Fed Seeks to Reassure Markets on Rate Increases amid Mounting Signs of Slump and Financial Crisis

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US Federal Reserve chair Janet Yellen testified Wednesday before the Financial Services Committee of the House of Representatives, presenting the central bank's semiannual Monetary Policy Report. Yellen will appear today before the Senate Banking Committee.

In her opening statement and her replies to questions from Democrats and Republicans on the committee, Yellen sought to reassure financial markets in the US and around the world that have taken huge losses since the beginning of the year and are being further pummeled by recessionary pressures and signs of a new banking crisis.

Yellen broadly hinted that the Fed would hold off on a further increase in its benchmark federal funds interest rate when its policy-making Federal Open Market Committee meets again in mid-March. At the same time, while not ruling out a possible reversal of the quarter percentage point increase the central bank imposed in December, its first interest hike in nine years, Yellen said the Fed stood by its announced intention to institute incremental and gradual increases in the course of 2016.

Yellen's prepared statement, released early Tuesday morning along with the Monetary Policy Report, helped fuel a rebound on European stock markets. They had fallen for six straight sessions amid new indications of slowing growth in the US as well as China and further declines in the price of oil and other industrial commodities, combined with mounting concerns over the financial stability of major European banks.

US stocks initially rose in response to Yellen's testimony, but her assurances proved insufficient to overcome the general mood of gloom and foreboding. The US indexes closed mixed, with the Nasdaq registering a gain, the Standard & Poor's 500 ending flat, and the Dow Jones Industrial Average losing 99 points.

The slide toward global recession was sharply expressed this week in the descent of Japanese government bond yields into negative territory. In the US, the yield on 10-year Treasury bonds has plunged well below 2 percent, reflecting the same deflationary trends.

The proliferation of super-low and even negative interest rates is wreaking havoc on banks that remain burdened with bad loans and stand to incur more losses from energy-related assets that are souring due to the collapse of oil prices and its impact on energy revenues and profits.

Bank stocks in Europe are down an average of 27 percent so far this year, with Deutsche Bank, Germany's biggest, suffering a loss of more than 40 percent. In the US, bank stocks are down 18 percent, with shares of Bank of America and Morgan Stanley having dropped 27 percent and 28 percent, respectively.

US stocks overall have fallen by more than 9 percent since the beginning of the year, and stocks in Europe have declined even more sharply. In the US, tens of thousands of job cuts have been announced in both the industrial and retail sectors. Among the major non-retail firms announcing layoffs are Johnson & Johnson, Norfolk Southern, US Steel, Yahoo and Altria. Energy and mining firms have laid off thousands more workers.

The worsening social crisis impacting broad sections of the US population is reflected in the wave of store closings and layoffs by major retail chains, including Wal-Mart (269 stores, 16,000 job cuts), Macy's (40 stores, 4,500 layoffs) and Sears-Kmart (more than 50 stores, thousands of job cuts).

US economic growth is estimated by the government to have slowed to 0.7 percent in the final quarter of 2015, and data on manufacturing continues to show recessionary conditions.

US corporate profits are also down. Profits reported by firms in the S&P 500 index for the fourth quarter of 2015 are down 4.1 percent from a year earlier. Sales are down 3.5 percent. This means profits have declined, year-on-year, for two straight quarters, the first time that has occurred since 2009. Sales have fallen for four consecutive quarters.

The near panic in financial circles was summed up in a statement released last week by strategists at Citibank, which declared, "The world appears to be trapped in a circular reference death spiral." Predicting that the world economy would grow by only 2.7 percent this year, far below the already depressed projections of the International Monetary Fund, Citibank warned of "a proper/full global recession and dangerous disorder across financial markets." Its report concluded, "The stakes are high, perhaps higher than they have ever been in the post-World War II era."

Leading economists, including former treasury secretary Lawrence Summers, are raising their estimates of the chances of a recession in the US this year. Summers, echoing estimates by JPMorgan Chase, puts the likelihood at one in three. Others say the recession has already begun.

In her statement and her responses to members of the House committee, Yellen played down the prospect of an economic contraction in the US. However, she acknowledged the slowdown in the US and pointed to other trends, such as falling share prices, higher interest rates for high-risk borrowers, and a further appreciation of the dollar, as increasing the downside risks to the economy. She implied that these trends could lead the Fed to hold off on further interest rate hikes.

Significantly, she also pointed in some detail to negative international trends and said the Fed was monitoring them closely in considering whether and when to again raise rates.

"As is always the case," Yellen said in her opening remarks,

> "the economic outlook is uncertain. Foreign economic developments, in particular, pose risks to US economic growth. Most notably...declines in the foreign exchange value of the renminbi have intensified uncertainty about China's exchange rate policy and the prospects for its economy.

> "This uncertainty led to increased volatility in global financial markets and, against the background of persistent weakness abroad, exacerbated concerns about the outlook for global growth. These growth concerns…contributed to the recent fall in the prices of oil and other commodities. In turn, low commodity prices could trigger financial stresses in commodity-producing firms in many countries. Should any of these downside risks materialize, foreign activity and the demand for US exports could weaken and financial market conditions could tighten further. …"

She once again stressed that any further rate increases would be small, that the Fed's monetary policy would remain "accommodative," and that the federal funds rate would remain below normal levels for the foreseeable future.

In a further reassurance to banks and hedge funds demanding a continuation of cheap credit, Yellen added,

> "Of course, monetary policy is by no means on a preset course. We will take into account…readings on financial and international developments. … If the economy were to disappoint, a lower path of the federal funds rate would be appropriate."

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