-0.29	-0.35	1.41	-0.56
3/15/2023	0.42	0.19	0.30	0.16	0.52	0.70	0.53	0.21	13.21	1.89	-0.56	-1.10	-0.50
LARGE BANKS													
Levels, millions of dollars													
3/15/2023	10,330,475	3,739,305	3,151,794	1,961,209	6,591,170	1,523,720	1,561,803	1,425,190	1,527,912	13,222,247	10,740,046	482,978	10,257,069
Change over previous period, %													
Annually													
2021/2020	5.55	27.59	30.58	23.60	-4.49	-7.90	-4.59	-6.10	108.60	12.39	20.51	-42.46	24.99
2022/2021	9.39	15.11	15.12	7.33	5.91	2.52	0.40	10.39	-13.00	6.21	8.62	-5.11	9.07
2023/2022	1.44	-7.74	-8.18	-6.91	7.51	10.32	6.01	8.39	-10.72	-0.30	-5.20	53.75	-6.88
Weekly													
3/8/2023	-0.03	-0.21	-0.15	-0.02	0.08	0.38	-0.28	0.41	-3.14	-0.37	-0.71	1.42	-0.81
3/15/2023	0.32	0.10	0.26	0.15	0.44	0.30	0.66	0.19	24.95	2.47	0.62	0.29	0.64
SMALL BANKS													
Levels, millions of dollars													
3/15/2023	6,020,775	1,488,431	1,068,232	743,354	4,532,344	788,279	957,871	441,712	501,664	6,959,452	5,455,919	512,611	4,943,309
Change over previous period, %													
Annually													
2021/2020	13.16	28.94	25.60	26.12	8.97	35.11	-1.28	-1.41	110.94	18.50	24.72	-16.25	29.95
2022/2021	9.67	28.73	30.75	23.42	3.68	-14.33	8.43	13.27	-4.21	8.01	9.56	-9.07	11.09
2023/2022	9.58	-3.57	-3.69	-9.83	14.72	8.50	17.02	15.53	-30.81	5.29	-1.39	46.87	-4.64
Weekly													
3/8/2023	-0.07	-0.58	-0.65	-0.86	0.10	-0.21	0.16	0.20	-3.38	-0.24	-0.19	1.12	-0.31
3/15/2023	0.33	-0.17	-0.16	-0.29	0.49	1.11	0.33	0.32	23.85	1.72	-2.15	1.00	-2.47

Source: Federal Reserve H.8, accessed 3/24/23.

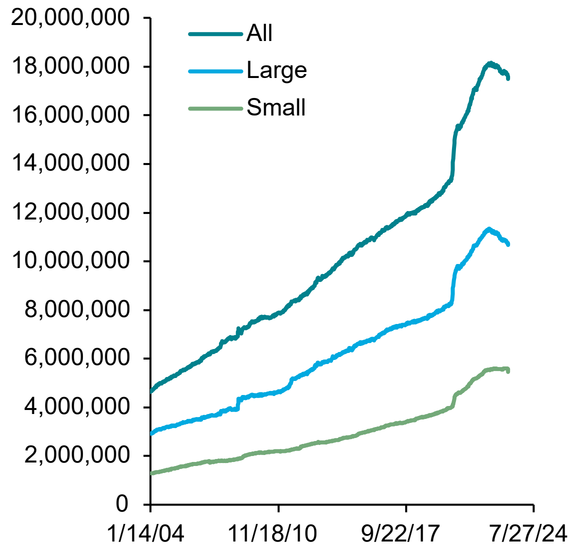
Assets and Liabilities of Commercial Banks in the United States

