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ECONOMIC DIGEST

THE INFLATION - TARGETING JOB OF THE FED IS BECOMING MORE TOUGH AMID THE RECENT US BANKING CRISES

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It seems that since 2020, i.e. from Covid Year, we are living in interesting times, followed by the geopolitical issue, inflation challenge, weak market sentiments, probable recessionary fears and recently two US banks; Silicon Valley Bank (SVB) and Signature Bank have ducked and the historied 'too big to fail' Credit Suisse (CS) came on a brink of collapse. Interestingly, the "Early Warning Signs" were missed, the rumor that was hovering five months ago came true for Credit Suisse. According to its latest quarterly report (9 Feb'23) net income loss towards shareholders stood at CHF (-)1,393 million (fourth-quarter'22) whereas pre-tax income loss remained at CHF (-)1315 million. In FY22, the overall loss to shareholders appears at CHF 7,293 million, more than four times that of FY21. Also, the 4Q22 loss has been impacted by the adverse "Investment Bank performance" and "lower client activity."

Another Swiss investment bank, UBS has declared in its 19th March 2023 Press Release that it plans to acquire Credit Suisse, which is expected to create a business with more than USD 5 trillion in total invested assets and sustainable value opportunities, though this came at a rather substantial cost for some categories of investors, as acquisition price was CHF 0.76 a share, well below CS's CHF 1.86 closing price on 17 March2023, and around CHF 16 billion worth of CS Additional Tier 1 capital bonds are being smeared out, along with other lenders' AT1 bonds are also burdened.

Given this backdrop, for Fed, the decision on the policy rate has become more challenging. The weight is still tilted towards a 25 bps hike (this probability is slightly over 68% from the bond market) and given that ECB has raised by 50 bps indicates that Central Banks (CBs) are still putting inflation at their top priority. One of the problems with Fed is that it has to balance carefully between rate raising and measuring stress testing sentiments for banks, as SVB case has shown a mark to market loss of their long-term mortgage securities.

Roughly, they had to sell US bonds at a loss. The SVB incident has re-established the classic case of the Nobel Prize winning Diamond-Dybvig Model that suggests that the way that banks operate fundamentally, i.e. by offering short-dated claims against long-dated assets, leaves them vulnerable to runs. Moreover, market sentiments are at the low down, given the surge in the bond volatility. Adding to the injury, rating agency Moody's has downgraded the entire US banking sector from stable to negative.

Another point is that the impact of such rate hikes has to be felt in a lag, so taking a pause this time would allow to monitor the trend of the CPI in immediate future without disturbing further the already fragile market stability. The most difficult part is that the hike in the federal fund rate would not distinguish between different interest-sensitive components, for instance, while services related items have shown stickiness with the bulk of the contribution coming from shelter (and the housing market's role in CPI continues to be sticky), we are still unsure how such rate hike would impact balance sheets of banks and other financial institutions.

A continuous rate hike might expose more such fragility in the US banking system, and the trade-off is important so that attempt to contain inflation should not translate into a banking crisis. Assurance have been provided by the Fed as US banks have borrowed from the backstop facilities, with an increase in the discount-window lending. Fed has tried providing extra liquidity to money markets by boosting the frequency of its USD swap lines operations from weekly to daily. Further, Fed and the ECB, BoE, the SNB, the BoC & the BoJ announced coordinated liquidity measures in the form of daily swap lines to improve global access to dollar liquidity. Nevertheless, the future path regarding this still remains shallow. Possibly, the time has come to explore what Jason Bloom, Head ETF strategies of the Invesco has emphasized "It's time to take a pause and look at how much damage has been done from tightening." The challenge for Fed is clearly to balance between financial and price stability- a choice which is not so easy.