Fed maintains money flow to Wall Street

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The US Federal Reserve has kept its base interest rate at near zero and maintained its asset purchases at the rate of $120 billion a month. That decision, announced yesterday after a two-day meeting of its policy-making committee, was expected.

But in response to concerns by some members of the Fed's governing body that the present sharp rise in inflation may prove to be permanent rather than a "transitory" effect of economic recovery from the pandemic, the official statement from the meeting hinted that "tapering" of its bond purchases may be closer than previously thought.

Last December, the Fed said its asset purchases would continue until "substantial further progress" had been made toward its goals—full employment and 2 percent inflation.

"Since then," the statement said, "the economy has made progress towards these goals, and the committee will continue to assess progress in coming meetings."

This was widely interpreted as a signal that it was at least moving to a closer consideration of a wind-back in asset purchases.

But Fed chair Jerome Powell, who has been characterised as occupying a centre position between the so-called doves and hawks within the governing body, made clear there were no immediate plans to withdraw the unprecedented levels of support the central bank has provided to financial markets and Wall Street.

With US employment levels still some 7 or 8 million below where they were before the pandemic, he said further gains in employment would be needed before any tapering of asset purchases.

"We have some ground to cover on the labour market side," he said at his press conference following the meeting. He repeated his assertion that inflation was "transitory" while insisting the Fed would use its "tools" to counter any permanent rise.

In his prepared remarks he said conditions in the labour market had continued to improve and demand for labour was "very strong" but "nonetheless, the labour market has a ways to go."

The focus on the state of the labour market as the reason for the maintenance of flow of money is essentially a cover for the real objective which is to ensure that the monetary props for Wall Street remain in place—a fact that is well known in financial circles.

As Thomas Hayes, chairman of Great Hill Capital, an investment management firm, commented to the *Wall Street Journal* on Powell's remarks: "I don't think he could have been more dovish. There's nothing that the Fed could do that would be more accommodative to the stock market."

Despite the Fed's claim that the US economy is on the road to recovery there are significant contradictory signals. While inflation is rising, along with economic growth, the yields on Treasury bonds have been falling—an indication that financial markets consider growth could stall, if not develop into a recession.

Asked about the divergence between the economic growth outlook and the bond market at his press conference, Powell could offer no explanation apart from saying that it may be due to "technical" factors "where you put things you can't quite explain."

The fall in bond yields, a result of increased demand and rise in their price (the two move in opposite directions), has been significant.

At the end of March when there was an expectation of increased growth and inflation, the yield on the 10-year Treasury bond was at a 13-month high of 1.75 percent. By the middle of June it had fallen to 1.57 percent—a significant movement in this market—before dropping further to 1.26 percent on Wednesday. This could well be on the back of financial market expectations that what lies ahead is stagflation—higher prices combined with lower growth.

In an interview on CNN *Financial Times* columnist and editorial board member Rana Foroohar said in her 30 years in finance journalism she had never seen so many variables—from the effect of the Delta variant, inflation, to lower growth in China—impacting on the global economic outlook.

Apart from the continuing stimulus for Wall Street, another significant decision by the Fed was to establish a new facility to provide liquidity to big Wall Street banks as well as foreign central banks in times of financial turbulence.

Under the facility, the Fed would enter overnight repurchase (repo) agreements in which it would take in Treasury debt and mortgage-backed securities in return for cash at a rate of 0.25 percent. There would be a daily cap on the facility of $500 billion. A similar facility would be extended to foreign central banks with a daily limit of $60 billion. The facility may also be expanded in the future to include deposit-taking banks.

The new facility has been developed in response to the financial market crisis of March 2020 when the $21 trillion US Treasury market—the bedrock of US and global financial system—effectively froze in what was dubbed a "dash for cash" as buyers for Treasury debt disappeared.

The measure has been under discussion for some time as the Fed continues to try to assess what took place in the March crisis. New York Fed chief John Williams said earlier this month that a standing repo facility would not be used much in normal times but if there was an "unanticipated shock" it would keep short-term interest rates from spiking.

Its establishment indicates that another crisis on the scale of March 2020 could take place because none of the underlying problems and contradictions that gave rise to it have been resolved.

The decision of the Fed is in line with recommendations in a report from a group of 30 former central bankers and financial policymakers issued yesterday. The group, which includes former US Treasury secretaries Timothy Geithner and Larry Summers and former Bank of England governor Mervyn King, said reforms were needed to ensure that the most essential bond market was able to function smoothly in times of financial stress.

It said a "standing repo" repo facility was the "single most important near-term measure" that should be adopted.

But it pointed to deeper concerns. "This is a market that has outgrown its infrastructure and its regulatory framework, Oversight is fragmented and diffused. The capacity of existing market makers has not grown with the size of the Treasury market itself," the group said.

According to Geithner, in remarks reported by the *Financial Times*, the pressure for reform could be "undermined by the belief that the Fed can always step in and fix things" and this was "not a particularly wise approach."

The report underscores the findings of a report by the G20 Financial Stability Board last November. It said that while the intervention by the Fed in March 2020, when it pumped out trillions of dollars, may have stabilised the situation, the "financial system remains vulnerable to another liquidity strain, as the underlying structures and mechanisms that gave rise to the turmoil remain in place."