US Fed caught in global turbulence

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The US Federal Reserve Board's decision on Wednesday to maintain its benchmark interest rate at 2 percent was not so much a policy decision as the expression of the growing paralysis in government and central banking circles in the face of the powerful forces now at work in the US and global economy.

On the one hand, the deepening slump in the US pointed to the need for a further interest rate cut to try to provide an economic boost. On the other hand, rising US and global inflation, as well as a weakening US dollar—itself a factor in inflationary pressures—pointed to an interest rate increase. In the event, the Fed decided to do nothing.

Announcing its decision, the Fed's open market committee tried to put the best face on the worsening US economy. "Recent information," it stated, "indicates that overall economic activity continues to expand, partly reflecting some firming in household spending ... The substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help promote moderate growth over time."

These assertions prompted *BusinessWeek* economics writer Michael Mandel to ask: "Is the Fed living in a fairy-tale world? Unemployment is rising, housing prices and plunging and oil prices are sky-high. Oh, yes, and consumer expectations of their future economic prospects are at a record low, according to the Conference Board."

The latest US economic data point to the worsening state of the economy. Sales of new homes continued to decline in May, dropping to 512,000 at an annual rate, the lowest level since the recession of 1991. Compared with a year ago, sales of new homes are down by 40 percent.

Earlier the Case-Shiller index of housing prices had revealed a decline of 15.3 percent in the year to May, with many market observers predicting that there was at least another 15 percentage point fall to come.

The impact on homeowners of the collapse of the housing bubble is indicated by figures published by the Financial Markets Center based on Federal Reserve data. It found that in the first quarter households' net worth had dropped at an annual rate of 2.9 percent, the second successive quarterly decline and bringing the total decline to $2.23 trillion since reaching the peak achieved in the third quarter of 2007.

The Center noted that between 1952 (the first year for which quarterly data were collected) and 1999 there was only one occasion in which net worth shrank in two consecutive quarters. That was in the recession of 1974. Since 2000, amid ever greater volatility in housing and financial markets, that phenomena has been repeated three times, with losses far exceeding those of 1974.

At the same time, there has been a considerable fall in other forms of wealth. Between January and March, the value of pension savings and mutual fund shares declined at an annual rate of 18.8 and 31.1 percent respectively. The value of equities held by households fell at an annual rate of 40.8 percent.

The Fed's decision was criticised by those who want further action to stimulate the US economy. Other critics, however, want an increase in interest rates in order to bring down inflation.

This was the theme of an editorial in the *Financial Times* on Wednesday. "If there were a Central Bank of the World its monetary policy committee would glance at today's inflation rates and expectations of future inflation and then raise interest rates. There is no such bank, but there is something close: the US Federal Reserve, the monetary policy of which is mirrored by many countries in the Middle East and Asia. The Fed may not want that responsibility, but it would be wise to worry because, like it or not, low Fed rates are contributing to global inflation."

The editorial pointed out that many countries in these regions set their currencies in line with the US dollar. Consequently, when the US lowers interest rates they must follow suit in order to prevent an inflow of speculative capital and a rise in the value of their currencies. However, in conditions where inflation is already running at up to 10 percent, this leads to further upward pressure on prices.

But there is another aspect of this problem to which the editorial also pointed. If Asian countries, above all China, are forced to raise their interest rates as a result of inflationary pressures then they may cut their links to the US dollar, leading to an outflow of money that has been invested in US financial assets. “The results for the US would be unpleasant: a currency crash and even higher domestic inflation.”

Faced with such dilemmas there is a growing air of perplexity in some of the major economic institutions.

According to the World Bank Global Finance 2008 report published earlier this month: “Rarely has the international community been called upon to respond to so many complex policy challenges at once—from immediate actions to address soaring global food and energy prices and the taming of volatility in private global finance to the needs for mitigating the effects of high-income-country slowdown and sustaining economic momentum without jeopardising long-term growth and stability. Tackling such challenges requires collective resolve and clear thinking.” But both those commodities are in short supply.

Far from “collective resolve”, the world’s two major financial authorities are working in opposite directions. While the Fed lowered interest rates in response to the subprime financial crisis, the European Central Bank (ECB) refused to follow suit and may lift its base rate by 0.25 percentage points next week.

Consumer inflation in the euro-zone nations rose at an annual rate of 3.7 percent in May, well above the ECB’s target of 2 percent. The ECB is looking to launch a pre-emptive strike against demands for increased wages.

“In particular, wage growth may be stronger than anticipated, given high rates of capacity utilisation and a tight labour market,” ECB governor Jean-Claude Trichet said. “In this context, the risk of triggering an inflationary wage-price spiral is particularly acute,” he said, especially where wages are indexed to inflation.

In other words, faced with a growing movement of the European working class to maintain living standards against inflation, the ECB will lift interest rates to induce a recession.

Meanwhile, the Fed is hoping that the food and energy price hikes will pass through the economy and “expects inflation to moderate later this year and next year.” But this is more a hope than a soundly based prediction.

All indications are that prices are set to rise further. According to the World Bank, higher food prices are set to stay and oil prices could climb even further—up to $200 or even $250 a barrel according to some forecasts.

Already the rise from $53 per barrel at the start of 2007 to the present price of $136 has increased the annual cost to consumer by around $2,600 billion a year—an amount equivalent to around 4.5 percent of world gross domestic product.

Far from being a one-off hike, there are indications that the oil price rises are flowing through to other areas of the economy. Last Wednesday’s *Financial Times* (FT) warned of a “spectre of inflation over [the] global economy” and noted that major companies dependent on oil inputs were now passing on price increases. Dow Chemical, which announced price increases of 25 percent—the largest in the company’s history—said the rises were aimed at trying to offset a “staggering” increase in costs.

The FT’s economics columnist Martin Wolf noted that the world was being buffeted by two storms: “an inflationary commodity-price storm and a deflationary financial one.”

One of the most significant features of the present situation is how rapidly these processes have taken place. A year ago major reports from global financial bodies such as the World Bank and the IMF pointed to the risks of inflation and the possibility of financial turmoil. But they were still relatively small clouds on the horizon. The situation has now changed dramatically as the world economy faces its most serious crisis in more than three decades.