

US Macroeconomics

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The Anatomy of a Crisis

When the Fed buys treasuries or mortgages from primary dealers, bank reserves are created. The opposite is the case when the Fed sells securities or allows them to mature, as has been the case since last May. When commercial bank reserves decline so do commercial bank deposits. This is illustrated in the chart below which shows the change in bank reserves versus the change in bank deposits.

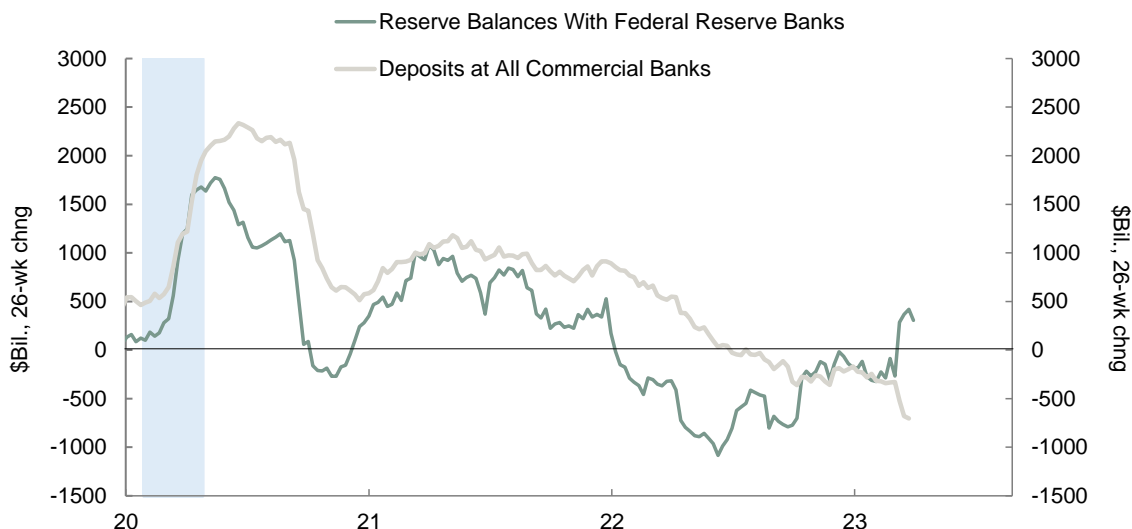
When the Fed began slowing the pace of quantitative easing (QE) in 2021, the amount of bank reserves being created began to slow. Not surprisingly, the amount of commercial bank deposits began to slow, too. In 2022, the amount of bank reserves in the financial system began to shrink, consistent with quantitative tightening (QT). Not surprisingly, the amount of bank deposits in the financial system began to shrink, too.

By last fall, both bank reserves and deposits were both declining. QT was draining liquidity out of financial markets. But there was another factor causing deposit flight as well — higher overnight borrowing rates. The dramatic increase in the funds rate pushed the yield on three-month treasury bills above 5% on a bond equivalent basis, its highest rate since July 2007. This spawned an acceleration in deposit flight out of the banking sector.

In the four weeks ending March 29th, which is the latest available data, the commercial banking system had lost \$474 billion in deposits. Our best guess is that this drain has intensified. In response to the current crisis, the Fed has lent \$404 billion to the banking sector through various discount window programs to offset this deposit flight. These liquidity measures can be seen by the recent jump in bank reserves. But this is not enough.

With yields on three-month bills going higher, because the bond market now expects another hike at the May 3rd FOMC meeting, **market participants remain incentivized to take their funds out of commercial banks to seek higher returns elsewhere** such as in money market funds. With nearly \$7 trillion still sitting in deposits at small- and medium-sized banks, the potential for further significant deposit flight remains high.

Since this crisis is largely of the Fed’s own making, the simplest fix would be to cut the funds rate and cut it by a lot. That way bank clients will not seek higher returns elsewhere. Unfortunately, policymakers have pushed back against a pivot toward rate cuts. Consequently, we are not yet out of the woods.



Sources: Federal Reserve, Haver, SMBC Nikko

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