Fed to keep interest rates near zero indefinitely

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The US Federal Reserve Board has indicated interest rates will remain at virtually zero at least to the end of 2022 and that it will continue to pump money into the financial system.

In response to a question at his press conference about whether the Fed would change its policy outlook if there was a surprise upturn in the US economy, Fed chairman Jerome Powell said: “We’re not thinking about raising rates. We’re not even thinking about thinking about raising rates.” In other words, the commitment is virtually indefinite.

Reporting on the Fed announcements, the US business channel CNBC ran a banner “Zero interest rates forever?”

Giving its first forecast on the direction of the US economy since last December – no forecast was provided at its last meeting on the basis that it was too early to assess the effects of the pandemic – the Fed indicated it would take years before unemployment came down to levels in the pre-COVID-19 period.

It forecast the US economy would contract by 6.5 percent this year and unemployment would be 9.3 percent. In his opening statement to his press conference, Powell said the decline in GDP in the second quarter was “likely to be the most severe on record.”

Powell said there was a group of people who would not be able to go back to work quickly and “that could be many millions of people.”

The Fed’s policy statement said it was “committed to using its full range of tools to support the US economy in this challenging time” and it would keep interest rates close to zero until it was “confident the economy has weathered recent events.”

Powell made clear throughout his remarks that the flow of central bank funds into financial markets would continue.

The Fed said it would increase its holdings of government debt “at least at the current pace to sustain smooth market functioning.” It is currently buying around $20 billion worth of US Treasuries every week, an average of $4 billion per day.

The Fed continually insists that its financial market interventions are not directed to bolstering the stock market and are directed to ensuring the smooth flow of credit to households and businesses in the broader economy.

But as is widely recognized in financial circles, the rise of the stock market since its plunge in mid-March is entirely due to the massive intervention of the Fed to the extent that it is now the backstop for all areas of the financial system, from government bonds to student and credit card debt.

At his press conference Powell rejected assertions the Fed had artificially boosted financial markets and this could lead to problems in the future.

He said what he called “financial stress” – all financial markets in effect froze in mid-March – risked exacerbating “the negative effects of what was clearly going to be a major economic shock” and the Fed had to intervene to ensure that markets continued to function.

He claimed the Fed was “not looking to achieve any particular level of asset prices.” However, this assertion is belied by the historical record.

Throughout 2018, the Fed carried out four interest rate rises, each of 0.25 percentage points, and indicated it would wind down its holdings of financial assets at the rate of $50 billion a month.

This very limited attempt to return monetary policy to previous norms produced a massive reaction on Wall Street which experienced its biggest December fall in

2018 since 1931. It produced an instant response in early January 2019 when Powell delivered a speech in which he made clear that further interest rate rises were off the agenda and the reduction of the Fed's balance sheet would not continue.

This was followed by interest rate cuts later in the year and massive interventions into the overnight repo market following a sharp spike in interest rates in mid-September.

Throughout his press conference Powell offered assurances to the financial markets that the Fed was ready to respond rapidly to any signs of turbulence saying it would continue to use its powers "proactively and forcefully."

Financial markets are pressing for what is known as "forward guidance" – that is even more specific commitments by the Fed as to what action it will take to support them.

This includes what measures the central bank will take in response to the issuing of trillions of dollars of new government debt to finance corporate bailouts under the CARES Act.

The issuing of more government bonds, increasing their supply, in and of itself, tends to lower their price. If prices fall their yield rises (the two have an inverse relationship), thereby putting upward pressure on interest rates throughout the economy, countering the zero interest rate regime.

Consequently, the Fed is considering a policy of yield targeting, that is, purchasing bonds so that their price does not fall and interest rates do not rise.

This policy has already been implemented in Japan where the government issues new debt which is then bought by the Bank of Japan. It is also been initiated by the Reserve Bank of Australia which announced yield targeting as part of new measures it set out in March in response to the freezing of financial markets.

The *Wall Street Journal* reported earlier this month that Fed officials "were closely studying the Australian experience." It said the policy of yield caps could "limit any unwelcome jump in Treasury yields" in response to "a coming surge of government-debt issuance.

At his press conference Powell said the Fed was continuing to discuss "explicit forms" of forward guidance on interest rates and asset purchases while the imposition of caps on Treasury bonds yields remained an "open question" that would be the subject of discussion at further meetings.