US Fed attempts a balancing act on interest rates

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The US Federal Reserve has sought to thread the needle by maintaining its interest rate increases to deal with what it continually refers to as the "extremely tight" labour market, while seeking to calm market concerns about their effects on the banks and the financial sector more broadly.

At the conclusion of its two-day meeting yesterday, the Fed lifted its base rate by 25 basis points (0.25 percentage points). Fed chair Jerome Powell said a pause had been considered due to the turmoil set off by the collapse of the Silicon Valley Bank, and the monetary policy statement hinted that rises could ease in the future.

The latest statement removed a previous phrase that "ongoing increases" would be needed to bring down inflation and replaced it with "some additional policy tightening may be appropriate."

While a pause was considered, it was rejected, most likely on the grounds that it would have raised greater concerns about the state of bank finances, especially in the small and medium-sized sector, and would have undermined the continual assurances from government and financial authorities that the US banking system remains sound and resilient.

In his opening remarks to the press conference, Powell said the events of the past two weeks had demonstrated, as history had shown, that "isolated banking problems, if left unaddressed, can undermine confidence in healthy banks" and threaten the entire system.

But the actions of the Fed, the Treasury Department and the Federal Deposit Insurance Corporation—bailouts for uninsured depositors at the failed SVB and Signature together with the provision of increased liquidity for banks—had demonstrated that "all depositors' savings and the banking system are safe."

Powell said the Fed would continue to monitor conditions in the banking system and it was "prepared to use all our tools as needed to keep it safe and sound. In addition, we are committed to learning the lessons from this episode and to work to prevent events like this from happening again."

That prompted questions at the press conference as to how the crisis at SVB had erupted seemingly under the Fed's radar. Powell said that Fed supervisors had noted concerns and made them known. That response only raised the issue of why it had taken no action.

In response to such embarrassing issues, Powell then resorted to the dodge so often used by state and government officials in the past. He deferred to the Fed inquiry set up under vice chairman Michael Barr of which he would not be a part and would not offer comments in advance of its report.

He did, however, remark that the failed SVB, which had to be taken over after a $42 billion run, one of the most significant in US financial history, was an "outlier" because it did not hedge its major investments in Treasury bonds and other supposedly "safe" financial assets.

It is worth recalling that in 2007 the subprime mortgage market was also considered an "outlier." But it was revealed that its practices were in fact the norm throughout the financial system, leading to the implosion of 2008.

SVB became vulnerable when, because of the Fed's interest rate hikes, the market value of its assets fell below their book value and the bank incurred major losses when they had to be sold to meet the cash demands of depositors.

But Powell's explanation of its problems only raised another question. If SVB was merely an "outlier," then why did its failure require emergency action undertaken

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to counter what the Fed and the FDIC said was "systemic risk?"

The answer is to be found in the fact that SVB was only the most extreme case of a much broader process: the loss of market value of supposedly "safe" financial assets held by the swathe of smaller banks which play a crucial role in the functioning of the US economy and its financial system.

Calculations by Goldman Sachs, reported in the *Wall Street Journal*, reveal that banks with less than $250 billion in assets account for around 50 percent of US commercial and industrial lending, 60 percent of residential real estate lending, 80 percent of commercial real estate lending and 45 percent of consumer lending.

All these areas are sensitive to interest rate rises which put downward pressure on the market value of the assets on which the loans are based.

When asked about the possibility of problems in the real estate market, Powell gave the issue short shrift. But there are warnings that serious problems are developing. Earlier this week a JPMorgan executive involved in asset management warned that real estate is an area of risk and "when the Federal Reserve hits the brakes, something goes through the windshield."

An article in the *Wall Street Journal* on Tuesday warned that "strains in the banking sector are roiling" the $8 trillion market in the mortgage bond market, which is sensitive to interest rate rises.

Powell acknowledged that the banking turmoil was leading to a tightening of credit and would impact on the economy, saying it may have some of the same effects as interest rate hikes.

But he then made an admission which will hardly inspire confidence, saying how much the stress would slow the economy was "guesswork, almost, at this point."

The potential was "quite real" and "that argues for being alert as we go forward." But given the record on SVB, that is hardly a reassurance.

As Powell was holding his press conference, Treasury Secretary Janet Yellen was speaking to a Senate committee and trying to deal with another problem that has arisen for financial authorities. This is the question of how far the bailout for uninsured wealthy depositors at SVB and Signature Bank will go.

On Tuesday, Yellen told a bankers' meeting the intervention was necessary to protect the US banking system and similar actions could be warranted if others suffered bank runs that posed the risk of contagion.

Her remarks were the subject of a scathing editorial in the *Wall Street Journal* yesterday that financial regulators had torn up the post-2008 rule book and Yellen had made a "de facto guarantee of all $17.6 trillion in US bank deposits."

It pointed to the obvious contradiction between her assurances that the banking system was sound and the invocation of "systemic risk" as the justification for the bailout. The editorial noted that, while the administration was presenting the intervention as a one-off, once regulators took such action they created the expectation they would do it again. "And if they don't the ensuing market panic will invariably impel them."

Clearly responding to such "free market" criticisms, Yellen ruled out a broad expansion of deposit insurance while speaking at a Senate hearing.

She said while there could be "reasoned discussions" on the lifting of the current limit of $250,000 she had not "considered or discussed anything to do with blanket insurance or guarantees of deposits."

Her comments had an immediate effect. A share index which tracks small and medium-sized banks dropped 5 percent, reversing all the gains it had made following her comments on Tuesday and no doubt contributed to the sharp fall on Wall Street when the Dow fell by more than 500 points in half an hour at the end of the day.

The gyrations of financial regulators, the Fed and government officials are not the outcome of some personal defects but are rooted in the insoluble contradictions of the profit system over which they preside.

In response to the crisis of 2008 and that of March 2020, they sought to overcome them by pumping trillions of dollars of essentially free money into the financial system. But far from providing any resolution, these measures have only created the conditions for new financial storms in which they twist and turn as gale-force winds are unleashed.

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