Fed chief points to rate rise this year

Nick Beams
25 September 2015

Federal Reserve Board chairwoman Janet Yellen sought to ease the financial market turbulence that followed the US central bank's decision a week ago not to increase interest rates in a major speech delivered Thursday at the University of Massachusetts.

Yellen concluded a nearly hour-long lecture on inflation and monetary policy by indicating that most members of the policy-setting Federal Open Market Committee (FOMC), including herself, anticipate that "it will likely be appropriate to raise the target range for the federal funds rate sometime later this year and to continue boosting short-term rates at a gradual pace thereafter."

Contrary to what has happened on previous occasions, when markets have risen on a decision to continue the near-zero interest policy, they fell on last week's decision, with the Dow losing 3.2 percent over the past week. The prospect of the continuing supply of ultra-cheap cash was outweighed by fears of the impact of worsening global economic conditions, which Yellen cited in her remarks outlining the background to the Fed decision.

Following the turbulence in Chinese markets and the signs of falling growth in the world's second largest economy, Yellen had pointed to the "significant economic and financial interconnections between the United States and the rest of the world." This required "close watching" and, in light of these "heightened uncertainties abroad" and softer inflation, the FOMC had decided that it was appropriate to wait for "more evidence" before lifting rates.

However, one week later the "significant" interconnections between the US and the rest of the world had virtually disappeared from her remarks. The worsening economic situation in China, which was central to last week's interest-rate decision, did not rate mention.

The explanation for the sharp turnaround—a further indication of the fact that the Fed, like other central banks, has no coherent policy guiding its actions—lies in the reaction to the decision to keep rates on hold.

Members of the Federal Reserve Board—including Jeffrey Lacker, who cast the sole dissenting vote on the FOMC decision—along with representatives of various financial institutions, have indicated that interest rates should be raised. In an interview this week, James Bullard, president of the St Louis Fed, said the Fed "cannot permanently raise stock prices."

Former head of the PIMCO bond trading company Bill Gross, now portfolio manager at Janus Capital Group, this week issued a sharp denunciation of the zero-interest rate regime in his latest Investment Outlook. He warned that zero bond interest rates "destroy the savings function of capitalism, which is a necessary and in fact a synchronous component of investment."

"The developed world is beginning to run on empty because investments discounted at near zero over the immediate future cannot provide cash flow or necessary capital gains to pay for past promises in an ageing society," he wrote.

An equally scathing comment by Danielle DiMartino Booth, a former adviser to the Dallas Federal Reserve, was published in the *Financial Times* on Wednesday under the headline "Fed must stop dithering and take action."

"The evidence is abundant," Booth wrote, "that the ability of monetary policy to spur economic growth is exhausted. More concerning are increasing distortions in the economy and financial system that threaten to collapse into crisis. The financial markets may not be fully on board with rising interest rates, but any further kowtowing to investors promises to strip the Fed of its last vestige of credibility."

The Fed's actions had facilitated bad behaviour on the part of corporate chieftains. "Why bother investing in the long term when it is so much more fun, to say nothing of more lucrative, to buy back shares, reduce share count and puff up profits?"

Responding to such criticisms, Yellen sought to counter perceptions that zero percent interest rates had become virtually permanent, by tilting to the other side. She said that members of the FOMC "implicitly expect" that "headwinds to economic growth" would continue to fade, thereby boosting the underlying strength of the US economy and opening the way for normalization of monetary policy.

In fact, in the week since the Fed cited global considerations as the reasons for not moving, those headwinds have become stronger. Data from the Chinese economy released this week showed that manufacturing had contracted by the largest amount since the depths of the global financial crisis in March 2009.

The prices of major industrial commodities—an indicator of global growth—have continued to fall, with predictions that they will go even lower. Interest rates on Brazilian government bonds have soared to 16 percent, an indication of the worsening situation in the country's China-dependent economy. The values of currencies in so-called "emerging markets," once touted as a new source of global growth, continue to fall and are at their lowest levels in 13 years.

Much of Yellen's speech centred on the dynamics of inflation, a question of importance for policy, given that the Fed's target is for 2 percent inflation in the US. She acknowledged that inflation was near zero but put this down to the fall in food and energy prices, implying that once these factors ceased to have an impact this situation would return to expectations.

However, she continued, the outlook was "highly uncertain" and it was conceivable that inflation could remain well below the 2 percent target despite the "apparent anchoring of inflation expectations," citing the example of Japan where deflation had set in despite predictions to the contrary.

And then, in what amounted to a telling admission that she and other central bankers are bereft of any understanding of what is taking place, Yellen continued: "The explanation for the persistent divergence between actual and expected inflation in Japan is not clear, but I believe that it illustrates a problem faced by all central bankers."

Despite claims that the American economy is strengthening, she acknowledged that "considerable uncertainties surround the outlook for economic activity" and it was not possible to be certain about "the pace at which the headwinds restraining the domestic economy will begin to fade."

Clearly responding to critics who have said that the Fed's inaction is creating the conditions for a crisis, Yellen said that if the Fed "were to delay the start of the policy normalization process for too long" it would be necessary to tighten abruptly and such an action "would risk disrupting financial markets and perhaps even inadvertently push the economy into recession."

Continuation of the zero rate could "encourage excessive leverage and other forms of risk taking that might undermine financial stability." However this is not a future prospect. It has already taken place, with speculative and parasitic financial activities, such as mergers and acquisitions and share buybacks, returning to levels reached before the 2008 financial meltdown.

The glaring contradictions in Yellen's speech and her obvious bewilderment underscore a point made long ago by Karl Marx.

Bourgeois economists, he noted, are unable to comprehend the real course of the economy because they seek to expunge the contradictions of the capitalist system and therefore view crises as an "aberration" and an external factor—a deviation from the normal—rather than arising from the very nature of the profit system itself.