

# As inflation rises, eyes turn to Fed meeting

Nick Beams  
11 June 2021

The rise in US inflation to 5 percent for the year to May—up from 4.2 percent in April—means that the issue of “tapering” the Federal Reserve Board’s massive injections of money into the financial system will be front and centre of discussions when its policy-making committee holds a two-day meeting next week.

The minutes of the meeting in April recorded that “some participants” favoured putting the issue on the agenda at future meetings. This was not mentioned by Fed chair Jerome Powell when he reported on the deliberations at the time. Powell has been insisting that price increases are temporary and the Fed must remain on its present ultra-loose monetary course.

But with inflation on the rise, the issue of how long the Fed should continue to buy up financial assets at the rate of \$120 billion per month will no doubt be raised at next week’s meeting.

While there is general support for the Fed’s policies within financial and media circles, there has been a rising drumbeat of criticism that, together with the Biden administration’s proposed stimulus measures, the central bank risks setting off runaway inflation of the kind seen in the 1970s.

The critics maintain that unless the Fed takes action now the economy could become “overheated” and it runs the risk of having to slam on the brakes in the future. This would set off significant financial turbulence because of Wall Street’s dependence on the continued flow of cheap money, and could even spark a major recession.

One of the most prominent critics of the Fed’s policies, former Treasury secretary in the Clinton administration and an economic adviser to Obama, Lawrence Summers, immediately responded to the latest inflation data. “If overheating takes place in the US and there is an eventual spike in interest rates driven either by the Fed or the markets, there will be enormous risks to an already fragile and over-leveraged

global economy,” he said.

The Biden administration’s response to the inflation numbers, which exceeded economists’ expectations, was to downplay their significance. According to a White House official cited by the *Financial Times*, so long as inflation expectations remained “well anchored and well behaved,” prices would trend down again.

Criticism of the Fed goes across the political establishment. Writing in the *Wall Street Journal* earlier this week, Kevin Warsh, a former member of the Federal Reserve Board, echoed some issues raised by Summers, a Democrat.

Warsh noted that the new policy doctrine unveiled by Powell almost a year ago, in which the Fed indicated it was prepared to allow inflation to rise for a period before taking action, reversed the “pre-emption” that was standard under Powell’s predecessors.

“Most in Washington can barely contain their enthusiasm for the new doctrine. Wall Street loves it too,” Warsh wrote.

Support from the financial markets is indicated by the fall in the yield on 10-year Treasury bonds to around 1.5 percent, after spiking earlier this year to 1.7 percent. This is a sign that Wall Street considers inflation is transitory and consequently there will not be a tapering of monetary policy in the immediate future.

The critics of the Fed, however, pointed to longer-term considerations and the global position of the US.

Warsh noted that the weakness of the dollar, evident since last autumn as a result of the Fed’s measures, “poses a host of dangers, including inflation risks. The Fed says it has the tools to stop an inflationary surge, but its new regime promises a tardy response. Late by design, the Fed would have to tighten more to stop an inflationary surge.”

Warsh pointed to a significant new development—the way in which government spending is being financed by the central bank. He noted that since the onset of the

pandemic in February 2020, the Fed had bought 56 percent of the total Treasury issuance of \$4.5 trillion in debt.

The Fed's massive intervention, starting in March 2020, was sparked by the freezing of the \$21 trillion US Treasury market, regarded as the safe haven for the global financial system.

One factor was the speculative activities of traders in Treasury bonds. But another significant feature was the sell-off by large foreign buyers. They have not made a significant return to the market since then, which may indicate a loss of confidence in the US dollar as a result of the Fed's policies.

Across the Atlantic, while the immediate economic and financial circumstances are not identical to those in the US, the European Central Bank (ECB) is broadly following the path being taken by the Fed.

While inflation has started to rise and there are increased growth forecasts, the ECB decided at its meeting on Thursday to "confirm its very accommodative monetary policy stance."

It would continue net asset purchases under its pandemic emergency purchase program (PEPP), which has total funds available of €1.85 trillion until at least the end of March, and it "expects net purchases under the PEPP over the coming quarter to be conducted at a significantly higher pace than during the first months of the year." In addition, purchases under its asset purchase program would continue at the rate of €20 billion a month.

In the introductory statement to her press conference on Thursday, ECB president Christine Lagarde said inflation had picked up in recent months and would rise further in the second half of the year but then decline as temporary factors faded out.

Lagarde was asked a number of times about a "time map" for an exit from the PEPP but pushed back the questions, saying that would be "premature."

But, as in the US, there are concerns, at least in some financial circles, about how the supply of cheap money and the escalation of debt is going to end. Deutsche Bank economists said earlier this week that to ignore inflation "leaves global economies sitting on a time bomb."

In a comment published in the *Financial Times*, Eric Knight, the CEO of a \$1 billion hedge fund, warned: "What worries me... is that debt in comparison to gross

domestic product is now at record levels in the US, eurozone, UK, Japan and China. Private sector debt is particularly dangerous as it tends to increase steadily over very long periods of time and will often bring down a number of banks when the cycle abruptly comes to an end."

An end to the cycle could be triggered by even a small shock to the system and there were any number of potential catalysts, ranging from "civil unrest to the collapse of a hedge fund, a pandemic or a military crisis."

Knight forecast the re-emergence of a "doom loop" in Europe, such as that of 2012, which "ties the solvency of banks to that of their host countries." He warned that France, Italy and Spain were the countries to watch.



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