March 27, 2023

Tighter Credit Conditions to Aid in Federal Reserve's Fight Against Inflation

Economic
INSIGHT

Last week, central bankers opted to raise rates for the ninth time in 12 months. Striking somewhat of a compromise between an aggressive 50 basis point (bps) increase supported by strong inflation data and a pause in rate increases amid recent uncertainty in the banking sector, the Federal Resere (Fed) increased the key lending rate by *"only"* 25 bps.

While projecting confidence that the *"powerful actions"* taken by the Fed have been enough to stabilize market conditions, the Committee reiterated its longer-run commitment to reinstating price stability. Federal Reserve Chairman Jerome Powell asserted that the effort to restore 2% inflation *"still has a long way to go and is likely to be bumpy."*

SOUND AND STABLE

The recent collapse of financial institutions is still fresh on the minds of investors, and contagion fears remain in the financial markets with ample uncertainty. For the time being, the Fed appears to be convinced financial conditions are *"resilient and on a solid foundation"* and that broader economic conditions are stable enough to move forward with additional policy initiatives. The U.S. banking system is "sound and capital liquidity strong," Powell professed on Wednesday without any hesitation.

Tighter lending standards are also likely to emerge in the aftermath of the bank failures, as institutions either face greater regulatory scrutiny or they become more aware of their own shortcomings. More stringent standards could tamp down investment and consumption, eventually resulting in a slower growth rate and more benign inflation. The suggestion here is that, tighter lending limitations would help to do some of the Fed's work, potentially reducing the peak level of rates needed to rein in inflation and limiting the level of distress shouldered by financial institutions.

As the March Federal Open Market Committee statement read, recent developments are likely *"to result in tighter credit conditions for households and businesses and will likely weigh on economic activity, hiring, and inflation."* The extent of these effects, however, is *"uncertain,"* and the Committee remains highly attentive to inflation risks.

In other words, the shift in the statement language from indicating *"ongoing rate hikes may be appropriate"* as seen in January to a somewhat softer wording of additional *"policy firming may be appropriate"* does not reflect or insinuate a lessened focus on inflation. After all, as Powell reiterated numerous times during the press conference, *"we will do whatever it takes to reinstate price stability,"* as inflation remains *"well above"* the

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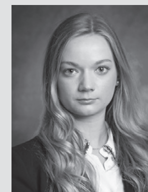

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Fed's 2% target. Thus, rather than undermining the Fed's resolve to stay the course until the battle against inflation is won, the adjustment in language reflects the uncertainty in which a change in market conditions will have on taming inflation. If recent market events have a minimal or modest impact, the pathway for rates will likely look more aggressive and more in line with expectations pre-Sillicon Valley Bank. Alternatively, if recent policy action results in tighter credit conditions, that would mean monetary policy has less work to do.

"It's possible that this [banking crisis] will turn out to have very modest effects…Inflation will continue to be strong, in which case, you know, the path will look - might look different. It's also possible that this potential tightening will contribute to significant tightening in credit conditions over time, and in principle, if that – that means that monetary policy may have less work to do. We simply don't know."

– Federal Reserve Chairman Jerome Powell March 22 Press Conference

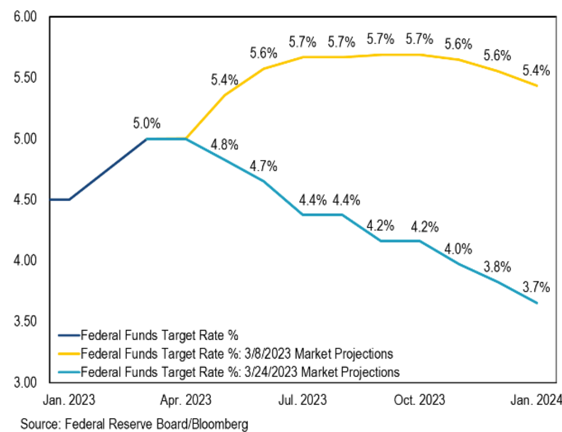
GLOSSARY

FOMC – Federal Open Market Committee

SVB – Silicon Valley Bank

MARKET DIFFERENTIAL

Of course, while the Fed is confident – or at least is projecting confidence – that its swift and decisive action has been sufficient to reinstate stability and calm to the markets, investors seem less convinced the worst is in the rear view mirror. Market players are still questioning the premise that the Fed can continue to raise rates while risks persist.



