Concerns over Fed tightening as deflation fears grow

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In the wake of the decision by the European Central Bank (ECB) to institute quantitative easing through the purchase of government bonds, questions have begun to be raised about whether the US Federal Reserve should continue with its plan to tighten monetary policy from the middle of this year by lifting interest rates. There are even suggestions that it should resume the purchase of financial assets, a program it halted in October.

With the Fed's policy-making Federal Open Market Committee meeting this week, most economists expect no change in the US central bank's previously stated plan to begin gradually raising rates later this year.

At a meeting held during last week's World Economic Forum in Davos, Switzerland, former US Treasury Secretary and Obama administration economic adviser Lawrence Summers warned that a deflationary spiral could ensue if the Fed tightened its monetary policy too soon.

"Deflation and secular stagnation are the threats of our time," Summers told a Bloomberg forum. He went on to say there was no confident basis for tightening and any threat of inflation was a long way off.

Summers warned that the world economy was headed for treacherous waters because the US economy was entering its seventh year of recovery, nearing the end of its life expectancy, after which there could be another, unexpected, recession. "Nobody over the last 50 years, not the IMF, not the US Treasury, has predicted any of the recessions a year ahead," he said.

Responding to Summers' remarks, International Monetary Fund Managing Director Christine Lagarde said she hoped he was wrong because the world economy was "short of any engine at the moment."

Since the eruption of the global financial crisis in September 2008, the US Fed has pumped some $4 trillion into the financial system and kept interest rates at near-zero. Last October, it ended its program of direct asset purchases and indicated that this would be followed by a gradual lifting of official interest rates in attempt to resume a more normal monetary policy.

This agenda seemed to be proceeding in line with an accelerated growth in the American economy, but has now been called into question by the emergence of outright deflation in Europe and the worsening downturn to which the ECB's quantitative easing decision is a response.

Summers' concerns were echoed in remarks by the head of the Bridgewater hedge fund Ray Dalio. He warned that what he called the "central bank supercycle" of ever-lower interest rates and increased debt-creation had reached its limits. Interest rates were already so low that the transmission mechanisms of monetary policy had broken down.

Dalio recalled the situation in the early 1980s in the US when a high dollar value and high interest rates plunged the American economy into a deep recession. However, he said, there was a major difference between then and now that made the present position "ominous."

"Back then we could lower interest rates," he said. If we hadn't done so, it would have been disastrous. We can't lower interest rates now. We're in a new era in which central banks have largely lost their power to ease."

New York Times op-ed columnist and Princeton economics professor Paul Krugman has also voiced disagreement with US monetary policy, writing last week that he was "very worried that the Fed may be gearing up to raise rates too soon" and expressing his agreement with Summers.

Both Summers and Krugman come from what could be considered the liberal pro-Keynesian wing of the US economic policy establishment. But opposition to the present course has also emerged from what might be considered an unlikely source.

In a comment published earlier this month, John Makin of the right-wing, free market American Enterprise Institute also voiced concerns. The Fed's message was that interest rate increases squared well with increased growth and lower unemployment, he wrote, but this was "bizarre" in conditions of falling inflation and the deflationary impulse coming from falling oil and commodity prices and a stronger dollar.

"The Fed has decided simply to assert that US deflation won't materialize, so it will continue on its current path toward mid-year tightening. This is a dangerous course to follow, especially in view of rising global deflation pressure," he wrote.

Makin noted that the expectation of falling prices was lowering consumption demand, as purchases were put off in the expectation that tomorrow's prices would be lower than today's. It was having an adverse effect on already low investment rates because if US inflation went negative, as it already has in a number of European countries, the real interest rate would rise, raising the cost of borrowing.

Bankers speaking at the Davos gathering also warned that financial markets could experience heightened volatility once the Fed started tightening. They claimed that regulators were starting

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to share their concerns.

Anshu Jain, the co-chief executive of Deutsche Bank, said he was "relatively comfortable" if there was a major unwinding in sovereign debt markets, as there were ways to work it out. "My main worry is if the same thing was to happen in investment grade credit, or, even worse, in the high yield or leveraged loans market," he said.

