Eventful past six weeks and uncertain growth in the midst of inflation

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The second fortnight of March witnessed four notable bank failures: Two of them were in USA with Silicon Valley Bank (SVB) starting the scare a week earlier in regard to the value of bonds held as assets. The Ides of March confirmed its failure as there were heavy withdrawals. The assets held by SVB, which were in long time bonds had all depreciated in market value due to the anti-inflationary policy stance adopted since May 2022 by the US Federal Reserve (the Fed) with higher interest rates. When SVB sold some securities to satisfy the demand depositors for raising cash, the paper losses were real. The management revealed they they had to incur losses. That was sufficient. The scare turned into reality. SVB could not meet the demand of the savers to get back their funds. Legally it was declared by regulators that it was insolvent. It was followed by Signature Bank. The third one was in Switzerland, Credit Suise, which had nothing to do with SVB crisis. The fourth one was a plunge on March 25 in share prices of the largest bank, Deutsche Bank, of Germany, but a kind of reaction to all these financial crises. The immediate impact on savers (lenders to banks) and investors (borrowers from banks) was intense all over the world.

On the first three crises, the Reuters reported that investors were fretting that regulators and "central banks have yet to contain the worst shock to the sector since the 2008 global financial crisis", as if the state sponsored bank rescues are "a must" whenever banks go under. The corollary appears to be banks feel they are not responsible for their negligence and mismanagement. In these days of free enterprise with an envisaged, greater role of private sector as an engine of growth, it is indeed strange that the private sector looks to public sector institutions for survival.

The reasons are not far to seek. Excess liquidity in the advanced economies began since the 2008 Global Financial Crisis and went on unabated in several episodes, including taper tantrums of 2013 and 2014, as the US Fed had to pump in money to save banking industry to survive. The crisis was ignited by a fall prices in the housing sector in the US and borrowers could not meet their re-payment obligations. The US Fed purchased bad debts of banks and bonds. The bonds add to deposits as well as reserves of banks. According to Bloomberg, about $7.9 trillion were uninsured deposits since the insurance coverage by the US the Federal Deposit Insurance Corporation limit (FDIC) is limited to deposits up to $ 250,000.Thus, only 46% of deposits or $18 trillion, put in by savers in US banks are covered by FDIC. Others are held invested in money markets or in currency. Excess funds have only been fanning speculative activities as the risk-free security return was at its lowest revolving around the range of zero to 25%.

The Fed's normalization of interest efforts have never materialized until rising trend in prices was recognized in mid 2021. The targeted inflation rate by the US Fed, which is 4%, was exceeded consistently in late 2021 but it was ignored on the grounds that they were due to transient factors. The Fed insisted nearly for since months since mid 2021, when inflation was exceeding the 2% target, it was transitory and would vanish. Only in January on wards in 2022, the Fed stopped alluding to the transient factors, as inflation rose to 8.5%, in April, as supply chain bottlenecks developed leading to shortages of availability of both petroleum crude and food grains imported by Europe from Russia and Ukraine following the break-out of the conflict between Russia-Ukraine war from February 2022.

The Fed had to wake up and recognized the need for increasing the rate from near zero

percent to 1%. As inflation reached at 9.1%, the highest in two decades, in June 2022, the Fed has mounted a monetary tightening policy. The Fed never admitted openly its mistake of delaying its "normalization of interest rate".

The Reserve Bank of India (RBI) too was avoiding its monetary tightening on the same "transitory" grounds for a while as could be seen on the Table. In May 2022, RBI increased the REPO rate from 4.0 to 4.4%, as the Fed raised its fed Funds rate to 1%. May be RBI had thought keeping up the interest spread at the same level or higher was in the interest of hot money inflows, though unreliable, for exchange rate stability.

It was clear SVB should have seen the writing on the wall that the so-called safe securities including government issued bonds would deprecate in market value as the market interest rate, which revolves tightening stance of the Fed Funds rate. By keeping the depreciated, low market value bonds the paper value also goes down and they become real losses when sold in the market. The SVB management has failed in duties. The US regulators of banking industry ruled out any rescue.

The US Treasury Secretary Janet Yellen told the media in late March: "Let me be clear that during the last financial crisis, there were investors and owners of systemic large banks that were bailed out … and the reforms that have been put in place mean that we're not going to do that again," Her focus is on "depositors and trying to meet their needs."

