# Fed holds interest rates amid mounting global turmoil

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The decision by the US Federal Reserve to keep its base interest rate on hold is a measure of the worsening outlook for the global economy and financial markets. The overall situation is marked by growing concern over the US economy and a flight to "safe havens," in the form of purchases of government bonds by international investors.

The two immediate factors in the Fed's decision, announced at the conclusion of a two-day meeting on Wednesday, appear to have been the worsening jobs and economic outlook in the US and growing uncertainties surrounding the June 23 referendum in the UK on whether to quit the European Union, and the possible impact of a "yes" vote on equity and bond markets.

The statement issued by the US central bank's Federal Open Market Committee noted that the pace of improvement in the labour market had slowed, with diminishing job gains, and that fixed business investment was "soft." The Fed revised downward its estimate for economic growth in the coming year from the 2.2 percent forecast in March to 2 percent. Growth in 2017 was also revised downward from 2.1 percent to 2 percent.

As the *Wall Street Journal* noted, the decision suggested that Fed officials were coming to the conclusion that the economy could not bear higher interest rates even to achieve "mediocre growth."

The issue of a possible exit of Britain from the EU (Brexit) was not mentioned in the statement, but Fed Chairwoman Janet Yellen commented on it in her press conference. Asked whether the upcoming British vote had been one of the factors in the decision, Yellen said: "It is certainly one of the uncertainties we discussed and factored into today's decision." A vote to leave the EU would have consequences for global markets, she added.

When viewed against the backdrop of the last six months, Wednesday's decision indicates that the Fed is simply reacting to events as they occur, under conditions where its projections and forecasts are almost immediately blown off course amid slowing global growth and the rush by investors to the relative safety of government bonds. These are increasingly trading at zero or below-zero interest rates, and it is estimated that more than $10 trillion worth of bonds are returning negative interest rates.

When the Fed announced a 0.25 percentage point rise in its base rate last December, Yellen said the US economy was on a "path of sustainable improvement" and added that "we are confident in the US economy."

In the two months that followed, global financial markets experienced considerable turmoil, part of which was attributed to the December Fed action.

The prospect of "sustainable improvement" was dealt a major blow with the release of data for the first quarter of 2016 that showed gross domestic product in the US rising at an annual rate of just 0.8 percent, repeating a pattern of first quarter declines over the last several years. Then the jobs data for May showed that employment had increased by only 38,000 in May, well below forecasts.

The unemployment rate fell, but that was only because the labour force shrank by 485,000 people, as thousands gave up looking for work. Other data shows that the percentage of men aged 25 to 54 who are not working is at an all-time high, and median household income is 1.3 percent below where it was in 2007.

In a speech last week, Yellen continued to maintain what she called "cautious optimism" on the US economy, but did not repeat previous remarks that she expected a further rate rise "in the coming months."

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The so-called "dot plot," which indicates where members of the Fed believe interest rates will move, showed a lowering of projections in the short-term and stretching out to 2017 and 2018. This indicates that while the Fed would like to lift interest rates in order to have some means of stimulating the economy by lowering them in the event of a recession, it is unable to do so because the present low-rate regime is not bringing about a sufficient increase in growth.

Answering a question at her press conference, Yellen said: "We are quite uncertain about where rates are heading in the longer term."

In her prepared remarks, she noted that non-energy business investment was "particularly weak" during the winter and appeared to have remained so in the spring. The growth in household spending "slowed noticeably" earlier in the year.

The immediate reaction in financial markets was that any rate rise was off the table for the rest of the summer, with the earliest date for an increase being September, or even December.

The Fed decision came in the wake of a day of turbulence on global financial markets Tuesday when yields on German and Japanese government bonds hit new lows, with the 10-year German Bund entering negative territory for the first time. The increase in bond prices, which have an inverse relationship to yields, was fuelled by opinion polls showing that the Leave option in next week's Brexit referendum had attained a majority.

In addition to the falls in German and Japanese bonds, the yield on British 10-year bonds fell to a new low and the yield on the 30-year bond dropped to below 2 percent for the first time. The interest rate on US ten-year treasury bonds fell to 1.6 percent, just above its lowest level since 2012.

The British pound fell heavily on currency markets, with the cost of protecting swings in its value against the euro rising to a record high, exceeding levels reached in the global financial crisis of 2008.

While the immediate cause of the turmoil was the Brexit vote, longer term processes are clearly at work. Andrew Milligan, the head of global strategy at the UK insurer and investment group Standard Life, said it was "one of the most peculiar environments for investment I've known."

He continued: "The Bund's move below zero is symbolic of a trend we have been living with for more than a year, where the actions of central banks and the weight of money looking for positive returns is leading to unprecedented moves in markets."

The sense of shock at what is taking place was also reflected in remarks by Ralf Preusser, head of European rates research at Bank of America Merrill Lynch.

"We are seeing the death of quality, positive-yielding assets," he said. "Global growth is still weak and central banks are still buying bonds, but the real surprise, and the big driver behind this rally [the increase in bond prices, which sends yields lower], is the question of how sustainable the US recovery is."

In other words, what was once considered the "normal" functioning of the global capitalist economy, where investments were made in the real economy in the search of increased profits leading to higher growth, and investment in government bonds returned a positive rate, securing a long-term source of income for insurance firms and pension funds, has completely broken down.

The various "quantitative easing" measures pursued by the world's central banks have not only completely failed to increase real growth, they have created a mass of cash surging like a wrecking ball through financial markets as it seeks speculative profits.

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