# Wall Street hits record high on the back of Fed decision

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Wall Street celebrated the latest indication from the members of the Federal Reserve Board's governing body that they still expect there to be three interest rate cuts this year, amounting to 0.75 percentage points in total.

The Fed decided to make no change in interest rates at its meeting yesterday, but projections in the so-called "dot plot," in which members point to where they think rates will go, indicated the federal funds rate would be 4.6 percent by the end of the year, down from the present level of between 5.25 and 5.5 percent.

The markets rubbed their hands at the prospect of cheaper money sending all three major indexes—S&P 500, the Dow, and the tech-heavy NASDAQ—to record highs for the first time since November 2021.

In his press conference following the meeting, Fed Chair Jerome Powell said the US economy was "performing well." But he noted in his prepared remarks that activity in the housing sector was "subdued," because of higher mortgage rates, and higher rates "also appear to have weighed on business fixed investment."

With projections for core inflation this year at 2.6 percent, slightly higher than previously thought, Powell said the road to the Fed's 2 percent target could be "bumpy" and that is why it was "approaching this carefully."

Asked about the question of wages in relation to the inflation target, Powell said it was not about wages, but then made it clear it was.

The inflation was not originally caused by wages, he said, "that's not really the story." But he maintained that to get inflation back down to 2 percent "sustainably" wages had to come down "to levels that are more sustainable over time."

In other words, efforts by workers to overcome the major cuts in their living standards resulting from inflation, the impact of which is far higher than indicated by official data, must be suppressed. Though he did not say it, but is very much aware of it, the key role in this suppression is played by the trade union bureaucracy.

There was another issue, little reported but of considerable importance for the operation of the financial system in the Fed's deliberations. As a result of its quantitative easing program, involving the buying up of Treasury bonds and mortgage-backed securities, the Fed had at one stage more than $8 trillion on its balance sheet, compared to less than $1 trillion before the financial crisis of 2008.

Powell said the Fed had reduced its holdings by nearly $1.5 trillion since beginning its interest rate increases in March 2022. But it has now begun to discuss "slowing the pace of decline in our securities holdings."

In response to questions at his press conference, Powell indicated it was related to possible turbulence in the financial system such as took place in 2019 when the Fed had a program of asset reduction in place.

The withdrawal of the Fed through the reduction of its asset holdings can lead to a reduction of liquidity in the financial system. This took place in the September 2019 when interest rates in the very short-term repo, or repurchase, market, normally a fraction of a percentage point, shot up to nearly 10 percent at one point. Liquidity was also a major issue in the freeze in the Treasury market in March 2020.

On both occasions, the Fed had to intervene to the tune of trillions of dollars to stabilise the US and global financial system.

In his remarks Powell said the slowdown in asset reduction would begin "fairly soon" and, when asked to elaborate on that time frame, he pointed to some of the underlying issues.

While refusing to be more specific on the timing, he said the Fed wanted to avoid "the kind of frictions that can happen in the system. And there can be times when the aggregate reserves are ample or even abundant, but not in every part. And [in] those parts where they're not ample there can be stress."

Something like that, he indicated, had happened in 2019.

Answering a related question, about whether the Fed's plans for balance sheet reduction might be affected by problems in the banking sector—a reference to the crisis which erupted with the failure of three significant banks a year ago—Powell spoke of the need to avoid "turbulence."

"This is our second time in doing this and I think we're going to be paying a lot of attention to the things that started to happen and that foreshadowed what eventually happened at the end of that tightening cycle where we wound up in a short reserves situation, and we don't want to do that again."

These comments were instructive because they showed that notwithstanding the happy scenario of a "smooth landing," there are major unresolved problems in the financial system that could erupt to the surface, possibly from unexpected sources.

The other major development in global finance this week was the decision by the Bank of Japan (BoJ) to end its negative interest rate regime, initiated in 2016, by lifting its overnight interest rate to 0.1 percent in the first rise since 2007.

Announcing the move, which had been expected for some time, BoJ governor Kazo Ueda said: "The large-scale monetary easing policy served its purpose."

While yield-curve control, in which the BoJ intervenes in the market to keep rates in bonds within a targeted range, has been ended, along with purchases of exchange traded funds and Japanese real estate funds, central bank intervention is not over.

The BoJ said it would maintain its purchases of government bonds currently running at around $40 billion per month.

This is under conditions where the outlook for growth remains very low. Japan recorded a growth of just 0.1 percent in the last quarter of 2023 because of weak consumption spending, causing it to slip in US dollar terms from the world's third-largest economy to the fourth.

In its statement on the decision, the BoJ said there were "extremely high uncertainties surrounding Japan's economic activity and prices." As the *Financial Times* (FT) commented this translates to "pretty much anything could happen."

"Given the current outlook for economic activity and prices, it anticipates that accommodative financial conditions will be maintained for the time being," the BoJ continued.

In a situation where the population is aging and healthcare costs are rising, the FT noted: "With this as the backdrop, there is almost no prospect of real growth in Japan; the desire to save is high and the desire to invest is low."

The decision to keep intervening in the bond market means that the stock of government debt held by the BoJ will continue to rise. At present government debt is now worth more than 250 percent of gross domestic product, by far the highest for any major economy, of which the BoJ holds 54 percent.

This compares to 12 percent in 2013 before the central bank began its massive bond-buying operation. Since then, there has been a kind of round-robin financial operation in which one arm of the state, the government, issues debt while another arm, the central bank, buys it.

The costs are not small. In 2023, the interest bill, even with low rates, was the equivalent of $168 billion—one of the larger items in the budget—and will increase with the rise in rates.

The decision also has international ramifications. For some time, there has been concern in global financial circles that a rise in Japanese rates could spark a move of capital back into the country, possibly affecting the US Treasury market where Japan is the largest holder of US government debt.

So far, the decision has had little effect with markets barely moving on the announcement, but further rises may do so.

It may also have domestic consequences even though interest rates are very low by global standards.

Bloomberg reported that research revealed there were 565,000 highly indebted companies, known as "zombies," that have effectively been kept on life support by ultra-loose monetary policy, struggling to pay off debt from profits alone. That number could rise by 12 percent to 632,000 as a result of the 0.1 percentage point interest rate rise.