Fed chair Powell says backstop to markets to remain for a “very long time”

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The Federal Reserve made no major changes to its monetary policy following its two-day meeting yesterday but warned that hiring and consumer spending had slowed in the recent period as a result of the increase in COVID-19 infections.

At his press conference, Fed chairman Jerome Powell said the path of the economy was going to depend to a high extent on the course of the virus and the measures taken to keep it in check. But even with a re-opening of the economy millions of workers employed in industries that depend on large gatherings or close proximity indoors could be out of work for a long time.

In his prepared remarks Powell said there had been some pick-up in the economy, with household spending recovering about half its previous decline. However, business investment had yet to show an increase and “the contraction in real GDP in the second quarter will likely be the largest on record.”

As the meeting began, the Fed announced that emergency measures it put in place in March, when the key market for US Treasury bonds froze, would be extended for another three months to the end of the year.

The move was not a surprise but it underscored the way in which so-called emergency measures to backstop financial markets become permanent. The extension avoided what one analyst described as a “credit cliff.”

Powell said the Fed would continue to use its emergency measures until it was confident “we are solidly on the road to recovery,” adding that “when the time comes, after the crisis has passed, we will put these emergency tools back in the toolbox.”

However, the record shows that time never comes as the financial system becomes ever-more dependent on the outflow of trillions of dollars from the Fed.

The massive pile of financial assets it had accumulated as a result of the crisis of 2008 was never wound back. It rose by around $3 trillion over the past four months, playing the central role in fuelling speculation on Wall Street that has seen stock prices increase towards the record levels reached before the pandemic struck.

Asked at his press conference about when the Fed might consider raising interest rates, Powell repeated an earlier statement that it was not even thinking about thinking about raising rates. The present policies would be in place for a “very long time.”

The March intervention, which has seen the Fed emerge as the backstop for all areas of the financial system, came as the result of a crisis that threatened to go beyond the meltdown of 2008. Details of its extent have emerged in the financial press over the past week.

The crisis had its source in speculation by hedge funds in the market for US Treasury bonds. Their price began to fall amid a “dash for cash” as the economic impact of the COVID-19 pandemic hit.

As the *Financial Times* noted in its account of the crisis: “It is hard to overstate the importance of the roughly $20 trillion market for US government debt, or the alarm that its mounting dysfunction in March caused. The Treasury market is the biggest, deepest and most essential bond market on the planet, a bedrock of the global financial system, and the benchmark off which almost every security in the world is priced.”

Investors were unable to offload Treasury bonds and “broker screens were going intermittently blank and showing no pricing information for what is considered the world’s risk-free rate.”

Rumours of the collapse of hedge funds, heavily involved in the speculation, “spread like wildfire” and there were concerns that “the Treasury might face the previously unimaginable scenario of a failed auction of US government debt."

The hedge fund speculation was based on highly leveraged trades that assumed bond prices would continue to rise. When they fell these trades began recording big losses and banks demanded increased collateral, forcing further sales and exacerbating the crisis.

Essentially the intervention by the Fed on March 23, when it pledged unlimited asset purchases, including of corporate debt, was a bailout of the hedge funds lest their collapse bring down the entire financial system.

As the crisis spread around the world, the Fed organised dollar swap lines with other major central banks, a measure which it extended at this week's meeting at least until the first quarter of next year. Powell said there was nothing going on right now that raised concerns but "we want them to be there as a backstop for markets."

While its historically unprecedented measures have stabilised financial markets, at least for now, the underlying crisis remains. The growing fear is that the continuous creation of dollars out of thin air with the press of a computer button is leading to a crisis of confidence in the US dollar and its role as the world's major currency.

This is reflected in two interconnected developments—the fall in the value of the US dollar against other major currencies and the rise in the gold price to record heights as it is increasingly viewed as the only stable store of value.

This week Goldman Sachs strategists published a note warning that the dollar was in danger of losing its status as the world's reserve currency.

Goldman has raised its 12-month forecast for the price of gold to $2,300 per ounce from $2,000, compared to the current near record high of around $1,950.

Warning that the massive injection of money was triggering "debasement fears," the Goldman analysts wrote: "Gold is the currency of last resort, particularly in an environment like the current one where governments are debasing their fiat currencies and pushing interest rates to all-timer lows."

This raised "real concerns around the longevity of the US dollar as a reserve currency."

However, these issues were not raised by any of the reporters from the major media outlets present during Powell's press conference, although they are fully aware of them.

It is impossible to predict how and when such a "debasement" might take place. But the fact this prospect has been raised, and the price of gold is soaring, demonstrates that the Fed's interventions into financial markets have not provided stability, but only created the conditions for the eruption of new crises.