New turn in Fed policy threatening financial stability

Nick Beams
8 September 2022

While the interest rate hikes being initiated by central banks around the world dominate the headlines about financial markets, there is another development which could have major consequences for the increasingly fragile financial system.

This month the US Federal Reserve stepped up its reduction of its $9 trillion balance sheet in a process dubbed quantitative tightening (QT). The Fed has doubled the pace of its bond sales, reducing its holdings of Treasury bonds by $60 billion a month and its holdings of mortgage-backed securities by $35 billion monthly.

The wind back of quantitative easing (QE)—the pumping in by the Fed of more than $8 trillion into the financial system since the global financial crisis of 2008—is raising concerns in some quarters that the asset sales, while small in relation to the Fed's total holdings, could have major effects.

This is because instead of being a buyer of government and mortgage debt, the Fed will be a seller, and this could have major liquidity effects if there is a selloff with the Fed no longer acting as a backstop.

While it has been largely confined to the rear-vision mirror, the crisis of March 2020, when financial markets froze at the start of the pandemic and the Fed intervened by backing all areas of the financial system, is illustrative of what can happen if there is a sudden shock.

Wall Street Journal columnist James Mackintosh pointed to some of the issues raised by the onset of QT in a recent article entitled "The other doomsday scenario looming over markets."

He cited comments by Alex Lennard, investment director at the London-based money management firm Ruffer LLP, who warned of the possible effects of QT. "It puts a pincer on equities and bonds at the same time," he said. And it could be "the sort of event you tell the grandchildren about."

Back in June, an analysis produced by the giant investment management firm, Bridgewater, pointed to what it called an expanding "liquidity hole" which it said could envelop most financial assets.

"The Fed has shifted from massive quantitative easing in response to the COVID shock to tightening at a pace twice as large as that of past episodes. The Fed's actions are most directly creating this liquidity hole in the bond market," it said. And the hole threatened to expand because at the same time as the Fed is moving to sell bonds, banks are also turning from buyers to sellers.

It noted that over the past decade financial assets had disconnected from the economy due to the "massive money printing" and the fiscal stimulus in response to the COVID. Buoyed by these measures, corporations at the same time cut back on labour costs, "allowing profit margins to explode. We have so far only reversed a small part of this out performance."

The Fed first tried to wind back its asset holdings in 2017. The then Fed chair Janet Yellen said it would not cause problems and would be "like watching paint dry." At first that appeared to be the case but by the end of 2018 the stock market plunged in response to interest rate rises and remarks by the newly appointed Fed chair Jerome Powell that the reduction of the central bank's balance sheet at a rate of $50 billion a month was on "auto pilot."

Powell rapidly reversed course, and initiated interest rate cuts in mid-2019. But liquidity problems erupted in September when the overnight lending market, crucial to the operation of the financial system, seized up and the Fed had to intervene.

© World Socialist Web Site

In a podcast last month, *Financial Times* (FT) journalist Katie Martin said that portfolio managers at investment firms had no idea of the effect of QT.

"We don't know if this is gonna be a complete train wreck. We don't know if this is going to be absolutely fine. We don't know if it will be somewhere in between. We don't know if markets freak out, central banks will… change their minds and give us… a bit more slack," they told her.

"They have absolutely no idea how this is going to play out," she said.

Investors she spoke to were watching out for "some kind of accident in the Treasuries market" in conditions where "macroeconomic forces are pulling the market all over the place. Just don't be surprised if this does belly up at some point."

Adding to the uncertainty and the possibility of a major crisis is the fact that the shift to higher interest rates and the move to QT are being conducted under a rapid transformation in the economic conditions which prevailed over the past several decades—a transformation that has been accelerated by the COVID pandemic and the US-led NATO war against Russia in Ukraine.

The significance of war, as governments around the world lift military spending, was highlighted in a recent note to clients by Credit Suisse analyst Zoltan Poszar, cited by the FT, who said whether it was a hot war or an economic war, it meant inflation.

This was the exact opposite of the economic paradigm experienced over the past decades, he said.

"China got very rich making cheap stuff… Russia got very rich selling cheap gas to Europe and Germany got very rich selling expensive stuff produced with cheap gas," noting that $2 trillion of German value-added production was reliant on $20 billion worth of gas from Russia.

As for the US it "got very rich by doing QE. But the licence for QE came from the 'lowflation' regime enabled by cheap exports coming from Russia and China."

All these conditions are now changing very rapidly. This is being reflected in financial markets with the interest rates on US government debt rising as bonds are sold off. Significantly the yield curve has inverted with the interest rate on two-year bonds, around 3.5 percent consistently above that on the 10-year, around 3.3 percent. Under "normal" conditions the reverse is the case. Yield curve inversion is considered to be a predictor of recession.

The surge in the US dollar as a result of the Fed's interest hikes, which are expected to continue when its policy-making body meets later this month, possibly by another 75 basis points, is disrupting currency markets. The euro has fallen to below parity with the US dollar, the pound has never been weaker, apart from a brief period in the 1980s, falling from 1.4 to the US dollar in mid-2021 to 1.15, and the Japanese yen is at a 24-year low.

At the same time, the governments of Sweden and Finland have stepped in to the tune of tens of billions of dollars to provide credit for traders in the gas market lest they suffer a liquidity crisis which transmits to the banking system.

No one can forecast exactly what will take place, but all the indications are that the conditions are developing for another financial crisis, following those of 2008 and March 2020.

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site