Fed faces a dilemma as it meets to set interest rates

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12 June 2023

The interest rate setting committee of the Federal Reserve, which begins a two-day meeting today, faces conflicting trends in the US economy and financial system as it decides whether to continue lifting rates or announce a pause in the cycle which has seen rates increase by 5 percentage points in little more than a year.

On the one hand, the Fed is under pressure to continue the rises as the core of its so-called "fight against inflation," the central aim of which is to suppress the wage demands of the working class, inducing a recession if necessary.

On the other, there is a fear that a continuation of the rate increases will cause more problems in the financial sector following three of the four largest banking failures in US history in March amid warnings that the commercial property market could be the next shoe to drop.

Raghuram Rajan, former governor of the Reserve Bank of India, now a professor at the University of Chicago and one of the few to warn prior to 2008 that the Fed's ultra-easy monetary policies could cause a crisis, told the *Wall Street Journal* (WSJ) that the Fed was between "a rock and a hard place."

"It's a very, very tough situation. You're damned if you raise rates significantly more and put even more pressure on the banks, but you're damned if you don't," he said.

Despite some easing of price rises, the Fed is concerned that, so far, its interest rate increases have not sufficiently pushed back the working class as Fed chair Jerome Powell and other officials continue to refer to a "tight" or "very tight" labour market.

At present, the betting in financial markets is that the Fed will try to thread the needle, announcing a "pause" in rate increases at this meeting while indicating that further rises may take place and ruling out any cuts this year even as the US economy continues to slow.

That at least seems to be the sentiment on Wall Street with the S&P 500 index reaching its highest point in more than a year yesterday. The rise has been largely driven by tech stocks boosted by the belief that artificial intelligence will provide a profit boom. Other areas of the financial system present a different picture.

While the run on medium-sized banks has stopped because of emergency action by the Fed and other regulatory authorities, the underlying problems have not been resolved and they could be hit on two fronts.

They continue to face losses on securities they purchased when interest rates were low but the value of which has now fallen with the interest rate hikes over the year. This was the issue which pushed Silicon Valley Bank into bankruptcy, but it extends more broadly. The Federal Insurance Deposit Corporation has put the unrealised losses for banks at $515 billion. Other estimates put it as high as $2 trillion.

Even if the Fed pauses its rate rises, the general trend in financial markets is for interest rates to rise as banks tighten lending conditions for loans in response to the failures, a so-called "credit crunch."

Another factor is the expected increase in borrowing by the Treasury following the lifting of the debt ceiling. It has been estimated that the government will need to borrow more than $1 trillion in short-term Treasury bills by the end of the year.

The issue is who will buy them. The Fed is no longer a buyer, having ended its quantitative easing program and seeking to reduce its holdings of government debt (quantitative tightening) and, having already incurred losses on their holdings, at least on paper, banks will be reluctant to make new purchases.

This means there will be an upward trend in market

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interest rates, which could lead to financial turbulence of which there are warnings.

As Gennadiy Goldberg, a strategist at TD Securities told the *Financial Times* (FT): “Everyone knows the flood is coming. Yields [interest rates] will move higher because of this flood. Treasury bills will cheapen further. And that will put pressure on banks.”

Tortsen Slok, chief economist at Apollo Global Management, told the FT: “We’re running a significant budget deficit. We still have quantitative tightening. If we have a flood of T-bills as well, we likely have turbulence in the Treasury market in the months ahead of us.”

An article in the WSJ last week noted that the flood of more than $1 trillion of Treasury bills had the potential to spark “a new bout of volatility in financial markets.”

Another area of concern is the US commercial property market which is regularly being described as the “next shoe to drop.”

Interest rate rises depress the value of commercial loans under conditions where the demand for office space is falling because of the increase in working from home as a result of the COVID-19 pandemic.

Last month, Charlie Munger, vice chair of Warren Buffett’s Berkshire Hathaway fund, issued a warning about real estate, saying a lot of it was “not so good any more.”

“We have a lot of troubled office buildings, a lot of troubled shopping centres, a lot of troubled other properties. There’s a lot of agony out there.”

Some banks are selling off property loans at a discount even when repayments are up to date in an effort to reduce their exposure to the real estate market.

The FT reported that HSBC USA was in the process of “selling off hundreds of millions of dollars of commercial real estate loans, potentially at a discount” and troubled PacWest bank last month sold off $2.6 billion worth of construction loans at a loss.

In an interview last month, reported in the WSJ, Minneapolis Fed president Neel Kashkari said if inflation fell quickly—a prospect which does not appear likely—then the Fed might be in a position to cut rates. “But if, on the other hand, inflation is more persistent and much more entrenched … then I think the stresses in the banking sector probably become more serious.”

Former Fed official Richard Quarles told the WSJ the Fed’s present policy was already “tight” and over the summer there would be a revaluation of assets as people realised interest rates were going higher than they had thought.

That would cause more stress for banks, insurance companies and other financial institutions “that have been hanging onto the cliff with their fingernails, thinking that interest rates are going to start coming down.”

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