Millions of dollars

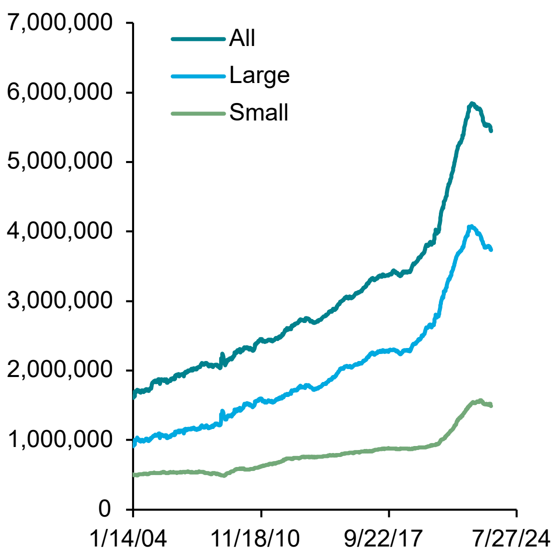
Bank Credit



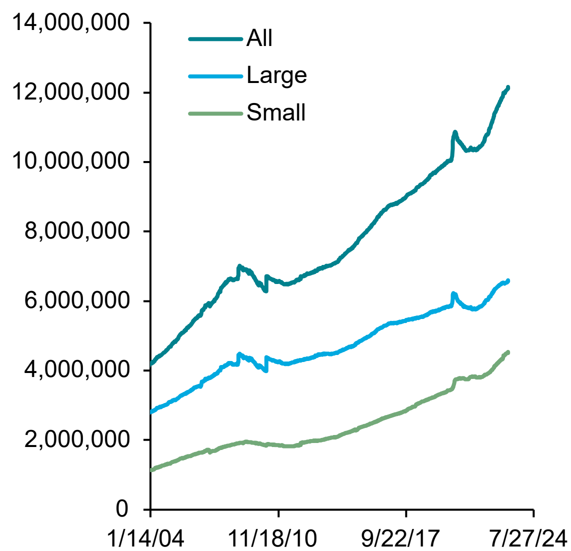
Total Deposits



Securities



Loans



Source: Federal Reserve H.8, accessed 3/24/23.

Why Will the Fed Likely Firm Further?

Fed officials likely believe that financial strains will be contained and orderly and that the economy could weather some firming in credit conditions. The 4¾ percentage points of tightening by the Fed over the past year has thus far gained little evident traction on spending, which is growing faster than trend from a starting point where resources were taut. Now, there is an uncertain amount of credit constriction to add to the mix, as expressed in the latest FOMC statement. Given the uncertainty associated with how this plays out, officials will be on watch, but they will be leaning forward to firming. With inflation still above goal, Fed officials believe that the federal funds rate needs to be moved up to, and then held at, a restrictive plateau. This was confirmed in the most recent FOMC statement: "The Committee anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time."[1] At the press conference, Chair Powell repeated his worrying arithmetic about the price process.

- The prior good news on inflation owed to the adjustment of the global economy to imbalances in the commodity and goods markets. As resources and sectoral demand shifted, those prices turned from an impetus to a drag on headline inflation. However, that only accounts for one-quarter of the consumer price basket.

- Forward-looking readings on shelter prices are similarly encouraging, but that only constitutes another one-quarter of the total.

- As noted in the recent FOMC minutes, there is "…less evidence of a slowdown in the rate of increase of prices for core services excluding housing categories that accounts for more than half of the core PCE price index…[A]s long as the labor market remained very tight, wage growth in excess of 2 percent and trend productivity growth would likely continue to put upward pressure on some prices in this component."

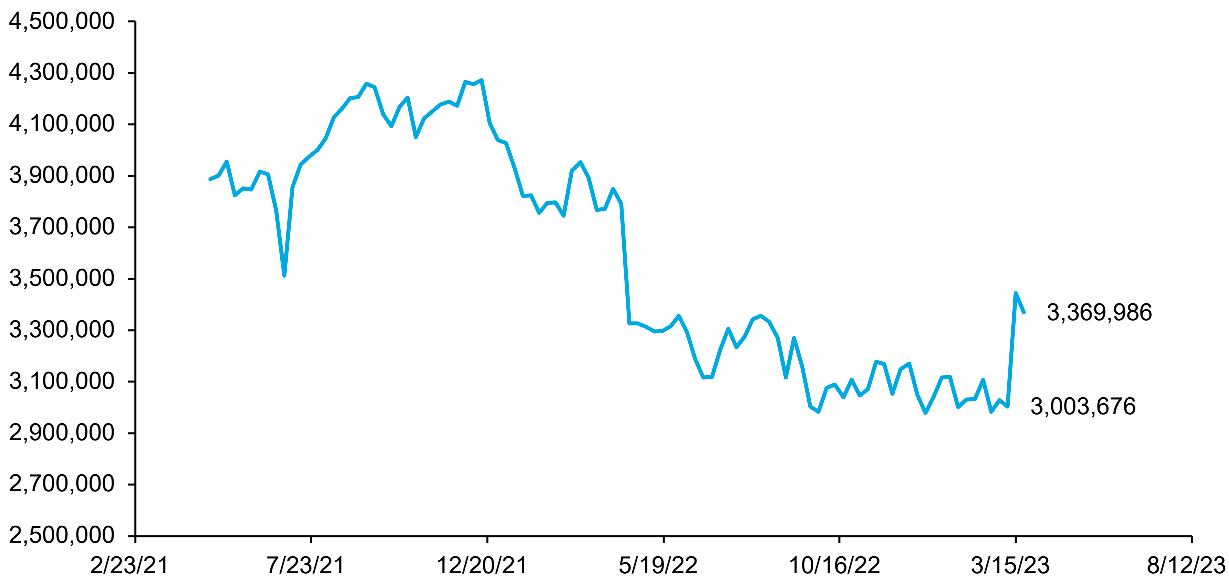
Fed officials mostly, and Chair Powell in particular, hold to a **separation principle** about central bank policy. The idea behind the principle: if supervision and regulation is done well, then they have a freehand to conduct monetary policy. There is also a dark side: if the Fed fails to act on macro considerations, does that not signal a lack of confidence in crisis management by domestic and foreign officials?

