Despite low inflation, US Fed lifts interest rates

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The US Federal Reserve Board yesterday increased its base rate by 0.25 percentage points to a range of 1 percent to 1.25 percent, despite further falls in retail sales and data showing that inflation remains below the Fed's target rate of 2 percent.

Chairwoman Janet Yellen indicated that the Fed was on track for further rate rises, including another quarter percentage point increase by the end of the year. She also laid out how the Fed intends to start to wind back its holdings of financial assets, Treasury and corporate bonds, purchased during its quantitative easing program, initiated after the 2008 financial crisis.

The overriding message from the Fed was that in the midst of low economic growth, falling consumption spending and the spread of part-time and casual work replacing full time jobs, the present situation represents the new normal.

Yellen said the latest rate rise reflected "the progress the economy has made," and was expected to make, toward the Fed's maximum employment and price stability objectives. In other words, for millions of working class families, this is as good as it gets.

There was a clear warning that if wages start to rise as workers seek to claw back what they have lost, the Fed will take action.

"We continue to expect the ongoing strength of the economy will warrant gradual increases in the federal funds rate to sustain a healthy labour market and stabilise inflation around our 2 percent longer-run objective," Yellen said.

So far as the Fed and the financial elites for which it speaks are concerned, a "healthy labour market" means real wages will continue to decline. This is not least due to the replacement of full-time work with casualised labour—a trend that saw some 94 percent of the 10 million jobs created during the Obama administration consist of temporary, contract or part-time positions.

Vast changes in the structure of the US economy are reflected in the changed relationship between inflation and the unemployment level. The present jobless rate is officially at a historically low level of 4.3 percent, but instead of improved wages and rising prices, both remain at depressed levels.

As one questioner noted during Yellen's press conference, the pre-recession US economy was very different. While the Fed's official position remains that low inflation is the result of cyclical factors, Yellen acknowledged during her remarks there could be some structural changes in the economy.

The low inflation climate was highlighted in figures released just before the Fed decision was announced. The year-on-year rate of consumer price inflation, stripping out volatile fuel and food prices, fell to 1.7 percent in May, its lowest level since 2015. This was below the market expectation of 1.9 percent. Other data showed a fall of 0.3 percent in retail sales, below the expected flat reading. The stagnation in consumer spending is reflected in the closure of hundreds of retail department stores across the country.

The inflation and retail sales figures sent the yield on US treasury bonds to 2.12 percent, down 9 basis points, to the lowest level for 2017. The fall in the rates on longer-term bonds has led to a flattening of the yield curve as they approach those on two-year debt, with the gap now close to a 10-year low. A flattening yield curve is generally indicative of worsening economic conditions and recession.

Josh Younger, an analyst at JPMorgan, told the *Financial Times*: "It is the third month in a row that prices have not gone up that quickly and it is causing a lot of hand wringing among investors about what this really means." There was a "lot of focus on inflation and to the extent that inflation disappoints it raises questions," he said.

Chris Rupkey, chief financial economist with the Mitsubishi financial group, said the economy was stuck in a rut in the first quarter "and early indications suggested that the slowdown was just temporary until we got hit with this one-two punch of bad economic news for May."

While the interest rate rise was expected, the detail the Fed provided on its plans to wind back the holding of bonds on its balance sheet was not anticipated. Before the financial crisis, the Fed held about $800 billion worth of financial assets. As a result of quantitative easing purchases this blew out to $4.5 trillion—a significant boost to the stock market and financial parasitism in general.

Under the plan, the Fed will gradually reduce the reinvestment of principal payments on the maturing bonds it holds in its portfolio. The money will be reinvested only to the extent that it exceeds a set of steadily rising caps.

For treasury bonds, the cap will start at $6 billion a month and increase in steps of $6 billion at three-month intervals over 12 months until it reaches $30 billion a month. For mortgage-backed securities, the cap will start at $4 billion a month rising until it reaches $20 billion a month.

The reason for the gradual approach is that if the Fed suddenly withdrew from the market, the price of bonds would fall, leading to a rise in interest rates (the two move in an inverse relationship).

Yellen emphasised that the policy sought to prevent "outsized" movements in interest rates. While she did not elaborate, such sudden movements could destabilise financial markets, as took place when the Fed indicated it was easing its asset purchases in May 2013, leading to a "taper tantrum."

No date was set for the beginning of the program and Yellen did not say what level of financial assets the Fed would continue to hold, other than it would be larger than before the crisis but "appreciably" below the level of recent years.

The monetary policy committee, she said, expected to learn more about the situation during the process of "balance sheet normalisation." However, there is no precedent for such a financial operation in economic history. Given the extent of the financial markets' dependence on cheap money provided by the world's central banks, the Fed is in uncharted waters.