US Fed confronts dilemmas over monetary policy

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7 September 2017

A speech by Lael Brainard, a member of the US Federal Reserve board of governors, to the Economic Club of New York on Tuesday pointed to the conundrums facing the central bank as it considers the next steps to take in "normalizing" monetary policy.

The Fed has two major decisions to consider at its meeting later this month: whether to continue to lift its base interest rate, and when to begin to reduce its assets holdings of $4.5 trillion. These assets have accumulated as a result of corporate and treasury bond purchases under the quantitative easing program initiated after the 2008 financial crisis.

Despite the massive injections of money into global financial markets by the Fed and other central banks, almost a decade on there is no sign of the US and global economy returning to anything resembling pre-crisis conditions and relationships.

The Fed is confronted by two contradictory sets of data. On the one hand, the fall in the official unemployment rate in the US to below 5 percent would indicate further rises in the base interest rate if historical precedents are to be followed.

However, the persistence of low levels of inflation, well below the Fed's target rate of 2 percent, and evidence that prices are falling, points to deciding to keep the base rate at its present historically low level.

The combination of low official unemployment levels coupled with low, and even falling inflation, contradicts the predictions of the so-called Philips curve, on which the Fed has based its policies in the past. According to this model, as unemployment falls, the inflation rate should start to rise as workers seek and obtain higher wages. But this is not taking place.

Brainard began her speech by repeating the official line that the US economy "remains on solid footing" with the strongest growth in the global economy seen in "many years" and a labour market continuing to bring "more Americans off the sidelines and into productive employment."

"Nonetheless," she continued, "there is a notable disconnect between signs that the economy is in the neighbourhood of full employment and a string of lower-than-projected inflation readings, especially since inflation has come in stubbornly below target for five years."

Brainard emphasised the importance of raising inflation so the Fed can lift its base rate and thus have room to manoeuvre on the downside when the next recession hits the US economy.

A number of economic commentators and analysts have pointed out that with the US economy in its third longest period of expansion—99 months since the last low point in June 2009—another recession is likely sooner rather than later.

The recession warnings are also based on indications that US corporations are on the edge of a profit downturn. In an interview with *Bloomberg* last month, Oxford Economics macro strategist Gaurav Saroliya said the gross value-added of non-financial corporations—a measure of the value of goods after adjusting for the costs of production—was now negative on a year-on-year basis.

"The cycle of real corporate profits has turned enough to be a potential source of concern for the next four quarters," he said in an interview. "That, along with the most expensive equity valuations among major markets, should worry investors in US stocks."

The official line on the low inflation rate, advanced by Fed chairwoman Janet Yellen, is that it is caused by "temporary" factors—the latest being a reduction in cell phone plan costs.

According to Brainard, however, "what is troubling is five straight years in which inflation fell short of our target despite a sharp improvement in resource utilization."

She contrasted the present situation with that which prevailed before the financial crisis. In the three years ending in early 2007, the unemployment rate was around 5 percent but inflation averaged 2.2 percent. This was in marked contrast to the past three years, when it has averaged just 1.5 percent, with a continued downward trend.

Brainard said some may conclude that monetary policy tightening was appropriate because inflation would accelerate as the labour market tightened in accordance with the Phillips curve.

"However, in today's economy, there are reasons to worry that the Phillips curve will not prove very reliable in boosting inflation as resource utilization tightens."

The curve was flatter than previously and this was also apparent in a number of other advanced economies, "where declines in their unemployment rates to relatively low levels have failed to generate significant upward pressures on inflation."

The Fed had fallen short of its inflation objective not only in the past year but over a longer period as well and "my own view is that we should be cautious about tightening policy further until we are confident inflation is on track to achieve our objective."

Brainard canvassed various reasons for the breakdown in the previous relationships, including lower inflation expectations. But she was careful to avoid the most fundamental reason.

The crisis of 2008 was not only financial. It was followed by a major restructuring of class relations in the US and other advanced economies. This has two major components. One is the imposition of an austerity agenda, through cuts in social services and government spending, to make the working class pay for the crisis of the financial system. The other is the systematic destruction of previous wage levels and working conditions.

While the official unemployment level in the US and Europe has fallen, this statistic bears little resemblance to previous data because of labour market "restructuring"—above all through the replacement of full-time positions with casual and part-time jobs.

In the US, for example, an estimated 90 percent of the jobs "created" since the crisis have either been part-time or casual positions. Together with the spread of zero-hours contracts, there are much lower starting wages for full-time positions, especially in the auto industry.

Apart from deciding whether to increase rates, the next Fed meeting will be confronted with the issue of when to start to reduce its assets holdings. There is a fear that too rapid a divestment of bonds could lower their price and thereby cause a spike in interest rates (the two move in an inverse relationship). This could create turbulence in equity and bond markets where there are concerns that asset prices, inflated by low interest rates, are already significantly over-valued.

The concerns of finance capital were articulated by Berkshire Hathaway chief Warren Buffett, one of the richest men in the world, in a recent interview with *Bloomberg*. He warned that the Fed must be "pretty careful" about reducing its asset holdings.

Asked about the overall effectiveness of quantitative easing, which had boosted asset prices but failed to bring about an economic recovery, Buffett acknowledged that any gains had gone disproportionately to the super-rich. This was a result of the workings of "the market."

The Fed had overwhelmingly done the "right thing," Buffett concluded, and quantitative easing "did wonders for us." But now, he asserted, the Fed was faced with the task of putting some $3 trillion worth of its asset holdings back into the market and "they have never played this game."