What Do We Make of Recent Development of the Fed Balance Sheet?

The Fed's balance sheet shrinkage reversed over the past two weeks, increasing almost $400 billion from March 8 to March 22, with a commensurate rise of reserves in the banking system. Arithmetically, increases were posted in loans to banks and repurchase agreements with foreign official institutions, as the securities portfolio shrunk $11 billion under the FOMC's instructions on runoffs of the System Open Market Account. The loans included those to officials (the Federal Deposit Insurance Corporation or FDIC according to Powell at the press conference and categorized in "other credit extensions"), the new Bank Term Funding Program and primary credit. The first two stepped up notably in the past week, but primary credit (which is expensive) ran off.

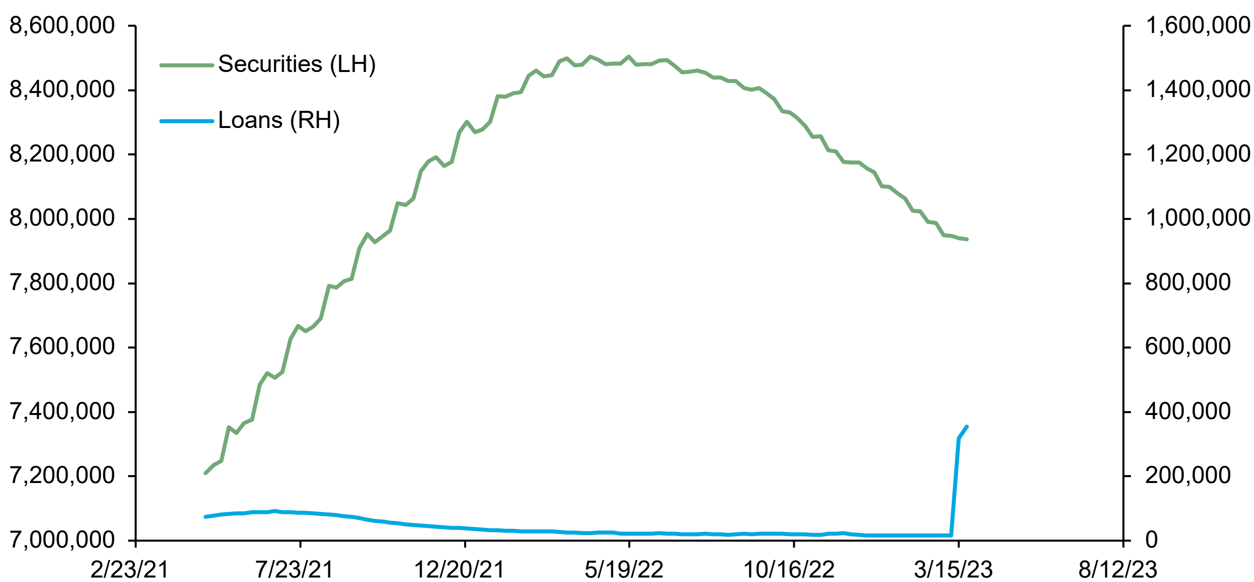
Whether the balance sheet expansion represents increased accommodation is an open question. To the extent that precautionary reserve demands rose, the Fed passively met them. This is especially so for the assets added to meet a foreign official call for US dollars and precautionary bank needs. Officials in Europe want to manage a significant institutional consolidation, and domestic banks want those extra reserves to meet potential deposit runoffs and to signal their soundness to counterparties. The failure to accommodate that heightened demand would represent an inadvertent policy tightening.

