Fed divided on policy amid warnings over state of global bond markets

Nick Beams
19 August 2016

The July minutes of the Federal Open Market Committee meeting reveal the US central bank is divided over its interest rate policy as warnings continue that the global bond market is heading for a crash as a result of the ultra-cheap money policies pursued over the past eight years.

The policy makers were split over whether to lift interest rates again this year, following a 0.25 percent rise in the Fed's base rate last December. Underlying the divisions is the lack of any clear understanding of where the US economy is heading.

An analysis prepared by Fed staff for the meeting said that before the financial crisis of 2008, traditional measures—involving small-scale interventions in the market—were "adequate for interest rate control even during periods of stress." This has now changed.

Evidence from the crisis and its aftermath, the report said, indicated that the Fed's previous framework "did not enable close control over the federal funds rates." The significant expansion of liquidity programs "was unable to generate sufficiently accommodative financial conditions to support economic recovery without the use of new policy tools."

In other words, the policy of ever-lower interest rates and "quantitative easing" (QE)—the pumping of trillions of dollars into financial markets—is failing to boost economic growth.

The analysis pointed to a major change from the pre-2008 period, noting that the overall size and composition of the Fed's balance sheet "may both be influenced by, and by themselves influence, incentives and activity in financial markets."

That is, in the previous period the Fed stood to some extent outside the financial market, intervening to regulate it and calm disturbances, whereas in the current circumstances it is an active participant in the market itself.

The upshot of the meeting was that the Fed decided to keep interest rates on hold. The general interpretation of the minutes in financial markets following their release on Wednesday was that the "dovish" stance would continue for some time.

But the minutes reveal that the announcement to keep rates on hold followed what the *Financial Times* described as a "hard-fought debate" over when to move again. At least two participants urged an immediate hike, while others called for a more cautious approach.

The minutes noted that business investment—the key driver of economic growth in the US economy—appeared to have declined further in the second quarter of 2016 "with broad-based weakness in equipment and another steep drop in drilling and mining structures."

"Based on conversations with their contacts, participants discussed a number of factors that may have been contributing to businesses' cautious approach to investment spending, including concern about the likelihood of an extended period of slow growth, both in the United States and abroad; narrowing profit margins; and uncertainty about prospects for government policies," the minutes stated.

The clearest divisions in policy came over the assessment of inflation, with some participants claiming jobs growth would need to slow in order to prevent an increase in inflationary pressures—implying that a rise in the Fed's base rate would be in order. "Other participants" judged that labour utilisation remained below the level required to attain the maximum employment objective—implying there should be no rise.

But the quantitative easing and ultra-cheap monetary policies of the Fed and other major central banks have raised concerns that bond markets are set for a collapse. Globally there are now around $13 trillion worth of government bonds trading at negative yields, meaning bond prices are so high than an investor would make a loss if they held them to maturity.

Writing in the *Financial Times* on Wednesday, leading global bond market trader Bill Gross likened present measures to “dirty oil” that can eventually destroy a car’s engine. In the case of central banking it was “the motor of the real economy that is at risk.”

Gross questioned whether the global store of about $13 trillion worth of negative-yielding bonds was good for the real economy. Recent data suggested it was not. “Productivity growth, perhaps the best indicator of an economy’s vitality, is abysmal in most developed countries. It has been declining in the past half-decade or so, not coincidentally tracking the advent of QE and zero lower bound interest rates,” he wrote.

Gross noted that in the US the year-on-year trend for productivity had turned negative. While most central bankers dismissed this as an aberration, Japan, where the economy was all but stagnant, indicated what could result.

In other major economies, investment, an important source of productivity growth, has never returned to the norms seen before the financial crisis of 2008.

“Corporations are using an increasing amount of cash flow to buy back shares as opposed to investing for growth,” Gross wrote. “In the US, more than $500 billion is spent annually to boost investors’ incomes rather than future profits. Money is diverted from the real economy to financial asset holders.”

Another danger of near-zero yields and interest rates was that insurance companies and pension funds, whose business models are based on long-term liabilities, “are increasingly at risk because they have assumed higher future returns and will be left holding the short straw if yields and rates fail to return to more normal levels.”

Earlier this year, Gross said the bond market was a “supernova” waiting to explode. This warning was underscored in a note issued this week to investors by Paul Singer, head of the $28 billion hedge fund Elliott Management. He said the global bond market was “broken.”

The world was experiencing “the biggest bond bubble in history” and investors should not move into sub-zero yielding debt, Singer said. Such moves are only made if the investor believes that the high price at which they are buying will rise even higher, so they can make a capital gain.

Singer told investors that holding such instruments posed the danger of “serious injury or death to your capital.” He added: “[T]he ultimate breakdown (or series of breakdowns) from this environment is likely to be surprising, intense, and large.”

Such warnings from the very mouth of finance capital point to the enormous dangers confronting the working class the world over, where the actions of the major central banks have created the conditions for a financial catastrophe going far beyond that of 2008.

As the past eight years have demonstrated, the loss of trillions of dollars in financial markets—the ratings agency Fitch estimates that losses would total $3.8 trillion if conditions returned to where they were in 2011—will bring devastation to billions of working people.