Federal Reserve Watch

One day at a time

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Economics
United States

US Economics
BofAS

Ethan S. Harris
Global Economist
BofAS
+1 646 855 3755
ethan.harris@bofa.com

Michael Gapen
US Economist
BofAS
+1 646 855 3270
michael.gapen@bofa.com

Aditya Bhave
US Economist
BofAS
+1 646 855 9929
aditya.bhave@bofa.com

Shruti Mishra
US and Global Economist
BofAS
+1 646 855 1040
smishra44@bofa.com

Jeseo Park
US Economist
BofAS
+1 646 855 8688
jeseo.park@bofa.com

See Team Page for List of Analysts

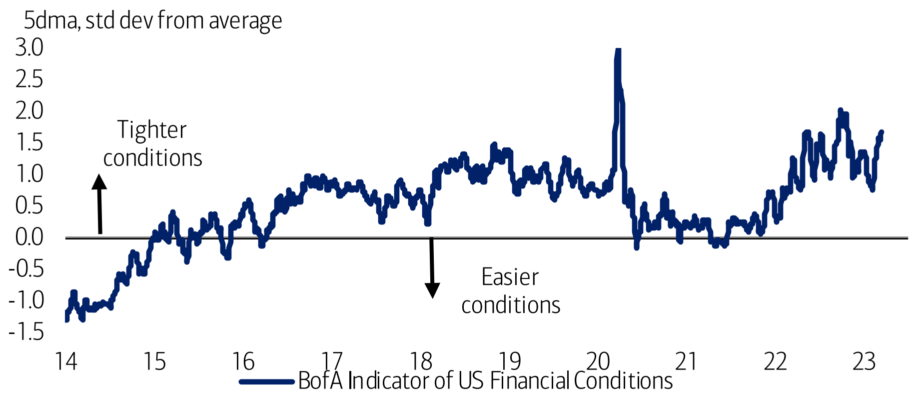
A forceful response...

We revisit actions taken by policymakers in recent days to stem deposit outflows from affected financial institutions and prevent broader contagion. In our view, the Fed took forceful steps to provide liquidity by altering access to the discount window and opening the Bank Term Funding Program. In addition, we see policymakers as implicitly guaranteeing deposits – both insured and previously uninsured. We think these actions should be enough to contain stresses in financial markets and maintain our view for a 25bp rate hike in March and ongoing balance sheet reduction.

...But more action might be necessary

That said, conditions are fluid and other policy options may be needed, including, but not limited to, the explicit guarantee of deposits. If it takes longer to quell market volatility, as was the case following the stock market crash of 1987 or the LTCM crisis in 1998, then the Fed could engage in insurance rate cuts and halt balance sheet runoff for a period of time, before resuming rate hikes. Then again, should financial conditions combine with heightened financial stress to curtail economic activity more forcefully, then we cannot rule out a move to a more prolonged easing cycle. Either way, risks to the policy path have shifted in the direction of less, not more.

Exhibit 1: BofA Indicator of US Financial Conditions (std deviation from period average, 5dma)
Financial conditions have tightened further, despite lower Treasury yields



Source: BofA Global Research. The BofA Indicator of US Financial Conditions is intended to be an indicative metric only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise relied upon by third parties for any other purpose, without the prior written consent of BofA Global Research. The BofA Indicator of US Financial Conditions was not created to act as a benchmark.

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Another day, tighter financial conditions

Recent market action has tended to raise our BofA Indicator of US Financial Conditions, reaching 1.7 standard deviations. This is because the positive signal of a steeper yield curve is more than offsetting the negative signals from weaker risk assets. This puts the index close to the peak reached in October and closer to levels consistent with prior downturns (about 2.0 or more standard deviations above average) (Exhibit 1).

Introduction

As we noted in "Fed launches Bank Term Funding Program" (see report), the Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) took several steps to alleviate concerns about liquidity demand that could result in adverse effects on lending conditions and economic activity. We concluded by saying – given what we know – that our outlook for monetary policy had not changed.

