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What if I was the Fed Chair?

Synopsis
The Federal Reserve's failure to recognize inflation as more than just a transitory issue led to a rapid interest rate hike causing significant losses for banks. The Fed should have realized the potential losses and done more to identify risks associated with its actions. The rapid rise in interest rates was beyond the career memory of almost all market participants, which should have been a warning sign for regulators. The Fed infused liquidity to keep faith in the banking system, which partly undid its own monetary tightening through interest rates.

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Devina Mehra, Chairperson and Managing Director of First Global, is a gold medalist from IIMA as well as from Lucknow University where she broke several records. She had a seven-year-long stint at Citibank in Investment Banking & Corporate Credit/ Risk before becoming a member of the Bombay Stock Exchange in 1993 - her proprietorship which later corporatised and became India's leading institutional brokerage firm, First Global. She spearheaded First Global's globalisation over two decades ago, making First Global the first Asian (ex-Japan) firm to become a member of the London Stock Exchange and then the NASD.

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Sounds like a school essay topic?

Actually, someone recently asked me what I would have done better as a central banker, specifically if I had been running the Federal Reserve, the Central bank of the US.

Who knows whether I would have done any better, as armchair advice is always easier, but at least in hindsight, there are two areas where, in my view, the Fed clearly flubbed up.

One was to call inflation transitory long after that description should have been junked ie right into 2022.

It let hope overpower analysis when it blamed inflation entirely on Covid and war related supply issues and forgot all about the amount of money slashing around in the system which as economic theory teaches us, causes inflation.

This meant that when the Fed finally realized that inflation was not going to come down on its own, it had to hike interest rates by too much too fast!

The rate hikes, when they came, had to be of a quantum not seen in most people's living memory and hence were difficult to process, react to and de-risk for players in the system - the most prominent of these being the banks.

For context, the 4.75% Fed rate hike in just about a year had last been topped over 40 years ago, in 1980 and 81 - well before almost all bankers and market participants had started working.

The Silicon Valley Bank that went under, for instance, was founded in 1983 - so it literally was the first time such a rapid hike been encountered in the Bank's own memory.

The other is the problem that I talked about earlier too, that having rapidly raised rates, the Central Bank should have known that there would be losses hiding somewhere in the system.

Obviously the managements of regional banks, like Silicon Valley Bank, should have managed the risks on the investment book better and so on, but what about the regulators?

They knew that this kind of interest rate hike was beyond the career memory of at least in 95% of the bankers and other market participants.

Plus unlike credit risk, where the regulator cannot know the quality of the loan book without considerable digging, this is an easily modelable problem.

The quantum of outstanding fixed income securities is known and I suppose roughly where they are held is also known.

So the regional bank investment book risk should have been a very easily foreseeable problem.

Overall the holding of security is by US banks went up from roughly 3.3 to 3.5 trillion dollars before the pandemic to about 5.8 trillion dollars when the Fed started hiking.

This was partly due to the money put in the hands of the citizens by the government, but even as a percentage of deposits the funds invested in securities went up from about 26-28% of deposits to 32%.

In defence of the Fed, as we all know, for most banks rising rates are a positive because the interest rates on credit assets (loans, credit lines etc) are increased immediately whereas the deposit rates are hiked much more slowly.

Thus, rising rates are margin positive for many banks, at least in the beginning. Hence, the Central banks may not have worried about the fallout of their rapid rate hikes.

SVB was in a peculiar position where rates were a double whammy for them, unlike for credit oriented banks. The rate hikes brought down the value of their asset (investment) book, even as they effectively dried up deposits, as its customers (the startup ecosystem) could no longer raise funds easily.

Even so, in my opinion, the asset side problem should have been on the regulatory radar as with the rapid rise in rates somewhere in the system some entity(s) was obviously going to be taking a hit... as a direct result of the Central Bank's own actions.

The fact that it would be a never before seen phenomena for almost all market participants should have been a further warning sign for regulators.

To some extent, they were a caught sleeping. The Fed could, and should, have been a lot more proactive in identifying the risks associated with its own rate hikes.

In short, having neglected the problem of inflation, it ended up in a place where it had to hike rates too quickly.

This in turn caused massive losses in the securities books of banks.

Now in order to keep the faith in the banking system, the Fed has to then infuse liquidity which partly undoes its own monetary tightening through the interest rates.

In a sense, by over looking a problem and then trying to plug it later, the Fed's actions are causing other unintended, but foreseeable, consequences in the system.

Of course, second order impact of rising rates can be in the form of higher delinquencies/ poorer asset quality.

For example, in India, I see some calculations that the mortgage rate hike has dramatically increased burden. If EMI is not changed, 20 year loans have become 40 or 50 year loans!!

But that's a topic for another day.

As the cliché goes: Picture *abhi baaki hai!*

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