Trump strips Fed of key emergency lending powers

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THE Trump administration is to shut down the emergency lending powers of the US Federal Reserve, taking extraordinary action to block reserve funds for the incoming Biden treasury and prevent a Democrat bailout of state and local governments.

The pre-emptive strike marks a breakdown in the normal cooperation between the US treasury and the Fed, and comes just as the winter wave of Covid-19 reaches a crescendo. The services sector is already spiralling back into contraction, with a cliff-edge approaching for jobless support.

“We are in a perilous moment for the economy,” said Jason Furman, the former head of the White House Council of Economic Advisers. Vaccine euphoria has lifted Wall Street to record highs but evisceration of the Fed’s backstop powers before the pandemic is over threatens to destabilise parts of the credit system.

The Fed may be forced to step up QE in order to compensate for the loss of its credit instruments. Steve Mnuchin, US treasury secretary, has told the Fed that he will not roll over five of its nine Great Depression powers under Article 13 (3) of the Federal Reserve Act. There will be a suspension of its lending facilities for companies, local governments and “Main Street” loans at the end of the year.

He instructed Fed chairman Jerome Powell to return the unused portion of a $454bn (£342bn) account approved by Congress during the market meltdown in March. This seed money gave the Fed $4.5 trillion extra lending power under a policy of 10:1 leverage and had an electrifying effect on market confidence, helping avoid the errors made in 2008.

Krishna Guha from Evercore ISI said the Fed’s market stabilisation policy had been politicised. Congressman Bharat Ramamurti, a member of the House oversight committee on stimulus, called Mr Mnuchin’s move an unjustified and ideological decision by the treasury department.

The Fed retains its monetary policy powers and can purchase further US treasury bonds but that is a blunt tool at this juncture unless it is married to aggressive fiscal expansion, which the Republican Senate has vowed to block.

The Fed is concerned that more QE will chiefly inflate asset prices without doing much to help the real economy, exacerbating social inequality.

Congress stripped the Fed of its discretionary powers under Article 13 after the Lehman crisis. The Fed now needs permission from the treasury to go beyond its normal mandate. This was granted immediately during the panic in late March.

The crucial action then was to mop up the corporate bonds of junk-grade “fallen angels”, preventing a cascade of forced sales and a financial chain reaction.

The lending facilities acted chiefly through psychological and confidence effects. The markets knew that the Fed stood behind the system in extremis. The incoming Biden administration will be able to renew the Fed’s Article 13 powers in late January but that does not imply a return to the status quo ante.

The key lending facilities in question are anchored in seed funding from Congress.

Mr Mnuchin has demanded that this money now be returned to Congress. Since the Republicans have no intention of funding Mr Biden's Keynesian expansion and are likely to retain control of the Senate, there is little chance that the Fed's credit tools will be revived.

Senator Patrick Toomey, the expected chair of the Senate banking committee, said emergency credit facilities were no longer needed now there was ample liquidity. He said it was never the intention of the Senate that Mr Biden should be able to use residual funds to bail out insolvent state and local governments.

Gregory Daco from Oxford Economics said a Biden treasury could still use $70bn of uncommitted funds in the Exchange Stabilisation Fund but this was a popgun by comparison.

The market fallout from this dispute is far from clear.

The Fed may be forced to step up QE in order to compensate for the loss of its credit instruments.

The economy may muddle through if vaccines come soon enough and optimism holds up.

But risks are mounting. The main pandemic support for those unable to work expired at the end of July and many are running down their savings.

A fresh relief bill has been scuppered by gridlock on Capitol Hill.

Roughly 12 million will lose the last of their unemployment support when the guillotine comes down after Christmas, unless Congress acts very soon.

Mr Powell says fiscal stimulus is "absolutely essential" but the chances of it actually happening are receding.

Now, his own credit wings have been clipped. All that remains is raw monetary policy.

A potent economic recovery beckons once life returns to normal in mid-2021. Getting from here to there is going to be a stormy ride.