In this report, we expand on our initial thoughts, explaining in more detail the actions taken by the Fed, their implications, and potential outcomes for monetary policy. We note here that it is difficult, if not impossible, to discuss the actions taken by policymakers without making references to the 2008-09 Global Financial Crisis or the onset of the global pandemic in 2020, when similar actions were taken to contain systemic risk, promote the flow of credit to households and business, and support economic activity. That said, when making these comparisons, we are not implying that the situation today is as challenging as those episodes. Instead, we make the comparisons with the intent to provide clarity on policymaker intentions and motivations.

Joint actions to manage liquidity

In a joint statement, the Treasury, the Federal Reserve and the FDIC announced that they would protect all depositors of Silicon Valley Bank (SVB) of Santa Clara, California and Signature Bank of New York. Both institutions received a systemic risk exception, although the FDIC will continue its resolution of SVP, and Signature Bank was closed by its state chartering authority. The statement was clear in saying "shareholders and certain unsecured debtholders" would not be protected and senior management would be removed. In addition, any losses to the Deposit Insurance Fund in support of uninsured depositors would be recovered by a special assessment on banks.

The Federal Reserve also announced it would provide additional funding for eligible institutions through a new facility entitled the Bank Term Funding Program (BTFP). The program will offer loans up to one year in length to eligible banks, savings associations, credit unions, and other depository institutions pledging US Treasuries, agency debt and mortgage-backed securities, in addition to other qualifying collateral. The assets will be valued at par. In its announcement, the Fed said the facility will be "an additional source of liquidity against high-quality securities, eliminating an institution's need to quickly sell securities in times of stress".

The Fed also made adjustments to the discount window, its traditional lending facility that provides ready access to funding during periods of financial stress. In particular, the discount window will now apply the same margins used for the securities eligible for the BTFP, thereby increasing the lendable value at the discount window.

The BTFP will be backstopped by $25bn from the Exchange Stabilization Fund (ESF). The ESF was used in this capacity most recently during the COVID-19 pandemic, when $50bn was pledged from the fund to cover any losses in new lending programs. The ESF was also used in this capacity during the 2008-09 Global Financial Crisis. For example, funds from the ESF were used to temporarily guarantee deposits in certain money market mutual funds. ESF funds should only be thought of as a temporary solution, particularly should extensive lending be required.

A formal declaration that the situation is systemic

In unanimously voting to establish the BTFP, the Federal Reserve Board described the vote as creating a 13(3) facility. We note that Section 13 of the Federal Reserve Act limits 13(3) facilities to "unusual and exigent circumstances". Finally, the "systemic risk" vote for the FDIC to cover uninsured deposits was also voted on by the Board of Governors. In other words, by virtue of the actions and votes taken by policymakers over the weekend, regulators have determined these are "unusual and exigent circumstances" for liquidity and made a determination that "systemic risk" is present. What is also new, to our eyes, about this declaration is that it took place during a tightening cycle, and not an easing cycle, as was the case previously.

Accelerating the provision of liquidity to banks

In setting up the BTFP, the Fed is taking a page out of its traditional financial crisis response playbook. During a financial crisis, the Federal Reserve will strive to lend early and freely, to solvent firms, against good collateral, and (normally) at penalty rates of interest (e.g., Bagehot's dictum). In this case, the Fed likely made the determination that traditional discount window access, with its usual haircuts, was not working effectively. By lending against full par value, and adjusting the discount window to do the same, the Fed is taking forceful steps to deliver liquidity. We note that only existing holdings of eligible securities can be used to access the BTFP; banks cannot purchase securities at a discount today and use them as par value collateral in the facility. Hence, we see the design of the facility as more about improving liquidity provision than improving conditions in secondary markets.

Implicit guarantee of all deposits

The action to guarantee deposits is, in some ways, reminiscent of the approach policymakers took in 2008-09, when Treasury and the Fed created the Temporary Liquidity Guarantee Program, which guaranteed interbank loans and non-interest transactions accounts, including checking accounts. By contrast, we think the resolution of the two financial institutions over the weekend points to an implicit guarantee for uninsured depositors. After all, we think regulators would find it difficult to not provide guarantees to uninsured depositors in future such instances, were they to arise.

