US: The Federal Reserve’s dilemma

Andre Damon
4 July 2008

Earlier this month, Federal Reserve Board Chairman Ben Bernanke hinted that the US central bank would shift to a tighter monetary policy, leading analysts to expect multiple interest rate hikes this year. In a speech given June 3, Bernanke stressed the need to ensure that record oil prices do not feed into wage inflation, and all but announced a plan to boost the US exchange rate by raising interest rates. Now, a month later, the Fed has proven unable to act on either of these goals, having kept the Target Federal Funds Rate at a steady 2 percent at its Federal Open Market Committee (FOMC) meeting last week.

In our analysis of Bernanke’s speech, we stressed that the shift in policy emphasis represented an attempt to orchestrate a controlled recession, leading to a moderate rise in unemployment and a steady lowering of real wages. This process would in turn boost the profits of US corporations, guaranteeing a certain baseline level of returns to carry through the de-leveraging of financial firms and the write-downs of hundreds of billions of dollars in financial assets. The Fed aimed to oversee a controlled purge of infected assets, financed by a recessionary assault on the working class.

But the best-laid plans often go awry, and in the weeks that passed from Bernanke’s speech to the June 25 policy decision the conditions facing US finance capital have taken a tremendous turn for the worse. From late March through May, there was a certain recovery in the financial markets. Stock prices started to creep back up, banks succeeded in reducing the ratio of borrowings to assets by receiving significant infusions of capital, in many cases from abroad. The recovery reached its peak around mid-May, after which stocks began to slump rapidly. Last month ended with stock indexes registering their worst June since the Great Depression.

The institutions that recapitalized banks suffered significant losses on their investments, and—after some had their fingers burned—other institutions are far less willing to invest in bank stocks. The inability to raise capital—together with the precipitous decline of already existing share values—has left many banks, even very large ones, hurtling towards insolvency. As the Fed’s March 14 and March 16 minutes make clear, the Federal Reserve board firmly believed that the collapse of Bear Stearns would have resulted in an uncontrolled destabilization of the financial system leading to further bank failures. The conditions for such a crisis have fully reemerged in recent weeks, only perhaps in more pervasive and systematic form.

Far from being merely a technical operation, monetary policy is among the main regulators of aggregate relations between the working class and the owners of the productive forces—the bourgeoisie. In the US economic system, wages are set by the labor market—that is, by the interaction of labor supply and labor demand. But monetary policy, by spurring or constricting business activity, increases or reduces the demand for labor. Wage levels—if accompanied by aggressive action by one or the other class—tend to move accordingly.

The theory goes as follows: in the event of an unwanted economic slowdown, the Fed will stimulate demand by lowering interest rates—making credit easier to obtain and thus furthering business and consumer consumption. In case of an upturn in the class struggle, the Fed will raise rates, rein in demand, and suppress the wage struggles of the working class.

The Fed—under the leadership of Paul Volcker—successfully implemented such a policy in the 1980s, when the breaking of the PATCO strike was accompanied by a manufactured recession—the sharpest since the 1930s—opening up a still-ongoing assault on the US working class.

The Federal Reserve is mandated by the US

© World Socialist Web Site

government to pursue a monetary policy that minimizes both inflation and unemployment. Aside from these policies, it acts as the guarantor of depository institutions; a “lender of last resort” with whom banks are required to keep a certain minimum amount of reserves. But with the latest crisis, the Federal Reserve has taken on the task of preserving the “shadow banking system” of hedge funds, loan distributors, and other unregulated entities, significantly complicating its operations. In so doing, it has granted itself quasi-legal authority to lend to investment banks and to take the assets of distressed institutions onto its own balance sheet.

These latest developments have complicated the Fed’s role. Aside from the “discount window,” through which the Fed lends to banks that are otherwise unable to borrow, the US central bank must operate with the blunt instrument of the Federal Funds rate, which impacts not only wages—the intended target—but also financial performance and exchange rates. In setting interest rate policy, the Federal Reserve now confronts problems on both sides. On one hand, rising commodities prices are fueling inflationary expectations and are likely to lead to a wages counteroffensive by the working class; to guard against this the Fed would need to raise interest rates and tighten the labor market. On the other hand, there is a very real threat of more crises like that of Bear Stearns.

Recent discussions in the business press have made clear that the US financial system faces a long-term solvency crisis that, if stock prices continue to fall, could well result in the failure of multiple “systemically important” institutions, prompting their rescue by the Federal Reserve or the broader US government. Such an event—referred to as the omnipresent “tail risk” in Bernanke’s parlance—could entail the government’s appropriation of hundreds of billions of dollars in toxic assets, putting into question the creditworthiness of US Treasury securities. This could, in turn, precipitate a dollar collapse and a catastrophic reordering of the international economic system.

To guard against this possibility, the Fed would seek to lower interest rates, making cheaper financing available to stimulate business activity and consumer spending, resulting in lower default rates on debt and safer conditions for finance. But to the Fed’s chagrin, its two most pressing goals—anti-inflation and the prevention of a financial meltdown—necessitate opposite policy responses. As the credit crisis reared up again this month, the Fed was forced to back down from its emphasis on raising interest rates.

Meanwhile, the European Central Bank faces the same dilemma. In line with previous announcements by ECB President Jean-Claude Trichet, the bank raised its benchmark rate from 4 to 4.25 percent on Thursday, hoping to stave off a wages offensive in response to rising commodity prices. But the dismal performance of financial stocks has made the likelihood of bank failures even more significant and, according to most financial analysts, further rate hikes unlikely.

Thomas Mayer, chief European economist at Deutsche Bank, observed, “The ECB is hiking at a time when confidence is plummeting.” He continued, “The question is, ‘What do you do when asset prices fall at the same time that consumer prices rise?’ The central bankers seem to have reached the end of the line.”

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site