A revealing speech by US Fed chief Yellen

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The US Federal Reserve will continue to pump ultra-cheap money into the financial system and boost the speculative activities of banks and finance houses, despite the risk that this policy is creating financial bubbles that could burst and cause even more damage than the crash of 2008.

That was the essential content of the message delivered in a speech by Fed chairwoman Janet Yellen to an International Monetary Fund (IMF) forum on Wednesday and in a subsequent question and answer session conducted with IMF managing director Christine Lagarde.

While she did not mention either by name, Yellen's speech constituted a reply to two recent criticisms of the Fed. The Bank for International Settlements annual report, issued last Sunday, pointed to the disconnect between booming financial markets and the underlying economy. And former Fed governor Jeremy Stein argued that higher interest rates should be considered to help deflate potential asset bubbles.

Describing monetary policy as a "blunt instrument," Yellen said the "primary role" in preventing financial instability had to be so-called macro prudential regulation and supervision.

She insisted that if the Fed had used interest rates to try to head off the US housing bubble in the mid-2000s—the immediate cause of the 2008 crisis—there would have been serious damage to the US economy. "A very significant tightening, with large increases in unemployment, would have been necessary to halt the housing bubble," she said.

"Macro prudential policies, such as regulatory limits on leverage and short-term funding, as well as stronger underwriting standards, represent far more direct and likely more effective methods to address … vulnerabilities."

Consequently, Yellen saw no need for the Fed to deviate from its primary focus on price stability and maximum employment—the rationale for the present policies of boosting financial markets.

The fundamental flaw in Yellen's attempted assurances that the Fed could contain financial turbulence by regulatory means was quickly apparent in the question and answer session with Lagarde.

"You've beautifully demonstrated the efforts that have been undertaken from a macro prudential point of view in terms of the universe that you have under your jurisdiction," Lagarde told Yellen. "But this universe, being restricted and well supervised at it is, has generated the creation of parallel universes."

The response of the financial markets to regulation had been to create a shadow banking system, "outside the realm of central bankers," Lagarde said. "What can be done about them in order to make sure that there is no creation of significant risk threats out there which are not covered by macro prudential tools?" she asked.

Yellen's reply was highly revealing.

"I think you're pointing to something that is an enormous challenge," she told Lagarde. "And we simply have to expect that when we draw regulatory boundaries and supervise intensely within them, that there is a prospect that activities will move outside those boundaries and we won't be able to detect them."

In other words, the financial system is out of the control of those who are supposed to regulate it.

Responding to Yellen's assertion of the need to look outside the perimeter of supervision "to see where threats are emerging," Lagarde said she was "obsessed" by what was not known from history "and that will be the risk of tomorrow."

The issue, however, is not simple ignorance, important as that is. There is also the wilful ignorance of growing problems, because to deal with them would mean confronting powerful financial interests.

Yellen claimed she and others did not recognise that risks to financial stability had risen to "dangerous levels” in the mid-2000s, and, while there was concern about rising house prices, there was no appreciation of how serious the fallout would be for the financial system and the economy as a whole.

In fact, there were warnings about the danger of rising debt levels, but these were simply shoved aside because hundreds of billions of dollars were still being accumulated on Wall Street. As the saying goes, there were none so blind as those who did not want to see.

Yellen’s discussion with Lagarde also showed how the impossibility of any rational control of the financial system is rooted in the very structure of the capitalist nation-state system.

As IMF managing director, with nominal responsibilities for the global capitalist system, Lagarde pointed to the problems of “spillover” effects flowing from the policies adopted by the Fed.

The continued lowering of interest rates and the policy of quantitative easing has caused major problems for central bankers in countries around the world as they try to control the pressures generated by an inflow of dollars from the US financial system seeking higher rates of return. This has led to property bubbles as well as the appreciation of currencies, creating problems in export markets and industries that compete with imports, such as manufacturing.

In the past year, movements on the downside have also shown their destructive potential. Fears of the consequences of “tapering”—the winding back of the quantitative easing program—and the prospect of even marginal increases in US interest rates have seen significant outflows of volatile finance capital from “emerging markets” around the globe.

Asked whether the Fed was conscious of spillover effects, Yellen said it certainly paid attention to them but, as with other central banks, “the mandates that we’re given by our Congresses or the relevant legislatures tend to focus on domestic goals.”

In other words, while the financial system is globally integrated, each of the central banks, and above all the Fed, carries out policies in the interests of its own national state and the dominant financial interests in that state. Whatever the expressions of concern for global stability, they all operate according to the maxim, each for their own and the devil takes the hindmost.

The issue, which was neither addressed in Yellen’s remarks nor in the question and answer session, was how the situation had been arrived at where the world’s major economic and financial authorities have increasingly lost control of the system they are supposed to regulate.

No accounting was given of past decisions. But they have played a decisive role. The decision by then Fed chairman Alan Greenspan to open the financial spigots following the October 1987 stock market crash, determined the policy response to every financial problem and crisis that followed, leading to the collapse of 2008. Now a new disaster is being prepared.

Yellen’s speech and her conversation with Lagarde bring to mind the acute observation made by Karl Marx in the *Communist Manifesto*.

“Modern bourgeois society with its relations of production, exchange and of property, a society that has conjured up such gigantic means of production and exchange, is like the sorcerer who is no longer able to control the powers of the nether world whom he has called up by his spells.”