Hence, we see the current playbook as implicitly insuring all deposits of any potential troubled institution, while placing the cost of this deposit insurance on the banking industry, since the announcement states that any shortfall in the deposit insurance fund will be recovered by a special assessment on the banking system. Policymakers appear to desire an arms-length distance between the backing of deposits and any bailout of bondholders, which became controversial during the response to the 2008-09 Global Financial Crisis. Whether the broader public will see it that way may be a different question, but facility design and policymaker intent appear clear in this regard.

We note here that an implicit guarantee against uninsured deposits raises the risk of moral hazard and runs counter to a portion of the regulatory environment. Uninsured depositors, historically a large group of bank creditors, are thought by some to bring market discipline to banks and reduce propensity to take excessive risk. During periods of financial distress, these depositors would be forced to take a haircut, while small-scale depositors would retain insurance. Others argued uninsured depositors would not provide effective market discipline since they are unlikely to be able to monitor banks in a timely fashion, unable to charge appropriate rates of interest to affect bank behavior, and – most importantly in the current context – could be more likely to withdraw their funds rapidly in the event of a run as opposed to monitor effectively.[1] The current episodes suggest critics of the market-disciplining powers of uninsured depositors were onto something.

Monetary policy options

At present, our outlook for monetary policy has not changed. We continue to expect a 25bp rate hike in March, a terminal target range of 5.25-5.50% in June, and ongoing balance sheet reduction. That said, the situation remains fluid and, depending on the evolution of the incoming activity data and market stresses, the outlook for Fed policy could change quickly. We, like the Fed, are taking things one day at a time. Our base case assumes that the BTFP, the expansion of the discount window, and implicit insurance for uninsured depositors is enough to stabilize financial markets, or, at a minimum,

[1] See Bentsen, GJ, "The role of uninsured depositors and other market participants", Federal Reserve Bank of Boston

ringfence the core of the financial system from market turbulence. If so, the Fed could execute a 25bp rate hike in March and continue to reduce its securities holdings over time (though the balance sheet may rise in the meantime depending on the take-up in the BTFP).

- **A delayed policy peak?** One alternative, however, is that actions by policymakers take more time to stabilize the situation and other policy actions – like formally insuring all deposits as was done in 2008 – may need to be considered. In the meantime, the Fed may pause its policy rate hikes and halt balance sheet runoff. It may also cut rates briefly to provide insurance against any potential downturn in the economy. When the situation clears, the Fed could resume its hiking cycle. Historically, we can think of two such examples, including the stock market crash of 1987 and the LTCM crisis in 1998. To be clear, we are not saying the current situation resembles those episodes to any degree, but they can be instructive for providing insight as to how the Fed may react to uncertain financial stresses. Following both of these episodes, the Fed cut rates initially, only to ultimately raise the policy rate above pre-stress levels later.

- **The beginning of a downturn?** However, a third episode was the failure of Lehman Brothers in 2008, which helped to precipitate the subsequent downturn. Again, we are not saying the current situation bears any resemblance to this point in time, but we also cannot rule out that financial stress could combine with prior tightening in financial conditions to nudge the economy into a recession. A mild recession has been part of our baseline outlook for some time, although we currently foresee it happening later this year following additional policy rate tightening. That said, it may be the case that existing policy rate tightening and increased financial stress cause spillover effects into credit availability and household balance sheets via lower asset valuations more quickly than we anticipated. In such a scenario, the Fed would be inclined to alter its outlook for the economy in favor of lower employment and inflation, possibly opening the door for earlier rate cuts than we currently expect.

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Research Analysts

US Economics

Michael Gapen
US Economist
BofAS
+1 646 855 3270
michael.gapen@bofa.com

Aditya Bhave
US Economist
BofAS
+1 646 855 9929
aditya.bhave@bofa.com

Stephen Juneau
US Economist
BofAS
+1 202 442 7429
stephen.juneau@bofa.com

Shruti Mishra
US and Global Economist
BofAS
+1 646 855 1040
smishra44@bofa.com

Jeseo Park
US Economist
BofAS
+1 646 855 8688
jeseo.park@bofa.com