In the wake of December’s market turbulence

US Fed does about-turn on interest rates

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Not unexpectedly, the US Federal Reserve has bowed to market demands that it pull back from its previously stated policy of raising interest rates this year, following significant falls on Wall Street during December.

The most significant change in the statement from the Fed’s open market committee meeting yesterday was the dropping of language, retained since it began gradually raising rates in 2015, that further rises would be “appropriate.” Just six weeks ago, the Fed raised rates by 0.25 percentage points and indicated it planned two further rises in 2019. This has now gone by the board.

“The case for raising rates has weakened somewhat,” Fed chairman Jerome Powell told a news conference.

The financial markets duly celebrated. The Dow rose by 435 points, or 1.8 percent, and the S&P 500 was up to by 1.6 percent, bringing the increase in both share indexes to around 7 percent for the month, after the worst December since 1931.

One portfolio manager at a major investment fund told the *Wall Street Journal*: “Anyone who wanted them to be more accommodative today is very happy with this statement. There’s everything for the doves today.”

Powell indicated that the Fed had not changed its assessment for the future direction of the US economy. The Fed expected inflation would remain around its 2 percent goal and the economy would grow at a “solid pace” during 2019, though less than last year’s “very strong pace.”

“Despite this positive outlook, over the past months we have seen some cross-currents and conflicting signals about the outlook,” Powell said. “Growth has slowed in some major foreign economies, particularly China and Europe.”

At the same time, Powell said, financial conditions tightened somewhat in late 2018—a reference to the stock market turbulence—and remained “less supportive of growth than they were earlier in 2018.” He noted that while most incoming domestic data had been “solid, some surveys of business and consumer sentiment have moved lower, giving reason for caution.”

This led to the removal of the phrase in previous statements that the Fed judged further rises to be “appropriate” and its replacement by the message that the Fed would be “patient” as it determined future adjustments.

Powell said the policy change was not driven by a “major shift” in the Fed’s baseline assessment for the US economy. However, “cross-currents … suggest the risk of a less-favourable outlook.”

The Fed statement also contained a significant adjustment in its program for running down its holding of financial assets. These were accumulated under the “quantitative easing” policy, when the central bank was a major purchaser of bonds. This kept interest rates at record lows and pumped money into financial markets—the key factor in the escalation of share prices after they hit their low point in March 2009. Following the financial crisis, Fed holdings of bonds and other financial assets rose from under $1 trillion to around $4.5 trillion.

Last year, Powell attracted considerable financial market criticism when he said the Fed’s policy of reducing its holdings by $50 billion per month was on “auto pilot.”

In yesterday’s statement, the Fed said it was “prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments.”

Powell said the "normalization of the size of the portfolio will be completed sooner, and with a larger balance sheet, than in previous estimates" and it would be carried out to avoid "unnecessary market disruption."

While Powell gave no indication of what the final level could be, the decision means the Fed's holdings will not be reduced to anywhere near pre-crisis levels. Current estimates are that they could remain above $3 trillion.

"The process of balance sheet normalization is unprecedented," Powell said, and throughout the process "we've been willing to make changes as we learn more about the process."

One of the key issues confronting the central bank is that with interest rates still at historic lows and unlikely to be increased by significant amounts, there is limited capacity for reducing them in order to provide a stimulus to the economy in the event of a significant downturn or recession.

Powell reassured the financial markets that "we will not hesitate to make changes in light of economic and financial developments."

While the federal funds rate remained the central policy tool, "we recognize that the economy could again present conditions" where this was not sufficient and the Fed "would be prepared to use its full range of tools, including balance sheet policy."

In other words, the Fed would return to asset purchases in order to again pump ultra-cheap money into the financial system.

Notwithstanding the continuing upbeat assessment of the US economy, the worsening outlook for China and the European economy could impact upon it. China has reported its lowest growth since 1990 and the upturn in the European economy in 2017 has come to an end.

Initial estimates put growth in France at 1.5 percent in 2018, a significant decline from the growth of 2.3 percent in 2017.

The German government has cut its forecast for growth for 2019 to 1 percent from 1.8 percent, citing growing geopolitical and trade risks. A survey of forecasters has estimated that the eurozone economy will grow by 1.5 percent this year, its slowest expansion since 2014.

The head of macroeconomic research at AXA Investment Managers, Laurent Clavel, told the *Wall Street Journal*: "The slightest shock would send France into recession."

The European slowdown has raised concerns at the European Central Bank. Like its US counterpart, the ECB had ended its bond-buying stimulus program. But ECB president Mario Draghi told the European Parliament on Monday he was prepared to use all available tools, including bond purchases, if the slowdown became more severe.

Taken together, the extreme hostility of financial markets to even small and gradual interest rises, concerns over the reduction of the Fed's balance sheet, for which there is no historical precedent, and the slowdown in Europe and China, point to the fact that more than a decade after the financial crisis, any "normalization" of the global economy is further away than ever.