

As credit markets start to freeze

US Fed slashes rates to zero and returns to “quantitative easing”

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The US Federal Reserve has effectively cut its base interest rate to zero and announced the resumption of large-scale financial asset purchases, known as quantitative easing, to the tune of \$700 billion.

The emergency measures taken yesterday evening are an attempt to prevent another plunge on Wall Street when markets open today and a total freeze of credit markets.

The Fed said it would lower its interest rate to between zero and 0.25 percent and increase its holdings of US Treasury securities “by at least \$500 billion” and its holdings of mortgage-backed securities by “at least \$200 billion.”

In an indication of the global dimensions of the financial crisis, it lowered the cost of dollars available to five other central banks via international swap lines.

The latest action came in response to the failure of market interventions of around \$1.5 trillion conducted by the New York Federal Reserve at the end of last week in the overnight repo market, in a bid to halt a growing liquidity crisis.

At a telephone press conference following the decision, Fed chair Jerome Powell said the central bank had tried to restore stability by operating through dealers in the overnight repo market. While there was some stabilisation, it was not sufficient and the Fed decided to “go direct” with outright asset purchases.

This was because there was “very high illiquidity” in the markets for US Treasuries and mortgage-backed securities, closely aligned with Treasuries, which was adversely affecting all credit markets.

Asked about the reference in the Fed statement to asset purchases taking place “over coming months,” Powell said it was not going to be bound by a weekly or monthly limit, but was going to “go in strong” from today.

The decision was hailed by US President Donald Trump, who has been continually pressing for the Fed to lower interest rates and resume quantitative easing.

In a graphic expression of his malign indifference to the fate of millions of Americans—an attitude shared by the financial elites he represents—Trump told reporters: “I think it’s a tremendous thing that took place just now. I would think there

are a lot of people on Wall Street that are very happy. And I can tell you that I’m very happy.”

Whether the Fed decision is able to prevent what was rapidly developing into a total freeze of credit markets on the scale of 2008 remains to be seen. But the initial signs have been that it may not.

Stock markets in the Asia-Pacific were sharply down when trading opened today with the Australian market, which had experienced a revival on Friday, dropping by 7 percent at the opening.

The US futures market showed the Dow opening with a fall of more than 1,240 points.

As in 2008, one of the features of the present crisis is the speed with which it has developed, only matched by the speed of the coronavirus spread.

When the CEOs of America’s leading banks held a White House meeting on the pandemic with Trump on Wednesday last week, they issued reassurances they were sound and there was no financial crisis.

In less than 24 hours, as the markets experienced their worst fall since the October 1987 crash, those assertions were blown out of the water. Major cracks appeared in the complex mechanisms that underlie the US and global financial system.

Up until last Thursday, events in the US Treasury bond market had followed a predictable course in response to the share market sell-off. The yield on Treasury bonds fell and their price rose as investors sought a safe haven. But in the midst of the market plunge, the yield on Treasury bonds suddenly rose as they were sold off and the price of gold, regarded as another safe haven, also dropped.

These unforeseen moves indicated that the market sell-off had extended to all asset classes, in what has been described as a “dash for cash.” In the mortgage-backed securities market there were no buyers—an unmistakable sign of a liquidity crisis.

“Liquidity in [the] mortgage-backed securities market, which is usually the most liquid market in the world after Treasuries, is on a par with, if not worse, than what we saw during the financial crisis,” one bank credit strategist told the *Financial Times* (FT). “The market is telling the Fed: if you don’t

intervene, we are getting away from being a functional market.”

In a review of what it called a “crazy week in the markets,” the *Wall Street Journal* said last Thursday’s meltdown was “the first major test of Wall Street’s mettle since the global financial crisis.” The *Journal* noted that “the extent of the disarray is a sign that the post-crisis infrastructure is more susceptible to sudden shocks than many had assumed.”

Bloomberg reported: “The evaporation of liquidity was evident across virtually all asset classes, but its absence was most stark in securities which normally serve as safe havens and see their prices increase during a turmoil. That caused strange, unsettling moves as traders watched long-established cross-market relationships disintegrate.”

One dealer commented he had never before seen an inability to trade a US Treasury “and I’m pretty sure I’m not the only one who experienced this.” Another said that “basically everything was sold” and “you are seeing a large shift investor sentiment preference away from anything besides cash.”

“This is a liquidity squeeze I haven’t seen since the Lehman crisis, not even during the European debt crisis,” Shinji Kunibe the general manager at a major Japanese investment firm said.

In the decade since the global financial crisis, the official mantra has been that lessons have been learned and measures put in place to prevent another financial meltdown.

But these mechanisms have been blown apart in the space of just a few days, because the endless supply of ultra-cheap money from the world’s central banks to boost the stock market speculation that led to the 2008 meltdown has been further extended in the years since.

The rush to cash is going beyond market traders. The *Wall Street Journal* reported that the world’s major aircraft company, Boeing, was “laying plans to draw down its entire \$13.8 billion line of credit,” with the market taking it as a “sign of desperation.”

The scramble for cash is taking place throughout the airline industry, battered by the travel bans imposed by the US and many other countries.

British Airways has outlined plans to ground planes and lay off staff. Norwegian Air has said a government cut in aviation taxes is “not enough” and plans to lay off as many as half its employees.

Germany’s Lufthansa is trying to raise money by selling planes and is reducing flight schedules by up to 70 percent from pre-coronavirus schedules, as its bookings plunge by 50 percent.

In Europe, the crisis is exposing the weakness of the banking system covered over to some extent by the provision of cheap money. The *Financial Times* reported over the weekend that with companies having spent a decade “gorging” themselves on cheap debt, “a wave of defaults” was now likely that would “hit banks’ already anaemic earnings.”

Since their peak less than a month ago, European bank share

indexes have dropped by 40 percent in what the newspaper called an “indiscriminate sell off of financial stocks.”

The FT reported there was a “rush of companies” drawing on their credit lines in the oil, airline, hospitality and healthcare industries as companies sought liquidity to survive a “potentially prolonged period of global quarantine.”

The European financial system was thrown into turmoil last week following a meeting of the European Central Bank (ECB) when President Christine Lagarde said it was not the central bank’s task to “close the spread” in sovereign debt markets—a reference to the gap between Italian and German yields, regarded as the key risk indicator for Italian debt.

Her remarks prompted the biggest fall in Italian government bonds for a decade, forcing a statement from Lagarde that the ECB remained committed to prevent any “fragmentation” and a reported apology to members of the bank’s governing council for her comment.

But in another sign of the growing divisions among the member nations of the eurozone, a group of mainly retired German officials published a statement in the *Frankfurter Allgemeine Zeitung* supporting Lagarde’s initial remarks and asserting that it was “not for the eurosystem to reduce interest rate differentials.”

While the Fed and other central banks continue to pour trillions of dollars into the financial markets to try to counter the effects of the pandemic, they are caught in a major contradiction.

The pace of the economic downturn and the ensuing financial crisis is determined by the spread of the virus infection.

But the very economic and financial measures promoted by the central banks over the past three decades—based on the siphoning of wealth to the upper echelons of society and the gutting of vital social services—have left health systems in every country ill-equipped and unable to deal with the crisis they now confront.



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