Leading bankers are claiming that increased regulations introduced as a result of the 2008 crisis have meant that they are not able to hold large stocks of such investments and cannot provide liquidity by purchasing these assets from those who want to sell.

The *Financial Times* has reported that a clash erupted at two closed door meetings at Davos between Jain and other bankers on the one side, and US Treasury Secretary Jack Lew and Bank of England Governor Mark Carney on the other, over whether the "flash crash" of last October, when market conditions briefly recalled those of 2008, was caused by new regulations.

The disputes over the Fed's tightening trajectory, the impact of deflation and the causes of market volatility point to the intractable nature of the global economic breakdown. The Fed's agenda is far from representing some major clampdown on financial markets, but is guided by the belief that the issuing of endless supplies of money cannot continue indefinitely, and at some point monetary policy must start to return to at least a semblance of normalcy.

However, even the initial limited steps in this direction have prompted predictions that they will give rise another financial crisis.

On the other hand, there are warnings that, far from being an antidote to financial crisis, quantitative easing itself is creating the conditions for another meltdown. One of the leading proponents of this view is William White, former chief economist at the Bank for International Settlements, who warned well before the Lehman collapse in 2008 that a crisis was building up as a result of the expansion of credit.

In an interview with the British *Daily Telegraph* on the eve of the Davos summit, he said the major central banks were inflating asset bubbles through quantitative easing, while beggar-thy-neighbour currency devaluations—themselves one of the products of QE—were spreading.

"We are in a world that is dangerously unanchored," he said. "We're seeing true currency wars and everybody is doing it, and I have no idea where this is going to end."

He said quantitative easing by the ECB was not going to help because the European economy had a greater reliance than the US on small and medium-sized companies that obtained their money from banks, not bond markets, and the banks were cutting back their lending.

White noted that corporations in emerging markets, principally in Asia and Latin America, had up to $6 trillion of debt denominated in US dollars, and this was going to create a "huge currency mismatch problem as US interest rates rise and the dollar goes back up."

So far as the liberal commentators such as Krugman and Summers are concerned, the key problem in Europe, which is at the centre of the global deflationary spiral, is the insistence of governments, led by Germany, on austerity.

In his Davos remarks, Summers spoke of the "irresponsible decision" to launch a currency union without a fiscal union to back it up, leading to a refusal to share liabilities and a dysfunctional system.

But, contrary to Summers, the essential problem in the design of the EU is not a lack of perspicacity. Rather, it is rooted in objective conditions—the division of the continent into conflicting nation-states. While it initially provided a certain limited degree of economic unification, the monetary union is foundering on the contradictions created by this system.

Krugman takes a similar position, blaming the mounting crisis either on intellectual failings or psychological problems.

In a *New York Times* column published on January 22, he claimed that European austerity reflected a "wilful misdiagnosis of the situation." Officials in Berlin and Brussels chose to ignore evidence that the excesses which led to the crisis flowed from private rather than public debt. Pursuing a narrative that blamed budget deficits, they then imposed spending cuts, rejecting evidence that such measures would further depress the economy.

Such analysis is aimed at covering over the fact that the policies of the European governments were not the result of a false analysis, but the expression of definite class interests. Nowhere has this been more clearly demonstrated than in Greece, where money obtained through cuts under the so-called bailout measures has been used to get the major private banks off the hook.

Likewise, German opposition to quantitative easing, which American financial interests have demanded be implemented, is not the result of some misplaced ideology, but reflects the position of German finance capital.

Having lost large amounts of money in the US-based sub-prime crisis, German banks, which were the first to be affected in 2007, fear that further financial "innovation" will lead to another crisis and severely impact on their position, weakening them in the struggle with their rivals in the US and elsewhere.

The mounting disputes and conflicts testify not only to the absence of any coherent economic program to resolve the breakdown, but also to the growing rivalry between the major powers that will further develop as the crisis deepens.

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