

US Macroeconomics

March 14, 2023

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Why Pause?

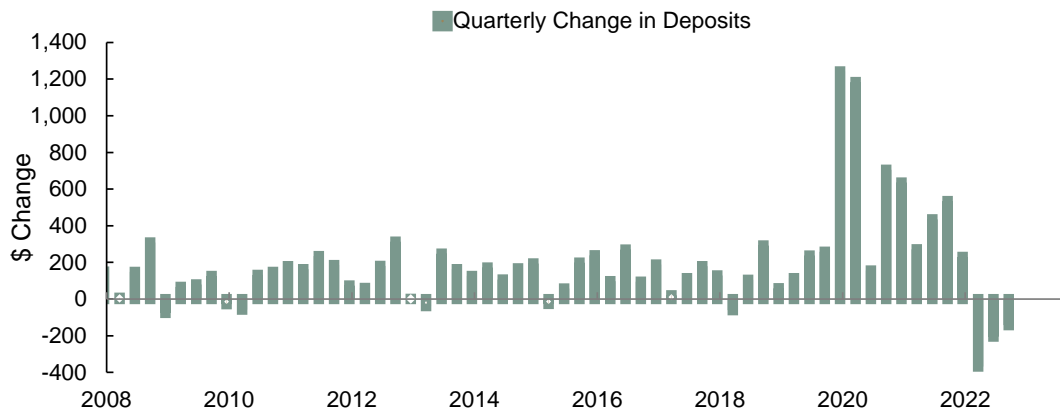
As we wrote yesterday, diminishing commercial bank liquidity is primarily the result of three factors. One, bank reserves are shrinking 11% annualized because of quantitative tightening. Two, investors are moving their deposits out of commercial banks into government sponsored money market funds where interest rates are much higher and where credit risk is effectively zero. Three, bank deposit growth is negative because the economy is slowing, consistent with aggressive monetary tightening. This affects both demand for, and supply of, credit. The result is a looming and perhaps protracted credit crunch.

To stem the liquidity crunch, many small- and medium-sized banks will need to raise rates to attract deposits. As we can see in the chart below, **commercial bank deposits are declining at an historic rate**. Never have deposits shrunk this much. This in turn will further slow money and credit creation. Remember that the big banks are already tightening lending standards on commercial real estate loans, commercial and industrial loans, and consumer installment loans, according to the Fed’s Senior Loan Officer Survey. Q4 2022 lending standards were consistent with a recession, well before the latest developments.

If the Fed raises interest rates next week and continues quantitative tightening, monetary policymakers will only further aggravate the problems that they helped cause. This is the result of singularly focusing on high inflation without recognizing policy lags or that inflation itself is a lagging indicator. We have long argued that a pause in interest rate hikes — after official rates were meaningfully above zero — would have been prudent because of these aforementioned lags. The 2s/10s treasury yield curve, our favorite spread, inverted last July. The bond market has been screaming for the Fed to pause if not reverse course.

Over the last 12 months, the Fed’s securities holdings declined \$550 billion, or -6%. This is twice the pace of the 2017-2019 runoff which ultimately led to major dislocations in the repo market ultimately warranting interest rate cuts. **Over the last six months, the pace of QT has accelerated with securities holdings down at an 11% annualized rate.** This matches the decline in commercial bank reserves, hence the need to attract deposits.

Since the underlying spark in financial market stress was aggressive rate hikes and QT, more of the same would only exacerbate the problem. Therefore, the Fed should pause rate hikes and QT next week. The Bank of England did something somewhat similar last October, and the Bank of Canada recently paused interest rate hikes. If the economy shows strength in the roughly five weeks between the March 22nd and May 3rd FOMC meetings, tightening can resume. This can be easily messaged to the financial markets if the interest rate “dot plot” continues to show a 5%-plus terminal funds rate as it likely will. In fact, by not moving, policymakers gain more optionality than by tightening.



Source: FDIC, FRB, Haver, SMBC Nikko

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