Source: Federal Reserve Board/Bloomberg

According to the fed funds rate forward curve, investors are predicting a decisively more dovish pathway relative to that anticipated prior to the March meeting. As recently as March 8, the market was pricing in a peak fed funds rate of 5.7% with the first rate cut delayed until November. In the aftermath of the recent bank failures and the latest March policy decision, forward projections now expect a 5.0% terminal rate with more than 100 bps of cuts by the end of the year.

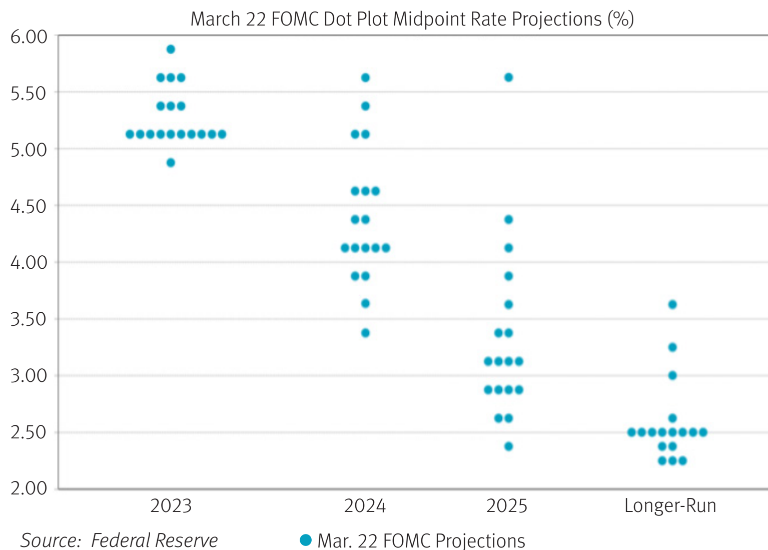
In contrast, the Fed's dot plot shows that despite recent activity, the majority of officials still anticipate a terminal fed funds rate rising above 5% with four officials forecasting a rate between 5.5% and 6% (up from just two in December). In other words, despite *"so much uncertainty,"* the 2023 dot plot was unchanged in its prediction of a 5.1% year-end rate. Of course, since *"rate cuts are not in our base case scenario,"* the consensus does seem increasingly optimistic that at least one additional rate increase coupled with a significant firming of market conditions could be sufficient in taming inflation.

LINGERING CONUNDRUM

The Fed faced an incredibly difficult decision this week, and it will face another difficult decision at its May meeting. Initally, the Fed was walking a delicate line between taming inflation and attempting a soft landing. Now, the Fed has the added challenge of navigating the tantrums – or wild swings – of an incredibly delicate banking system.

Amid the Fed's decision to press forward with additional tightening this week, coupled

with clear communication, the message of stability was received. The Fed is confident the banking system is sound. Period. End of story. And while the Committee recognizes the likely consequences of the recent turmoil, the resulting tighter credit conditions will likely assist the Fed in its quest to tame inflation.



From the Fed's vantage point, with *"modest"* growth in spending and production, a *"pickup"* in job gains, and a *"low"* unemployment rate, the economy remains positive and somewhat resilient. Thus, given the still *"elevated"* level of inflation, the Committee will not be distracted or deterred from its primary goal of reinstating price stability. Although again, additional *"firming"* may come from both policy action by the Fed along with a more organic adjustment in market conditions. In either case, as Powell has reiterated time and time again, and numerous times during Wednesday's press conference, *"the economy does not work for anyone"* without price stability.

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