Fed says interest rates to stay higher for longer

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The US Federal Reserve has signalled that its interest rate will remain higher for longer—at present it is around 5.25 percent, the highest for two decades—because it has less confidence that inflation is coming down to its target level of 2 percent.

At his press conference announcing the decision to keep interest rates on hold, Fed chair Jerome Powell said: “We do not expect it will be appropriate to reduce the target range for the federal funds rate until we have greater confidence that inflation is moving sustainably toward 2 percent. So far this year, the data have not given us that greater confidence.

“It is likely that gaining such greater confidence will take longer than previously expected.”

In response to a question, Powell said he expected inflation would resume its decline later this year, but added, “My confidence is lower than it was.”

The latest decision is in marked contrast to “market expectations” at the start of the year which were that there could be as many as six interest rate cuts this year, or at least three. Now there are doubts there will even be one, with some options markets pricing in the possibility of a rate hike.

To reassure financial markets, Powell added it was “unlikely” the next policy move would be a hike.

Asked whether stronger US economic growth and wage increases would affect policy, Powell said the Fed did not “target wages” but then added that it would like to see wage increases move down to more “sustainable levels.”

Another significant decision was to slow down the reduction of the Fed’s balance sheet. This rapidly expanded because of the massive injection of money into financial markets when the Treasury market froze in March 2020 at the start of the pandemic.

As of June 1, the Fed will slow the reduction of its Treasury bond holdings from $60 billion a month to $25 billion—the effect of which is to lower the price of bonds and increase interest rates.

Under conditions where US debt is rising rapidly, there are constant fears that not enough buyers for bonds can be found. Powell pointed to this in his opening remarks, saying slowing the pace of the reduction would ensure a smooth transition and reduce “the possibility that money markets experience stress.”

He was more direct in response to a question on the subject, saying it was to avoid “financial market turmoil” as had been experienced in 2019, the last time the Fed tried to reduce its balance sheet.

The effects of the Fed interest rate decision will not only be felt in the US where it will add pressure on finance houses and corporations that gorged themselves on cheap money from 2008 until 2022. It will also have significant international ramifications.

Its immediate effect will be to raise the value of the dollar against other currencies adding to the prospect of currency market turmoil, particularly as regards the Japanese yen.

On Monday the value of the yen briefly touched 160 to the dollar, its lowest point in 34 years—at one point it was described as “dropping like a stone”—before an intervention by the Bank of Japan (BoJ), estimated at $35 billion, pushed it to 155.

The trigger for Monday’s fall was the decision by the BoJ last Friday not to move its interest rate further into positive territory. It was only in March that it scrapped its negative interest policy and end yield curve control on 10-year government bonds.

Japan has moved to “normalise” policy but wants to do so at a slow pace. However, its plans are being disrupted by the surge in the US dollar which is putting heavy downward pressure on the yen.

A Wall Street Journal (WSJ) editorial earlier this week noted that the yen’s decline had been an “economic dilemma for some time. But now it risks becoming a political and financial problem beyond Japan.”

The falling yen is very much a two-edged sword. It raises the costs of imports and the level of inflation, meaning the BoJ may have to lift interest rates faster than it would like.

It also improves the competitive position of Japanese firms in global markets because it lowers the cost of their exports. But this raises the risk that, under conditions of a weakening...
global economy, countries may introduce tariff barriers against Japanese goods.

These same companies are also hit by the rising cost of their imports and are complaining that the fall in the yen has gone too far.

South Korea is also being affected by the dollar’s rise. Last month US Treasury Secretary Janet Yellen and the finance ministers of Japan and South Korea issued a rare joint statement that expressed the “serious concerns of Japan and the Republic of South Korea about the sharp depreciation of the Japanese yen and the Korean won.”

After a trilateral meeting in Washington, they said they would “consult closely on foreign exchange market developments.”

On Monday, Masato Kanda, a leading Japanese government official, offered an usually frank admission of the extent of the problems.

“It is difficult to ignore the bad effects that these violent and abnormal movements will cause for the nation’s economy,” he said.

One of the fears is that the dollar’s rise and the depreciation of other currencies will exert downward pressure on the Chinese currency, the renminbi, and lead a further cheapening its exports in global markets.

The pressure on the yen could be eased somewhat if the BoJ proceeded more rapidly with interest rate “normalisation” policy, pushing it further into positive territory from its very low rate of just 0.1 percent.

However, as the WSJ editorial pointed out, the reluctance of BoJ governor Kazuo Ueda to do that is driven by “concern about the fragility of Japan’s financial system after a long period of negative rates. You can understand his caution after he witnessed the British gilt fiasco in September 2022 and Silicon Valley Bank’s failure in March 2023, both of which highlighted the risks when interest rates are too low for too long.”

The concern of the US, as indicated by its involvement in the joint statement with South Korea and Japan, is that if the rapid fall in the yen leads to significant increases in Japanese interest rates this could affect the US Treasury market.

Japan is now the leading foreign holder of US debt and an outflow of money back to domestic financial markets, drawn in by rising rates, could cause problems in financing the growing mountain of US public debt, already regard as being at “unsustainable” levels.

Currency markets are not the only area where higher for longer US interest rates threaten significant problems. Another is their effect on the private credit market, outside the banking system and largely outside the purview of financial regulators.

A report issued by the Bank of England’s Prudential Regulatory Authority (PRA) last week said assets under management in the global private equity (PE) sector had risen from $2 trillion to $8 trillion over the past decade.

In March, the BoE’s financial policy committee warned that finance for riskier corporates would be vulnerable to a “significant deterioration in investor risk sentiment.”

In its report on the assessment, the Financial Times said: “Higher interest rates are already hitting private equity firms’ ability to finance new deals for companies and have also increased borrowing costs at some businesses they already own.”

The BoE noted that the lack of transparency around “asset valuations, overall levels of leverage, and the complexity and interconnectedness of the sector make assessing financial stability risks difficult.”

Its report on the PRA assessment was headlined “Lenders flying blind of private equity risk, Bank of England warns.”

In a letter to lenders’ chief risk operators on April 23, Rebecca Jackson, a BoE executive director, called on them to take “measures that ensure they are able to take a consolidated view” of their exposure to credit risk.

She was more direct in a speech, saying that many banks were unable to measure “their combined credit and counterparty risk exposures to the private equity sector.”

This lack of knowledge recalled the collapse of the private equity family company Archegos Capital in March 2021 which cost six banks more than $10 billion and was a factor in the downfall of Credit Suisse last year.

She warned that higher interest rates and a worsening macroeconomic environment, could pose new risks.

“The prospective correlations are everywhere,” she said, “and it’s not difficult to imagine a scenario, such as malpractice at a financial sponsor or the bankruptcy of multiple portfolio companies, where risk correlations increase significantly, and liquidity evaporates, leaving banks open to severe, unexpected losses.”

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