TABLE : USA and India: Inflation and Policy Interest Rates

YEAR/ MONTH	USA		INDIA	
	Inflation (Y to Y) (%)	Interest Rate (%)	Inflation (Y to Y) %	Interest Rate %
2021 Dec	7.0	0.25	5.66	4.0
2022 Jan	7.5	0.25	6.01	4.0
Feb	7.9	0.25	6.07	4.0
March	8.5	0.5	6.95	4.0
April	8.3	0.5	7.79	4.0
May	8.6	1.0	7.04	4.4
June	9.1	1.75	7.01	4.9
July	8.5	2.5	6.7	4.0
Aug	8.3	2.5	7.0	5.4
Sept	8.2	3.25	7.41	5.9
Oct	7.7	3.25	6.77	5.9
Nov	7.1	3.75	5.88	5.9
Dec	5.0	4	5.72	6.25
2023 Jan	6.4	4.25	6.52	6.25
Feb	6.0	4.5	6.44	6.5
March	5.0	4.75	5.46	6.5
April	TBA	TBA	TBA	6.5

Notes : India's policy interest rate decision was taken on April 6 before CPI inflation data for March were released on April 13. April inflation for USA & India will be known in mid May TBA; to be announced

In a sign that regulators have concerns about wider financial chaos, the Fed soon assured that it would make funding available for eligible financial institutions by providing loans against the government bonds at original face value, of course at a low penal interest rate. The Senate Banking Committee unanimously agreed in its preliminary hearing that bank executives should be punished.

Back to central bank's primary task

Relieved that SVB crisis was not a major crisis, he Fed had to focus on its objective: price stability. On March 27, 2023, it raised its rate to 5% by a quarter-point, the ninth consecutive rate rise and the highest rate since 2007. A year ago interest rates were close to zero. The Fed chair also made it clear that though he had considered pausing rates, he had to change his initial stand. He pointed out that "Inflation remains a global issue". The next meeting of the Open Markets Committee, which is the rate setting committee of the US Fed is May 2-4 and its decision will be announced in the afternoon of May 4.

As the inflation in UK was 10.4% in February, on March 23 the Bank of England raised its policy rate by a further quarter of a percentage point (25 basis-point) increase to 4.25%. That was its 11th consecutive increase in borrowing costs, beginning from December 21, four months earlier than Fed.The European Central Bank raised rates by 0.5 percentage points in March to 3% despite the Credit Suisse cisisis, as inflation in the eurozone at 8.5% was surging in February. The ECB's next rate review date is May 4 and it is likely that the rate would be increased

further by 0.50 percent or more. The rate setting committee member from Belgium is worried : "We are waiting for wage growth and core inflation to go down first, along with the headline inflation down before we can arrive at a pause".

In the meanwhile there are fond hopes that a slow down in growth, due to rise in the policy interest rate would also contribute to a slow down in growth in credit growth, without any monetary tightening efforts by central banks. Treasury Secretary Janet Yellen's fond hope expressed in a press meet, amounting to moral suasion was once dubbed as a monetary policy instrument in the last century's text books, in addition to interest rate changes and open market operations. Humorously, moral suasion is referred to "jawboning," since it amounts to persuasive talk in contrast to actual rate increases; and as "open mouth operations" in contrast to absorption of liquidity by open market operations.

Indian situation

The first bi-monthly meeting of the interest rate setting committee, known officially as Monetary Policy Committee (MPC) sprang a surprise, when it ended its three day deliberations on April 6. No doubt it had, as usual before them to consider more than one month old inflation data of February and not of March. It has been consistently suggested in this column for more than three years that MPC should hold its bimonthly meeting only in the second fortnight of the month, as inflation data of the previous month are released only around that time. In order that MPC, which meets bi-monthly, has full and complete data covering two full months on wholesale prices and retail inflation prices and core inflation and data on food and fuel and related volatile item, RBI should consider re-scheduling the MPC meeting only in the last week of the month, rather than early in the first fortnight.

Any way the MPC decision of April 4-6 was a surprise. It was expected that the key interest rate, RPO would be revised upwards, either by 0.25% or by 0.50%., in keeping with the major central banks' unchanged tightening interest

stance. The MPC decided to pause the rate change and the rate of 6.50% would continue until June. The RBI Governor made it clear that the rate of 6.50% is not a pivot, which was fixed in February. He also meant that if situation warrants he would tighten further. The RBI is well aware that monetary tightening since April 2022 by Fed and also by BoE since December 2021 and by ECB in April 2022 has given rise to financial stability risks across the world causing a mini bank turmoil. The Indian banking system, according to RBI's assessment, is strong since macroeconomic and prudential indicators are healthy from capital adequacy ratios and other conventional stress tests. A pause at this stage by RBI would certainly do a world of good for undertaking a fresh review of the impact of interest hikes on growth and prices since the first rise in RPO in May 2022 from 4.0% to 6.50% in April 2023. The next meeting of MPC is scheduled in early June, of course, much before May inflation data would be available around mid June. ■

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