US Fed at the centre of financial crisis

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As investors, speculators, hedge funds, and other sections of finance capital try to gauge where the Federal Reserve will next move on interest rates, a study released last month provided some significant data on how the US central bank has created the conditions for a financial crisis.

The report by Better Markets, an organisation devoted to trying to ensure better management of the financial system, focused on what it called "systemic instability."

It began by noting that while most of the media reports centre on how long and how fast the Fed will raise interest rates, the "focus also needs to be on the role of the Fed's prior actions in how we got here and in creating the serious risks we are now facing."

The basic effect of the Fed's monetary policies over the past 14 years, through which trillions of dollars have been pumped into the financial system, "decoupled asset prices from risk and ignited an historic borrowing and debt binge." Now the Fed is, in many ways, "fighting problems of its own creation."

The implication is that there could have been a different outcome if only different policies had been followed. But an examination of the two major crises of the past 14 years—the global financial crisis of 2008 and the market freeze of March 2020 at the start of the pandemic—reveals that a complete meltdown of the global financial system was only prevented by the Fed's massive monetary interventions.

Those interventions have only created the conditions for another, even deeper crisis. As the report put it, this is because "the US and the world are facing an unprecedented array of multiple, simultaneous, and consequential economic, financial, and geopolitical shocks that are causing stress in financial markets while straining consumers and businesses in the real economy." In this environment, the "margin for error is vanishingly small."

The crisis did not start with the pandemic, or the Russian invasion of Ukraine but was rooted in the Fed's response to the 2008 crash.

When the pandemic triggered a crisis at the beginning of 2020, the Fed doubled down on the quantitative easing policies that had already created a mountain of debt and fictitious capital after 2008.

Comparing the pre-pandemic period to the pre-2008 crash, it said the growth in US debt held by the public was nearly 500 percent larger, the growth in nonfinancial corporate loans and debt securities was around 90 percent larger and the growth in consumer debt, excluding mortgages, was around 30 percent larger.

Overall, after the crash there was a "culture of debt" due to the Fed's zero interest rate policy and its large-scale asset purchases. This meant that "the increase in debt during the 10-year period prior to the pandemic was significantly larger that during the 10-year period prior to the 2008 crash."

This debt binge was accelerated after March 2020. The immense pace and scale of the Fed's action in March 2020 is illustrated by the fact that the Fed "purchased $2.1 trillion of Treasuries [US government Treasury bonds] and MBS [mortgage-backed securities] in just the first 90 days after the pandemic stress, an amount that took nearly four years for the Fed to purchase after the 2008 crash."

In the two years after the onset of the pandemic, the Fed purchased $4.6 trillion worth of securities, some $800 million more than it did in the 8.5 years after 2008.

The effect of the low-interest rate regime and asset purchases meant that the yield on safe government debt was reduced to zero. Consequently, investors had to place their money in riskier assets to secure the same rate of return.

This process was compounded by the actions of the

Fed in removing massive amounts of safe assets from the markets and placing them on its books, leaving investors with cash but fewer safe assets in which to invest. They had "no choice but turn to riskier assets and 'reach' for yield much further out on the risk spectrum than they have before." This was particularly the case for investors holding short-term assets.

They did so in the belief, based on experience, that "the Fed would just bail everything out." This guarantee was expanded in scale and scope when the Fed intervened in the corporate bond market in March 2020.

This intervention had a broad effect despite the relatively small amount of money the Fed actually laid out in this area. The mere announcement that the Fed was effectively the backstop for the corporate bond market had a second-order effect far beyond the impact of direct purchases.

As a result, "companies with low credit ratings and poor financial performance—and often ever poorer prospects—were able to sell debt that they otherwise would not be able to or to sell more debt than they would otherwise be able to."

The Fed not only created incentives for unbridled risk taking, it also "effectively rewarded and, indeed, bailed out the most extreme pre-pandemic risk taking however irresponsible or even just poorly run. This included so-called zombie companies with revenues lower than the interest on their then-current debt. The Fed literally kept those zombies and created many more."

The turn by the Fed to higher interest rates—a policy implemented above all with the aim of suppressing the struggle of the working class for pay rises in response to rampant inflation—has major consequences for the financial system.

The Better Markets report warned that, at the same time as risk on debt securities and loans was being repriced, companies were facing lower demand for their products and the "possible effects could be dramatic."

Banks are by no means excluded. It has been said many times by Fed and other officials that banks were a "source of strength" during the March 2020 crisis. But that conclusion was "incomplete and misleading at best" because it was only two weeks before the Fed stepped in with trillions of dollars and effectively guaranteed all markets. In other words, had this not taken place the vaunted "strength" of the banks could have been sorely tested.

The report concluded with the observation that as the Fed tightens monetary policy "we move closer and closer to the potentially devastating realisation of some of the risks created or amplified by Fed policies over the past 14 years."

It pointed out that "although the Fed monitors and seeks to address risks to financial stability and the banking system, it simply failed to see—or didn't look or consider—itself as a potential source of those risks."

This is something of a misreading of the situation. No doubt the Fed did not care to look too closely into the future as it bailed out the financial system. However, it was aware, at least to some extent, of the risks contained in its action and made attempts in 2013 and 2018 to try to "normalise" monetary policy.

But on both occasions, it faced a violent reaction from the markets—the so-called "taper tantrum" of 2013 and the major market sell-off of December 2018—which forced it to back off.

The role of the Fed demonstrates not so much lack of oversight and awareness but is rather the expression of a more fundamental issue as underlined in the New Year perspective of the *World Socialist Web Site*. It explained that the dynamic of the capitalist crisis had passed beyond the capacity of governments and their agencies to contain it and their policies "are of an increasingly reckless and irrational character."