Divisions mount over US monetary policy

Nick Beams
19 May 2021

Minutes from the Fed's April 27–28 policy making committee released yesterday indicate a possible divergence in the central bank's governing body over the direction of monetary policy amid concerns that financial authorities are ignoring growing dangers that inflation could get out of control.

According to the minutes of the meeting, members of the Federal Open Market Committee generally agreed that the US economy remained "far" from the Fed's goals of full employment and price stability, with a level of inflation consistently around 2 percent, and this required the central bank maintaining the ultra-loose monetary policy initiated in March 2020.

But they also showed that a number of members indicated during the discussion that the time may be rapidly approaching when a discussion should begin on rolling back the Fed's asset purchases of $120 billion a month—more than $1.4 trillion a year.

However, when Fed chair Jerome Powell reported on the Fed's deliberations immediately after the meeting three weeks ago he made no reference to this significant discussion.

According to the FOMC minutes: "A number of participants suggested that if the economy continued to make rapid progress towards the committee's goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases."

The issue was very much a live one at the Fed meeting, with significant financial analysts and commentators warning it had to give some indication of when it might begin the tapering process lest it was forced to jam on the monetary brakes in face of an inflationary surge. Former US Treasury Secretary Summers had warned that combined with the stimulus measures of the Biden administration, the Fed's policies could lead to the kind of inflation seen in the 1970s.

These views were clearly evident at the Fed meeting, with the minutes recording that "a couple of participants commented on the risks of inflation pressures building up to unwelcome levels before they become sufficiently evident to induce a policy reaction."

Summers returned to the monetary policy fray earlier this week in comments at a conference hosted by the Federal Reserve Bank of Atlanta.

He said both the Biden administration and the Fed had "underestimated the risks, very substantially, both to financial stability as well as to conventional inflation of protracted extremely low interest rates."

The latest policy projections from the Fed, based on the assumption that price rises—a 4.2 percent increase for the year to April—are "transitory" effects of the economic reopening and it will keep interest rates at historic lows at least until 2024.

In his remarks Summers took direct aim at this scenario.

"Policy projections suggesting rates may not be raised for … close to three years are creating a dangerous complacency," he said, warning the Fed could be forced into a rapid tightening that would hit financial markets and the broader economy.

"When, as I think is quite likely, there is a strong need to adjust policy, those adjustments will come as a surprise," he said, and the "jolt" would "do real damage to financial stability, and may do real damage to the economy."

According to Summers, the "primary risks today involve overheating, asset price inflation and subsequent financial excessive leverage and subsequent financial instability" and not a downturn in the economy and excessive sluggishness and unemployment.

In previous times, the Fed would no doubt have started to increase interest rates, even if only gradually, and would have tightened its monetary policy regime. But it is now caught in the contradictions of the massive stimulus, running into more than $4 trillion, which it set in motion after the freezing of financial markets at the start of the pandemic.

The endless flow of cheap money has produced a speculative boom in all asset classes, promoted the mania of gambling in cryptocurrencies, and has led to a situation

© World Socialist Web Site

where the Fed fears that even the suggestion that it be cut back could spark in the financial house of cards it has created.

The contrary view is that monetary tightening should be initiated now, because to delay is only to create the conditions for an even bigger shock.

The chief economics commentator at the *Financial Times*, Martin Wolf, who has previously given some support to the views of Summers, returned to the issue in a comment published yesterday. While giving some credence to the idea that rising inflation reflected post-pandemic unpredictability, he noted deeper processes were at work.

He pointed out that "both monetary and fiscal policy settings are, by historical standards, wildly expansionary, with near-zero interest rates, exceptional monetary growth and huge fiscal deficits."

Tightening monetary policy right now would be extremely unpopular. "Yet if a central bank does not take away the punch bowl before the party gets going, it has to take it away from people who have become addicted to it. That is painful: it takes a Paul Volcker."

Wolf would like to see a tightening of monetary policy or at least ending the commitment to continue "emergency measures" over the next several years. The problem with this gradualist scenario is that the party has not only got going but become a bacchanalian orgy of speculation in which the entire financial system is dependent on essentially free money.

Wolf's reference to Paul Volcker is significant. As chair of the Fed, appointed by Democratic president Jimmy Carter in 1979, Volcker initiated the high interest rate regime in the 1980s, in response to the crisis of American capitalism resulting from the end of post-war boom, which led to two of the deepest recessions in the post-war period.

Now a new crisis is rapidly developing with potentially even more devastating consequences.

It appears, both from the Fed minutes and subsequent comments, that some Fed officials are coming to the view that a turn will have to be made soon.

In comments to reporters yesterday, St Louis Fed president James Bullard, who currently does not vote on policy, said when the pandemic was largely behind us "then I think we could talk about adjusting monetary policy. I don't think we're quite at that point yet, but it does seem like we're getting close."

His views were reflected in comments by voting member Atlanta Fed president Raphael Bostic who said in a Bloomberg television interview: "We're going to have to be very nimble in terms of our monitoring of the economy and our policy responses."

But given the extreme dependence of the US and global financial system on ultra-low interest rates, what exactly that "nimble" policy response might be is very much the trillion dollar question.

These concerns go beyond the US. In its financial stability report issued yesterday, the European Central Bank warned that the rising debt levels of both government and corporations could trigger financial instability.

Presenting the report, ECB vice-president Luis de Guindos expressed optimism that financial and economic conditions would "bounce back."

"There is, however, a reality that the pandemic will leave a legacy of higher debt and weaker balance sheets, which, if unaddressed, could prompt sharp market corrections and financial stress or lead to a prolonged period of weak economic recovery," he said.

The report said that "vulnerabilities from the outstanding stock of debt appear higher than in the aftermath of the global financial crisis and the euro sovereign debt crisis [of 2012], although debt servicing and rollover risks appear more benign given favourable financing conditions in terms of both pricing and duration."

But those present "favourable conditions" can change very rapidly if there is a rise in US interest rates and a tightening of monetary policy.

It warned that "recent increases in US benchmark yields [the increasing rates on US 10-year Treasury bonds] have revived concerns about the potential for shifts in financial conditions."

"Non-banks continue to have large exposure to corporates with weak fundamentals and are sensitive to a yield shock given their material bond portfolio duration, exposure to US markets and high degree of liquidity risk."

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site