Major swings on Wall Street as monetary policy tightens

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The move by the US Federal Reserve and other central banks to tighten monetary policies and clamp down on workers' wage demands in the face of rampant inflation is producing wild swings on Wall Street and raising major problems in financial markets in the US and around the world.

On Wednesday, following the Fed decision to lift its base interest rate by 0.5 percentage points (50 basis points) and the remark by chair Jerome Powell that the central bank was not "actively considering" a hike of 75 basis points, Wall Street surged.

But the so-called rally lasted less than a day. On Thursday the market reversed all those gains and more, undertaking the biggest U-turn since the start of the pandemic in early 2020.

The Dow fell by more than 1000 points, 3.1 percent, to record its biggest decline this year after posting its biggest rise since 2020 the day before. The S&P 500 dropped 3.6 percent. The biggest fall was in the tech-heavy NASDAQ, the most sensitive to interest rate increases.

It dropped by 5 percent to record its largest one-day percentage loss since June 2020 taking its total loss from its record high in November last year to 24 percent.

Thursday's selloff, which continued yesterday with smaller but significant losses, was a resumption of the trend since the start of the year which has seen more than $8 trillion wiped off the market value of stocks.

There was also another sell-off in the bond market which sent the yield on the 10-year Treasury note to more than 3 percent, its highest level since November 2018, with the rise continuing yesterday. (When bonds are sold off and their price falls the interest rate or yield rises.)

Besides lifting the interest rate by 50 basis points, with Powell stating there was a "sense" on the policy-making body that "additional 50 basis rises should be on the table at the next couple of meetings, the Fed also decided to start reducing its $9 trillion holdings of financial assets. They comprise Treasury bonds and mortgage-backed securities.

The Fed will start cutting its holdings of these assets by $47.5 billion for each of three months, starting in June, and then by $90 billion a month in September.

While the media coverage focused on the rate increases, the view of some analysts and commentators is that the balance sheet reduction is more significant. It has not been undertaken before, save for a brief period in 2018 when it was rapidly reversed after a violent response on Wall Street at the end of that year.

The Fed's assets, which stood at under $1 trillion in 2008, have increased nine-fold as a result of the quantitative easing begun after the global financial crisis and the further injection of around $4 trillion into the financial system following the crisis of March 2020 at the start of the pandemic.

No one in the financial world, in the Fed and certainly not Powell has any real idea of what the consequences could be.

Asked at his press conference on Wednesday about the effect that balance sheet reduction might have for monetary policy, Powell replied: "In terms of the effect… I would just stress how uncertain the effect is of shrinking the balance sheet. You know, we run these models and everyone does in this field and make estimates… And you know, these are very uncertain. I cannot really be any clearer.… We don't really know."

This is a telling admission, puncturing the myth that the Fed, with its vast array of information and computer-based analysis, is, if not entirely in control, has at least some idea of where it is going. But after unleashing one of the most far-reaching monetary policy changes in history—the pouring of trillions of dollars into Wall Street to prevent a collapse of the financial system—it has no idea of what any reversal might produce.

However, others have issued a warning. This week the

Economist noted that the Fed is now the largest single holder of US government debt with $5.8 trillion of Treasury bonds on its books, a quarter of the $23 trillion total. It also holds $2.7 trillion worth of mortgage-backed securities.

According to the article, the reversal of this “portfolio behemoth” through quantitative tightening “could spark a repeat of the temporary yet troubling breakdowns the world’s most important financial market has suffered in recent years—on a bigger scale.”

It was possible that “QT [quantative tightening] will cause the Treasury to malfunction” and that its “smooth running matters well beyond America” because Treasury rates “are a crucial benchmark for pricing virtually all other financial assets globally.”

Recent history, it said, was not encouraging, recalling the crisis in the repo market, where Treasuries can be swapped for cash in short-term trades, in September 2019, and the COVID shock of March 2020 when the Treasury market ceased to function for several days. No buyers could be found for US debt, supposedly the safest financial asset in the world.

These crises were “temporary” but only because the Fed massively intervened becoming the backstop for the Treasury market and virtually all other areas of the financial system. The crisis was averted but, as various reports have made clear, the underlying issues that led to it have not been resolved.

The *Economist* noted the conditions for a new crisis are developing because there is a “thinning” of liquidity in the Treasury market. This refers to a situation in which trades can have an outsized effect on the market as a whole as opposed to a situation of ample liquidity in which their effect is small.

Pointing to this situation, the article said there was “the growing possibility of renewed dysfunction” that would make it “likelier that the market seizes up.”

Were that to take place the Fed would have to intervene with massive support, as it has in the past, but this time under conditions not of low inflation but in a situation where inflation is racing out of control.

The turn to higher interest rates is starting to impact on all areas of the financial system and the broader economy in the US and globally. Even before the latest Fed decision, interest rates were increasing across a range of US markets, from home mortgages to car loans.

The *Financial Times* has reported that the value of high-risk junk bonds in the US trading at 70 cents on the dollar—a level taken as a sign of distress—has risen to $27 billion compared to about $14 billion at the end of last year.

In Europe, even though the European Central Bank (ECB) has not increased its interest rate, borrowing costs are starting to rise, and investors are demanding higher interest rates when lending to more indebted euro zone countries.

This raises the prospect of a divergence between European countries of the north and the south which led to the crisis that threatened the continuation of the euro in 2012. That was only averted when the ECB president Mario Draghi said the central bank would do “whatever it takes.” But inflation, coupled with the turbulence resulting from the war in Ukraine, has vastly changed the situation from a decade ago.

In all the major economies the central aim of the higher-interest-rate regime is to batter down the wages struggles of the working class in the face of inflation.

Nowhere is this class-war agenda more clearly illustrated than in the UK. Announcing a further interest rate increase of 25 basis points on Thursday, the Bank of England said there would be a “very sharp slowdown” in the UK economy leading to a recession as inflation rose to 10 percent.

Unemployment would rise from 3.8 percent to 5.5 percent in the next three years and this would help moderate wage claims.

Three members of the Monetary Policy Committee who wanted a 50-basis point rise said they did so to prevent “recent trends in pay growth” from becoming more widely and deeply embedded. Under conditions where wages overall have not kept pace with price hikes, the interest rate increases are a pre-emptive strike to crush an emerging movement of the working class.