Reserves at Federal Reserve Banks
Millions of dollars



Source: Federal Reserve, H4.1, accessed 3/23/23.

Securities and Loans
Millions of dollars



Source: Federal Reserve, H4.1, accessed 3/23/23.

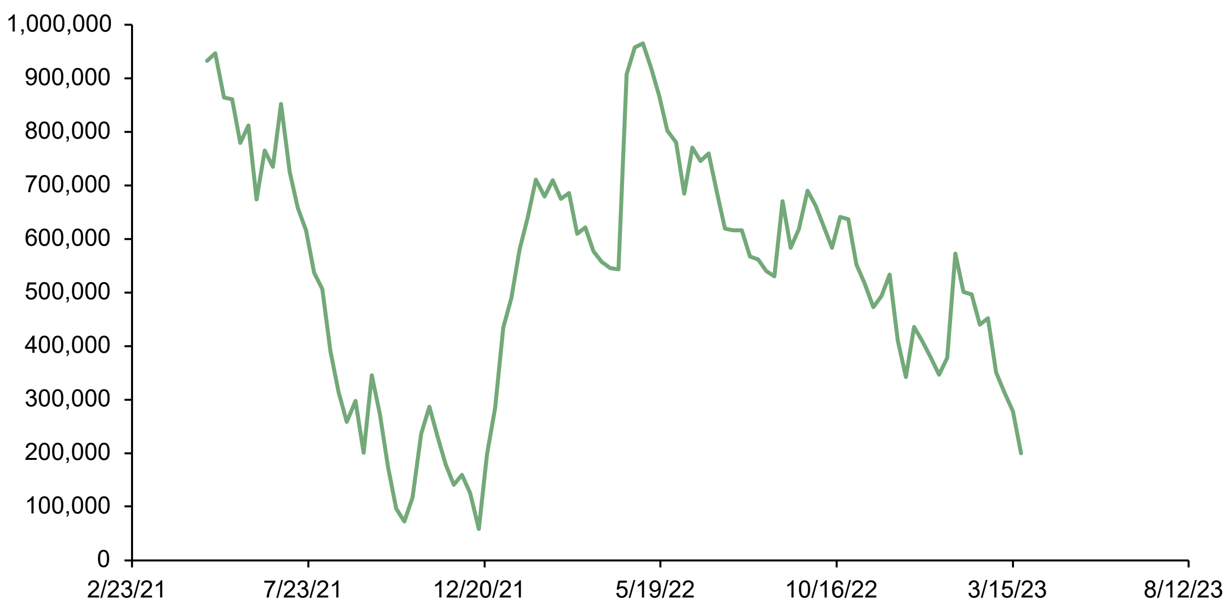
That is a mistake that Fed officials are unlikely to make because of a scarring historical precedent of dealing with bank runs. According to the towering work of Milton Friedman and Anna Schwartz published sixty years ago in *A Monetary History of the US, 1867 to 1960*, the Great Depression became what it was because of a "Great Contraction" in the stock of money from 1929 to 1933.[2] Confronted by gold outflows under the fixed-exchange rate system and three distinct banking crises, Fed officials watched as reserves and the money stock fell sharply. According to them, "Prevention or moderation of the decline in the stock of money, let alone the substitution of monetary expansion, would have reduced the contraction's severity and almost certainly its duration."[3]

As long as additional reserves can be provided via Fed facilities (the discount window and the Term Banking Funding Program for banks and lending to official institutions), a lesser amount can be routinely withdrawn through reductions in the securities portfolio. Key to this is to reduce the market stigma attached to these programs for banks, both through recurring use and official encouragement. As a corollary, higher reserve levels will not be inconsistent with a firm, or firming, cost of reserves—the federal funds rate.

Will the Recent Financial Stresses Influence the Debate on the Federal Debt Limit?

The spasm of financial stress associated with the problems at a few regional banks was sudden but, at this time, difficult to assess in terms of its scale and scope. In contrast, a risk that could trigger a tectonic shift in financial markets is marked quite clearly on the calendar of public events in the US. Around August, if the limit on the public debt is not raised, the US Treasury will run out of cash and miss scheduled payments. The first time that a missed payment is for coupon or principle on debt, the Treasury will default.

Treasury General Account at the Federal Reserve
Millions of dollars



Source: Federal Reserve, H4.1, accessed 3/23/23.

