Uncertainty grows over US Fed’s interest rate moves

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While it remains very likely that the US Federal Reserve will lift its base interest rate by a further 0.25 percentage points when it meets later this month, there is growing uncertainty about where monetary policy might be headed after that.

The Fed’s agenda is to return to a more “normalised” policy after almost nine years of ultra-low interest rates and the pumping of trillions of dollars into the financial system following the crisis of 2008. However, conditions in the US and the world economy are far from what was considered previously to be the norm.

This is clearly evidenced by the fact that the economic “model,” on which the Fed and other capitalist economic institutions have based their decisions in the past, has to all intents and purposes broken down.

One of its key components was the so-called Phillips curve, first advanced in 1958. It maintained that there was a relationship between the level of unemployment, wages and inflation. When near-full employment conditions were reached, the model held, this led to an upward movement of wages and prices.

Consequently, monetary policy should be directed to ensuring that interest rates were kept at low enough level to ensure that the economy continued to grow, but sufficiently high to ensure that wages and prices were kept under control.

Before the eruption of the financial crisis, the so-called neutral rate at which the economy would remain in “balance” was regarded as being around 3 percent. Since the financial crisis, however, all the assumptions on which this model was based have gone awry, pointing to far-reaching changes in the very structure of the economy.

The stated aim of Fed policy is to keep inflation at or near 2 percent, while ensuring at or near full employment. According to the Phillips curve, as the unemployment rate comes down so inflation should start to rise. Yet this has not taken place.

According to official figures, the core inflation rate has been below the Fed’s target of 2 percent for 58 months in a row, while the US unemployment rate has halved. And the inflation trend is down, with the rate of 1.5 percent for April, below the figure for a year ago.

Commenting on the inflation data, Lael Brainard, a member of the Fed’s policy-setting open market committee and regarded as somewhat of a “dove” on interest rates, said: “That reading marks a considerable shortfall from the committee’s 2 percent objective. And there does not seem to have been any progress over the past year or so.”

While indicating during a speech in New York that she favours a further interest rate rise “soon,” Brainard said that if soft inflation data persisted “that would be concerning and, ultimately could lead me to reassess the appropriate path of policy.”

Wages are showing the same pattern as inflation. According to the Phillips model, wages should start to rise with the fall in unemployment. This is also not taking place. The 2.5 percent annual growth in average hourly earnings is no higher than this time a year ago and well below the growth of 3.5 percent before the financial crisis.

The wages data point to an underlying structural change in the US economy—the replacement of better paid full-time jobs with part-time and casual employment.

A study by Harvard economist Lawrence Katz and Princeton economist Alan Krueger released in December last year found that 94 percent of the 10 million jobs created during the Obama administration were temporary, contract or part-time positions. The proportion of workers engaged in such jobs rose from 10.7 percent to 15.8 percent, with 1 million fewer workers engaged in full-time jobs than at the start of the recession of 2008-2009.

This trend was underscored in the latest jobs data released last Friday. The US unemployment rate dropped to 4.3 percent from 4.4 percent but this was due in no small measure to a 429,000 decline in the size of the labour force as workers dropped out of the jobs market.

Non-farm payrolls increased by 138,000 in May, while jobs growth figures for March and April were revised down by 66,000. The number of retail jobs fell for the third month in a row amid a spate of store closures by the major retail chains.

There are, however, some shortages in areas of skilled labour. In an indication of the class character of all its policies, the Fed noted that it would be prepared to lift interest rates if wages growth began to rise unexpectedly.

Another significant factor in the shattering of what was previously regarded as the "normal" pattern of economic development is the rise of financial parasitism. In the days when the Phillips model was first advanced, increased profits by corporations led to further productive investment, increased economic output and rising wages. That is no longer the case.

Profits are now increasingly not used for new investment. They are deployed in support of "financial engineering," involving share buybacks and increased dividends, as corporations operate under continuous pressure from hedge funds and investment funds to increase "shareholder value."

The trends in the US economy are being repeated elsewhere. In Britain, workers' wages are still some 10 percent below where they were before the global financial crisis, while Australia is showing the lowest growth in wages since records started to be kept. This is despite official data in both countries showing relatively low unemployment levels.

One of the main factors at work in all the advanced economies is the falling levels of investment in the real, as opposed to the financial, economy, which has depressed productivity growth.

The international character of these tendencies was underscored in the Global Economic Prospects reported issued by the World Bank on Sunday. It pointed to a "fragile" recovery in the global economy but warned that a slowdown in investment was threatening productivity growth in emerging economies and that long-term damage might already have been done.

According to the report: "Even if the expected modest rebound in investment across [emerging and developing economies] materialises, slowing capital accumulation in recent years may have already reduced potential growth."