US financial system awash with Fed money

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The extent of the wave of money surging through the US financial system flowing from the ongoing massive financial asset purchases by the Fed, running at an annual rate of more than $1.4 trillion, was underscored last week.

Last Thursday, it was revealed that a facility that allows money market funds to place their surplus cash with the Fed came in at $485.3 billion—an all-time record that eclipsed the previous high of $474.6 billion recorded on New Year's Eve in 2015.

The parking of nearly half a trillion dollars with the Fed at zero interest was the result of a fall in yields on short-term Treasury bonds to below zero. The yield on short-term Treasury debt had moved into negative territory because the price of the assets has been pushed so high an investor would make a loss if they held them to maturity.

Treasury bills with a maturity of less than one month were reported to be trading at yields of between minus 0.01 and 0.02 points, making the Fed's reverse repurchase program (RRP) paying zero the better option.

John Canavan, an analyst at Oxford Economics, told the *Financial Times* (FT): "The surge in demand for the Fed's RRP operations has been incredible. It is also not over yet."

Gennadiy Goldberg, a senior analyst at TD Securities in New York said the RRP facility was "the only safety valve" for the pressure building up in money markets and was "just holding back the flood of cash coming."

The central role of the Fed in the operations of the money markets was highlighted by Priya Misra, the global head of rates strategy at TD Securities.

"The Fed's role in markets is only growing," she told the FT. "Clearly the market is not functioning on its own."

A major component in the massive build-up of dollars in the money markets is the Fed's asset purchasing program of $120 billion a month, comprising $80 billion of government debt and $40 billion of mortgage-backed securities, that was implemented after the market meltdown in March 2020 at the start of the COVID-19 pandemic.

There is now growing pressure on the Fed to begin winding back its asset purchases in order to try to restore some degree of "normalcy" to financial markets. The rise in inflation is adding to this pressure but at this stage the Fed is insisting that its extraordinary interventions will continue until it begins to see "substantial improvement" in the economic outlook.

Critics of this stand maintain this improvement is already visible as evidenced by the rise in inflation and a tightening in the labour market. They warn that if the Fed continues with its present policies it will be forced to slam on the monetary brakes, prompting a crisis in the financial markets and possibly triggering a recession.

While there have been calls from some Fed officials for the initiating of a discussion on winding down asset purchases—so-called "tapering"—the majority view is still that inflation effects are "transitory" and the labour market has not fully recovered with employment numbers still 8.2 million below where they were before the pandemic struck.

The fear is that, such is the dependence of financial markets on the supply of cheap money, tapering will set off significant turbulence.

Commenting on the money wave, Subadra Rajappa, a strategist at the French financial firm Société Générale, said: "I don't think tapering is going to solve this. Tapering is only going to add to the confusion. If they taper asset purchases, it's going to roil global markets."

That fear is fuelled by experience. In 2013 there was major turbulence in global markets when the then Fed chair Ben Bernanke suggested that the central bank may start to “taper” the purchases of financial assets initiated after the global crisis of 2008.

More recently, at the end of 2018, the stock market experienced a major downturn—the worst December since the depths of the Depression in 1931—in response to indications from Fed chair Jerome Powell there would be further rises in the Fed’s base interest rate in 2019, following four rises in 2018, and the winding down of asset holdings would continue at the rate of $50 billion a month.

In response to the market downturn, Powell quickly reversed course. The asset wind-down was halted and the Fed began cutting rates from mid-2019, six months before COVID made its appearance.

The extent of the Fed’s intervention since March last year is highlighted by the fact that its balance sheet has doubled in size since the start of 2020 and now stands at $8 trillion. And according to estimates published by the Federal Reserve Bank of New York last week its holdings of financial assets will rise to $9 trillion by 2023, an amount equivalent to 39 percent of gross domestic product.

Comments reported in the FT from analysts and bank reports on the current situation focused on the dilemmas confronting the Fed and other central banks.

According to Matt King, a global markets strategist at Citigroup: “The paradox is that the more successful central banks are in driving up valuations of risky assets using stimulus, the harder it becomes for them to exit.”

He noted that it was “much more likely” that a rise in interest rates could prove destabilising as there was more debt outstanding.

According to some estimates, the effect of a 1 percent rise in bond rates is equivalent in effect to a 3 percent rise in previous times.

A study by Barclays Bank said the restoration of economic activity in the wake of the pandemic raised questions about the degree to which central bank support would be withdrawn and noted that “the risk of disorder seems meaningful in the US, where policy responses have been especially forceful” and “the prospect of a messy unwind could emerge for the Federal Reserve.”

If inflation started to rise after “transitory” effects had passed it would “likely involve painful trade-offs between prolonged unemployment and longer-term inflation.” In other words, bringing inflation under control would mean imposing a significant recession.

The ongoing turbulence in the money markets and the development of highly abnormal conditions are the expression of two significant developments.

First, the “free-market” mechanisms which operated in what were once considered “normal” times have completely broken down and the entire financial system is dependent on the capitalist state in the form of the central bank.

Second, that having intervened to rescue the system in response to the meltdown last year the world’s most important central bank, the Fed, is now caught in the ever-sharpening contradictions this intervention has produced.