

Inflation on the agenda at Fed and European Central Bank

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2 June 2021

The indications of rising inflation in Europe and the US have prompted deliberations, in both official and media circles, over how the world's two major central banks, the European Central Bank and the Federal Reserve, could start to pull back the extraordinary levels of support they have provided to financial markets.

The two central banks are being caught on the horns of a dilemma. On the one hand, they fear that even a limited withdrawal of support could set off major financial turbulence. On the other, if the ultra-loose monetary policy continues, under conditions where inflationary pressures become entrenched, they could be forced to clamp down hard, causing even bigger problems.

So far, the official view at the Fed and the ECB is that the recent rise in inflation is transitory, and the present levels of support should be maintained.

But there are concerns that the uptick in inflation could be the start of a longer-term trend. A major article in the *Financial Times* this week was headlined “A new economic era: is inflation coming back for good.”

It began by noting that in December 1964, the Fed's policy committee agreed that the US economy could cope with rising levels of spending “without any strong upward pressure on prices.”

This assessment was made at what turned out to be the start of a 17-year period, in which inflation at times exceeded an annual rate of 10 percent. It only ended with the deflationary policies initiated under Fed chair Paul Volcker, which produced two of the deepest recessions in the post-war period in the early 1980s.

Former Treasury Secretary Lawrence Summers is one of those who has warned that the spending policies of the Biden administration, coupled with the Fed's

monetary settings—interest rates at historic lows and asset purchases of more than \$1.4 trillion a year—could see a return of inflation levels last seen in the 1970s.

The prospect of endemic inflation has been heightened by data released by the Commerce Department last month.

In the biggest jump since the 1990s, it showed that the core personal consumption expenditure (PCE) index, which strips out volatile food and energy costs, recorded a 3.1 percent rise compared with a year ago. The increase in March was 1.9 percent. If food and energy costs were included, the rise was 3.6 percent.

Fed officials continue to maintain that the price increases are transient, the result of supply chain bottlenecks and other temporary factors, and that inflation will start to fall later in the year. The Fed has maintained that it will not start to tighten its monetary policy until inflation is consistently above 2 percent, and the labour market—and the economy more broadly—show “substantial improvement.”

But there are growing concerns this policy could lead to “wild markets,” if the Fed is forced to step in to contain price rises and there is discussion that a paradigm shift is underway. This was the subject of an article on Tuesday in the *Wall Street Journal*.

It noted that over the past three decades a virtuous circle was in operation. Every time the financial markets experienced major problems and crises, the Fed was able to intervene with increased support, under conditions of low and declining inflation rates.

Following the crisis of 2008, the Fed made major asset purchases under its quantitative easing program, and drove down interest rates to historic lows. The rationale for this program, was that lower interest rates would push investors into riskier assets and bring about a rise in economic growth.

Nothing of the sort happened. Instead, investors took the essentially free money made available to them to devise ever-more complex and highly leveraged operations in financial markets to make profit.

This meant that when the pandemic struck in March 2020, the financial house of cards, built up over the previous decade, was on the point of collapse. The \$21 trillion US Treasury market froze. The Fed was forced to step in as the backstop for the entire system, doubling its holdings of financial assets from \$4 trillion to \$8 trillion in less than a year.

Now there are warnings that the previous virtuous circle will turn vicious. The WSJ article cited remarks by Christopher Cole, chief investment officer of Artemis Capital Management, who pointed to the implications of the Fed's guarantees that it will not tighten monetary policy until inflation has risen for a considerable period.

According to Cole, this means that the Fed will restrict credit, when higher inflation is already causing problems for financial markets, and this will feed volatility, making the situation worse.

"The problem here is that if we get inflation—real inflation—it removes the Fed's monetary ability to support credit," he said.

The future direction of monetary policy is under discussion in leading bodies of the Fed, with the minutes of the April 27-28 meeting noting that a number of participants considered it "appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases."

With the rise in inflation since then and signs of a tightening labour market, this question is virtually certain to be put on the agenda at the next meeting of the policy-making Federal Open Market Committee (FOMC), scheduled for June 15-16.

In an interview with the *Financial Times* this week, James Bullard, president of the St Louis Fed, said there was evidence of a tightening labour market, despite data showing that employment was still eight million below pre-pandemic levels.

While he does not have a vote on the FOMC this year, Bullard's views are indicative of those of others. He said that when it was considered the pandemic was sufficiently under control "you can start to talk about changing the parameters of monetary policy. It does seem like we're getting close to that juncture."

The same issues are surfacing in Europe, though not to the same extent as in the US.

Inflation in the eurozone rose to 2 percent in May, the first time it has hit the ECB's target in more than two years. The ECB governing council meets on June 10 and will have to decide whether to continue or ease back on its asset purchases of €80 billion a month.

The official position of the ECB, articulated by its president Christine Lagarde, is that price rises are temporary.

In a somewhat testy response to a question last Friday, about whether the ECB was going to slow its bond purchases, Lagarde said it was "far too early, and it's actually unnecessary to debate long term issues."

"I have repeatedly said that policymakers provide the right bridge across the pandemic, well into the recovery, so that we can actually deliver on our mandate, and that's what we will do."

Lagarde is under continual pressure from so-called "hawks" in the northern European economies, who have been advocating, for some weeks, an easing of bond purchases, on the basis that there is an improved outlook for inflation and economic growth.

But the ECB faces the complication that any slowing of bond purchases, and the consequent rise in interest rates, will have a significant impact on the more highly indebted members of the Eurozone, such as Italy and other countries in the so-called periphery.



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