Already, the Treasury has worked off $375 billion from its general account at the Fed since Secretary Yellen invoked a debt-ceiling emergency in January 2023 (as shown in the chart on the previous page). The near-term prospects for the cash position depend importantly on income tax receipts, which will pour into the Treasury coffers over the next few months. However, the government is running a large annual deficit, so spending will once again outstrip receipts once that seasonal bulge is passed. (More uncertainty than usual attends forecasting receipts given the significant capital losses in 2022, which may reduce personal tax obligations, so take the August date as provisional.)

How recent market strains moved the needle on the orderly resolution of the debt-ceiling standoff is hard to judge.

- On the one hand, the elevated financial market volatility, significant repricing of some asset classes, and intense public scrutiny surrounding the problems of a few regional financial institutions might convince politicians to tread warily around an issue that tests the resilience of markets. If so, they will avoid a showdown on default and raise or suspend the debt limit in the regular order of the Congress before the summer.

- On the other hand, the response of the troika of financial regulators—the Treasury, the Fed and the FDIC—to the problems of a couple of regional banks was to broaden the safety net by protecting uninsured depositors. Some politicians take this as further evidence that the expansion of government obligations, both explicit and contingent, is unchecked. This raises the odds that they will rely on the debt ceiling as a device to force the discussion of the longer-term trajectory of federal debt.

While predictions about the political economy are always perilous, expecting the worst leads less often to nasty surprises. In any case, it is safe to say that if the resolution of the debt ceiling is not orderly, financial markets could be extremely volatile and investors skittish this summer.

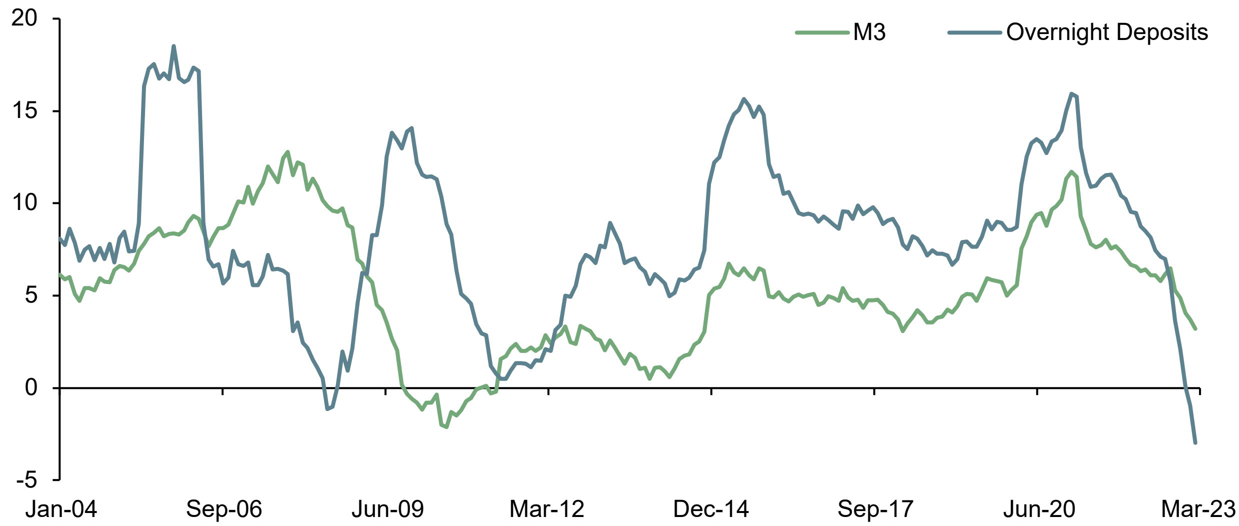
Are these Banking-Sector Pressures Unique to the United States?

Quite evidently not. In the global pool of finance, a wave in one financial center travels to all shores, in this case partly because increased uncertainty and aversion to risk affect all asset prices and partly because initial circumstances are similar. As for the latter, European monetary policy rates echoed that of the Fed by being held low for long and then marching up quickly in the past year. Predictably, low short-term rates channeled fund flows to deposits at banks and may have encouraged them to reach for yield in terms of both extending the duration of their holds and increasing exposure to credit risk. As short-term rates have risen, European financial institutions have been hit by deposit runoffs, increases in risk spreads and decline in equity values. The result has prompted the consolidation of two large Swiss institutions and market concerns about other European ones.

