Mounting uncertainty over effects of central banks’ tightening policies

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There is a growing sense in financial markets, reflected in media commentary, that for all their attempts to project an air of certainty under so-called “forward guidance,” central banks are confronting an economic and financial situation that is rapidly running out of their control.

In the wake of the global financial crisis of 2008 and again amid the market meltdown at the start of the COVID-19 pandemic in March 2020, central banks, led by the US Fed, pumped trillions of dollars into the global financial system to prevent a total crash.

Now they are hiking rates and tightening monetary policy in the face of the highest inflation in 40 years to try and suppress wage demands. But they are doing so under conditions never experienced in the past, where they have become the central prop for the financial system.

As a result of its asset purchases, especially over the past two years, during which it has outlaid a further $4.6 trillion, the Fed holds a quarter of all outstanding Treasury bonds and a third of all mortgage-backed securities.

The European Central Bank (ECB) and the Bank of England (BoE) own just under 40 percent of their own governments’ bonds and the Bank of Japan holds nearly half of all government debt.

The move to tighten monetary policy through interest rate increases and the reduction of these holdings is producing gyrations in financial markets because no one has any real idea of where it will lead.

Wall Street, which has just experienced its worst opening half-year for 50 years, moves up one day in the belief that the interest rates already carried out so far are producing a recession and the Fed will be forced to pull back, only to fall the next when inflation numbers and other economic data indicate monetary tightening will continue.

Commodity markets are also experiencing major swings. After escalating earlier in the year, because of the US-led NATO proxy war against Russia in the Ukraine, many commodity prices have fallen back sharply on recession fears. But as the Financial Times noted “even the commodities that have been on a downward path could rocket again tomorrow.”

Currency markets are also in turmoil—an expression of the so-called smile effect which describes a situation in which the US dollar tends to rise when the American economy is growing, as well as at other end of the scale when recession fears see massive amounts of money seeking a so-called “safe haven” in US assets.

The US dollar index, which tracks the US currency against a basket of six others, is now at a 20-year high as the euro has dropped to near parity with the dollar—a level not seen for almost 20 years—while the Japanese yen is at a 24-year low against the US currency.

While Fed officials, following the lead of chairman Jerome Powell, appear to be on course for another interest rate increase of 75 basis points at the end of this month, warnings are being sounded about the effects of monetary tightening.

On Monday, a voting member of the Fed’s policy making body, Kansas City Federal Reserve chair Esther George, who voted in favour of a rise of only 50 basis points at the June meeting, said during a speech that “moving rates too fast raises the prospect of oversteering.”

She said the present rise—the 75-basis point increase was the first since 1994—was a “historically rapid pace” for businesses and households to adapt to and “more abrupt changes in interest rates could create strains, either in the economy or financial markets.”

In a plea for greater certainty, she said
communicating the path for interest rises was “far more consequential” than the speed with which they took place. But certainty is a commodity in very short supply. George said she found it “remarkable” that just four months after rates started to rise “there is growing discussion of recession risk, and some forecasts are predicting interest rate cuts as soon as next year.”

Interest rate hikes and their effects are not the only issue leading to turbulence and extreme uncertainty in financial markets. A potentially even bigger issue is the impact of the decision by the Fed to reduce the size of its financial asset holdings which started this month.

The BoE and the ECB have also decided to stop reinvesting the maturing assets on their books and, according to estimates by Morgan Stanley, the combined balance sheets of the major banks will contract around $4 trillion by the end of 2023.

No one knows what the outcome will be because such measures have never been undertaken on this scale and the trillions of dollars injected into the final system now form the foundation of the financial system.

As investment manager Guilhem Savry of the Swiss firm financial Unigestion told the FT: “Liquidity is driven by central banks. Over the past 10 years there has been large liquidity in the US and everywhere else, and now investors know it’s finished. It’s over.”

When the first steps were initiated towards “quantitative tightening” (QT) in 2017, the then chair of the Federal Reserve Janet Yellen said it would be uneventful and “like watching paint dry.”

It proved to be anything but. At the end of 2018, after Fed chair Jerome Powell had indicated that the Fed’s reduction of its balance sheet would proceed on “auto pilot” at the rate of $50 billion a month, Wall Street went into its biggest December decline since 1932 during the Great Depression.

Powell did a U-turn. Further interest rate rises were put on hold and the Fed began cutting rates in July 2019 and asset reduction was halted. Beginning in March 2020, when the US market froze at the start of the pandemic, the Fed then bought up more than $4 trillion of financial assets.

The Fed can never say publicly that the aim of the operation was to prop up Wall Street and so the measures were couched in terms of encouraging banks and other lenders to increase their lending to businesses to promote growth. Nothing of the sort took place and the provision of essentially free money was used to finance the orgy of Wall Street speculation that took place in 2020 and 2021.

Now, amid rising inflation combined with the growing risk of recession, the issue is whether this financial house of cards will collapse.

Recalling the events of 2018, one senior bond trader told the FT: “Remember that had a huge impact, and that was just on QT. There was no inflation scare, no growth scare like we have now.”

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