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Jenna McNamee

Despite the ongoing banking crisis, the Fed's small rate hike shows it's still determined to fight inflation

Article

The news: The Federal Reserve raised the federal funds rate 25 basis points at this week's Federal Open Market Committee (FOMC) meeting, bringing the target rate to between 4.75% and 5%

Mostly anticipated, a bit unsure: At the beginning of the month, Fed Chair Jerome Powell suggested a stronger approach to tackle inflation. But his tune suddenly changed when multiple banks collapsed and the sector fell into disarray.

- The market largely expected the quarter of a percent raise, though it was smaller than previous increases.
- The Fed's policy statement also hinted at a potential pause in increases at future meetings.
- The Fed's remarks echoed those of Treasury Secretary Yellen that the US banking system is sound and resilient, and that the recent bank failures aren't indicative of a wider issue in the banking system. Powell also views the **UBS** takeover of **Credit Suisse** as a positive move.

Despite these reassurances, markets ended down on Wednesday, though at the time of writing on Thursday, they were rebounding. In an appearance before Congress on Wednesday, Yellen more bluntly (but not surprisingly) stated that regulators aren't considering insurance for all deposits.

Implications of the hike: The rate increase will impact banks—the rapid rise in rates is believed to be partially to blame for the banking collapses and instability—as well as consumers. But despite the recent slowdown in inflation this year, Powell made it clear that there's still work to do.

- **Smaller banks may continue to struggle with liquidity** as the rate increase puts pressure on bond portfolios, **but the Fed's standing and newly created liquidity programs can assist**.
- Though small, **the rate hike will continue to play a role in the consumer credit squeeze**. Consumer spending remains relatively strong, but credit card balances are on the rise. As interest rates rise, consumers may find themselves a bit too far under water.
- The Fed has also positioned **the banking sector's shakiness as acting similarly to a rate increase.** The financial stress has created tighter credit conditions in the economy, which will likely have short-term impacts on hiring and other economic activities.

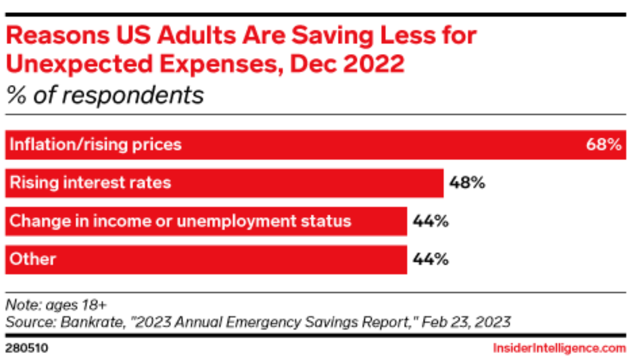
What's ahead? The Fed's dot plot, or chart that summarizes the FOMC's outlook on the federal funds rate, largely shows the increases peaking, though they also show less unanimity among officials.

- **The projection suggests that the rate will peak at 5.1%,** which signals just one more rate increase, though some officials estimated that it may settle a bit higher.
- On average, the estimate signals an 80 basis point reduction in 2024, and a 1.2% cut in 2025.
- The Fed has made it clear that a pause may be in order in 2023, but that there won't be any cuts this year.

The big takeaway: Uncertainty within the banking sector and consumer uneasiness will complement the small federal funds rate hike and will likely have an effect on inflation that's similar to the Fed's original plans. But the rate hike probably won't have the same effect on all banks.

- Larger banks are much more well-capitalized and better able to handle liquidity demands than they were during the 2008 financial crisis. Their comparatively greater strength has been visible throughout the past two weeks, and it's certainly aiding in calming the waters.
- But midsize banks aren't required to be so well-capitalized, and they will feel this and any other future rate hikes more. These banks must avoid becoming overly reliant on the Fed's liquidity mechanisms or taking for granted a bailout if they find themselves in trouble.

Big banks have so far stepped in when needed, but there's only so much they can do to keep smaller peers afloat. With so many smaller and midsize banks in the US, the Fed's fight against inflation might be a reckoning for sussing out some winners and losers.



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