After mid-September financial market turbulence

US Fed announces return to asset purchases

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The US Federal Reserve will shortly resume purchases of short-term Treasury bonds in order to try to quell the turbulence that impacted a significant area of financial markets last month and threatened to cause longer-term problems.

The move, which was foreshadowed in a speech by Fed chairman Jerome Powell on Tuesday, has been taken in response to a marked spike in interest rates in the overnight "repo" markets. The market is one where banks and investors obtain overnight cash from the short-term money market to close off their books for the day in exchange for Treasuries and other high-quality collateral.

Normally the market operates with little disturbance, but on September 16 and 17 the "repo" rate jumped to as high as 10 percent. This prompted an intervention from the New York Federal Reserve, responsible for controlling this market, making purchases of up to $100 billion worth of Treasury debt in order to restore stability.

The measures brought the overnight rate down to the more normal level of around 1.8 percent, but in the absence of any official explanation for the spike, there were fears that the problem could emerge again without any long-term intervention.

Announcing the decision at a speech in Denver, Powell said the new measures were not a return to quantitative easing—the purchase of long-term debt by the Fed following the financial crisis of 2008—because they were aimed at facilitating short-term financial operations, not at providing a financial stimulus.

"I want to emphasise that growth of our balance sheet for reserve management purposes should in no way be confused with the large-scale asset purchase programs that we deployed after the financial crisis," he told the annual meeting of the National Association of Business Economists.

But the two issues are related. After the Fed began to reduce its balance sheet following the end of its quantitative easing program in an attempt to return to a more "normal" monetary policy, the cash reserves held by major banks started to fall as well. It was anticipated that there would still be sufficient reserves within the system to ensure the smooth functioning of the "repo" market.

Powell provided no explanation as to why that had not happened and appeared somewhat mystified about what took place last month. "It can be that reserves are just kind of less … flexible than we had anticipated," he said in response to questions at the Denver meeting.

He said without sufficient reserves in the banking system even normal demands for cash, such as when companies need money to pay taxes, could cause "outsized movements in money market interest rates."

The Fed is anxious to discount any suggestion that the turbulence was a product of the central bank's supervisory requirements. In comments to the *Financial Times* earlier this week, the president of the Boston Federal Reserve Eric Rosengren said the largest US banks were holding larger cash reserves to satisfy "tastes or preferences" for liquidity and that some banks "may just be less willing to be anywhere close to the edge." But he gave no explanation as to why that might be the case.

There is no evidence, as yet, of direct market manipulation. But US president Trump, and the most rapacious sections of finance capital for which he speaks, have demanded even more significant cuts in Fed interest rates and have been critical of any attempts to "normalize" monetary policy by reducing the size of its asset holdings.

In his speech, Powell sought to convey the impression that the Fed had not been completely blindsided by the September interest rate spike. He noted that in its March statement on balance sheet normalisation, the Fed had indicated that "at some point we will begin increasing our securities holdings to maintain an appropriate level of reserves. That time is now upon us."

The new measures will be unveiled after the meeting of the Fed's open market committee at the end of the month. Powell also indicated in his speech that there could be a further cut in interest rates following the reductions of 0.25 percentage points at each at its two most recent meetings.

He said the Fed would "act as appropriate to support continued growth," after citing heightened global risks to the US economy, including weakening growth, "uncertainties around trade, Brexit and other issues."

There is no official immediate explanation for the "repo" turbulence. But the underlying causes are no doubt rooted in the transformation in the global financial system resulting from the so-called "unconventional monetary policies" implemented by the world's major central banks that have sent interest rates plunging to record lows.

With central banks around the world holding a fifth of total government debt, any attempt to unwind the enormous financial stimulus of the past decade is bound to have major repercussions.

At the beginning of this week, the Bank for International Settlements, sometimes referred to as the central bankers' bank, issued a report saying the growth in the balance sheets of central banks through the purchases of government debt contained dangers for the functioning of global financial markets.

The BIS explained that while these measures had contained the 2008 financial crisis, there were negative side effects. It warned that the scarcity of bonds available for purchase by other market participants could result in "market malfunction when large central bank balance sheets are eventually unwound."

The BIS said the full consequences would only become apparent when major central banks started to reduce their balance sheets. However, as the *Financial Times* noted, fears about "the side effects of the past decade of unprecedentedly loose monetary policy were highlighted last month by the sharp rise in borrowing costs in overnight money markets."

The "repo" turmoil is only one expression of the contradictions now besetting the global financial system. It is recognised that the continuation of financial stimulus *ad infinitum* creates enormous dangers, while on the other hand attempts to wind it back sets off financial market turbulence.

In scathing comment in the *Financial Times*, well-known financial analyst and commentator David Rosenberg said the Fed was now on course to pushing the Fed funds rates to zero or even below, with chairman Powell set to describe this as just a "mid-cycle adjustment to policy."

"This is not some little adjustment. This is an economy that never fully recovered from the financial crisis, for if it had, real gross domestic product would be substantially higher than it is today," Rosenberg wrote.

"Central banks and governments can try to paper over this reality by generating asset reflation, but that is really no way to run an economy. In the end, this has only exacerbated already-extreme inequalities in wealth."

He said the Fed decision to "call time" on its interest rate increases at 2.5 percent, an unprecedentedly low level, reflected "the vulnerability of … a debt burdened economy—especially in the business sector."

The increase in debt was also highlighted in a speech delivered this week by the incoming managing director of the International Monetary Fund, Kristalina Georgieva. Previewing the semi-annual meeting of the IMF and World Bank next week, she said the "global economy was in a "synchronised slowdown" and there would be downward revision" in the IMF's growth forecast both for this year and next.

She said prolonged low interest rates came with "negative effects and unintended consequences." New analysis by the IMF showed that if a major downturn occurred, corporate debt at risk of default would rise to $19 trillion, or nearly 40 percent of total debt in eight major economies, above levels seen during the financial crisis.