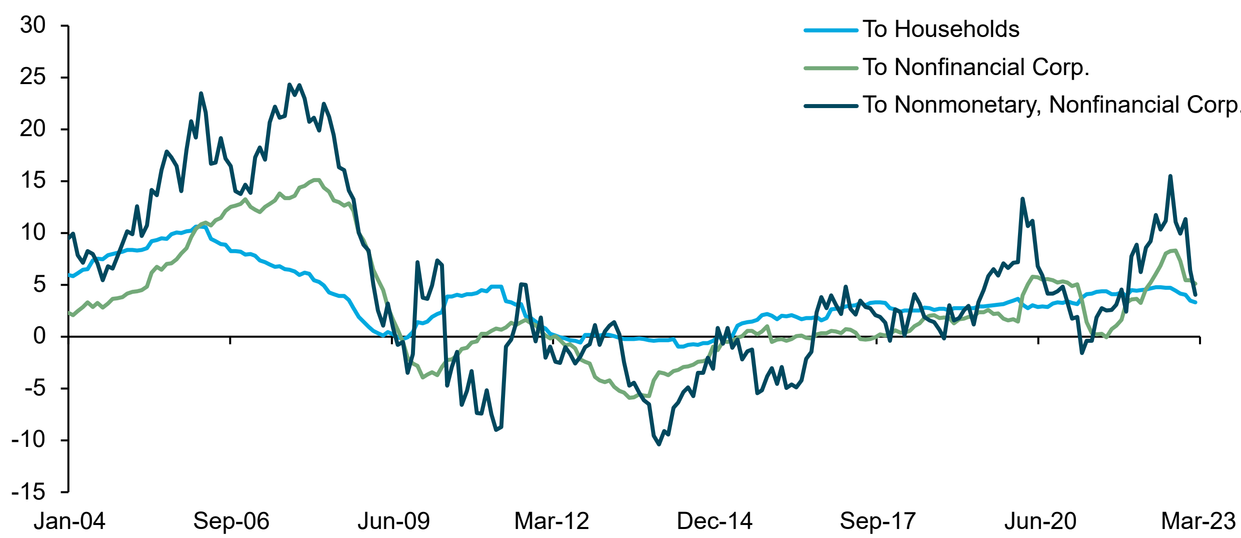
The formal monetary framework of the European Central Bank (ECB) provides a window to the influence of the policy rate cycle on banking risks because it explicitly incorporates "two pillars" of analysis—economic fundamentals and the monetary aggregates—to consider risks to its price-stability goal. The framework was modernized in 2021 to drop the explicit architectural reference and now considers "…two interdependent analyses: the economic analysis and the monetary and financial analysis."[4] Importantly, money still matters to ECB officials. The chart on the next page takes the ECB for its word about monetary analysis, plotting the 12-month growth rate of the main monetary aggregate (M3) and its most important component, overnight deposits (about 60 percent of the total) in the upper panel. The lower panel looks at the asset side of bank balance sheets that supports economic activity (loans), which are known as the counterparts to M3.

M3 and its Counterparts
12-month change, percent

M3 and its Overnight Deposit Component



Loans as Counterparts to M3



Source: European Central Bank, Monetary Statistics, Statistical Data Warehouse, updated 3/27/23.

Low-for-long short-term rates buoyed short-term deposits at banks, which were further supported by fiscal transfers, to put M3 at a double-digit growth clip. Banks used these inflows to fund lending, importantly to financial institutions. More lately, rising short-term rates sapped deposits, and loan growth fell in tandem. In that regard, bank constriction should be considered part of the monetary transmission mechanism and is more obvious in Europe than the US because the European economy depends more on banks. The lesson for everywhere is that the stresses playing out now in financial markets reflect idiosyncratic risks taken by specific private institutions layered upon the wave of encouragement and discouragement to the financial industry created by central banks.

Vincent Reinhart
Chief Economist & Macro Strategist

Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

1. Board of Governors of the Federal Reserve System, Federal Reserve issues FOMC statement, March 22, 2023. Accessed at: https://www.federalreserve.gov/newsevents/pressreleases/monetary20230322a.htm

2. Milton Friedman and Anna Jacobson Schwartz, A Monetary History of the United States, 1867 to 1960, Princeton University Press, 1963.

3. Ibid, page 301.

4. https://www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_statement.en.html

Disclosure

For more market perspectives and insights from our teams, please visit www.mellon.com.

40 YEARS OF INDEXING

MELLON

www.mellon.com

BNY MELLON | INVESTMENT MANAGEMENT