Long-Term Scenario of Economic Stagnation and Financial Instability: US Federal Reserve Chair Janet Yellen

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In a much-anticipated speech Friday to the annual meeting of central bankers held by the Federal Reserve Bank of Kansas City in Jackson Hole, Wyoming, Fed Chairwoman Janet Yellen indicated that the US central bank was preparing to raise interest rates at least once this year.

Virtually all attention and commentary on the conference was focused on its implications for the short-term movement of the benchmark US federal funds rate. This reflects the fixation of the financial elite on the near-term implications of Fed policy for its own speculative bets and stock and bond holdings.

ECONOMY | CENTRAL BANKS

Fed's Yellen Aims to Move Rates Up Soon, but on a Slow Path

Central bank chief defends accountability as House Republicans blast leak probe

Federal Reserve Chairwoman Janet Yellen delivers the central bank's semiannual report to Congress on Wednesday. Photo: AP

By JON HILSENRATH and KATE DAVIDSON

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Federal Reserve Chairwoman Janet Yellen signaled that recent turbulence in Greece, China and elsewhere overseas isn't threatening the U.S. economy enough to divert the central bank from plans to raise short-term interest rates later this year.

Screenshot WSJ

Yellen’s remarks, which kicked off the two-day conference, together with similarly “hawkish” statements by other Fed officials attending the meeting, had a generally negative impact on the stock indexes. The Dow Jones Industrial Average, which was up by more than 100 points in early trading, ended the day down 53.

There was little comment on the more fundamental significance of Yellen’s speech, which all but acknowledged that low levels of economic growth and extreme financial instability were permanent features of the US and world capitalist economy, requiring the Fed and other central banks to continue indefinitely their policies of ultra-low interest rates and massive subsidies for the financial markets in the form of bond purchases (so-called quantitative easing).

Citing “solid growth in household spending” and “job gains [averaging] 190,000 per month over the past three months,” Yellen said: “Based on this economic outlook, the [Fed] continues to anticipate that gradual increases in the federal funds rate will be appropriate over time to achieve and sustain employment and inflation near our statutory objectives. Indeed, in light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months.”

In an interview with CNBC following Yellen’s speech, Fed Vice Chairman Stanley Fischer said her remarks were consistent with a possible rate hike at the next meeting of the Fed’s policy-setting Federal Open Market Committee in September.

More significant were Yellen’s statements about the likelihood of extremely low interest rates for the indefinite future as well as the incorporation of quantitative easing into the permanent “tool kit” of the US central bank. She noted, “Forecasts now show the federal funds rate settling at about 3 percent in the longer run. In contrast, the federal funds rate averaged more than 7 percent between 1965 and 2000.”

She related this to “the marked decline over the past decade, both here and abroad, in the long-run neutral real rate of interest–that is, the inflation-adjusted short-term interest rate consistent with keeping output at its potential on average over time.” She attributed this, in part, to “a paucity of attractive capital projects worldwide.”

This long-term decline in the so-called neutral interest rate, defined as that rate which neither boosts nor slows the economy, is an expression of a systemic crisis, rather than a mere conjunctural downturn, in the American and world capitalist economy. The fact that interest rates have been driven so low—to the point where one-fourth of world output is from countries with negative interest rates—shows that the crisis that erupted in September 2008 with the collapse of Lehman Brothers marked a historic breakdown in the system. It refutes all claims that trillions in bank bailouts and subsidies to the financial markets via super-low interest rates and trillions more dollars in virtually free credit have effected a genuine recovery.

These policies have had the intended result of rescuing the global financial aristocracy and adding to its wealth by massively inflating stock and bond prices. They have also made possible a ruthless assault on the jobs, wages and living standards of the working class and a further redistribution of wealth from the bottom to the very top of the economic ladder.

But they have completely failed to engineer a revival of productive business investment, the original justification given for their implementation. They have done the opposite, encouraging a growth of financial parasitism and speculation even beyond the manic levels that led to the 2008 crash in the first place. Business investment in North America and Europe has failed to return to its pre-2008 levels.

Banks and corporations are hoarding their vast profits and using a portion of them to increase the holdings of executives and big investors through stock buybacks, dividend increases and mergers and acquisitions—all entirely non-productive and socially destructive activities that generally involve job losses rather than gains.

In her remarks, Yellen alluded in passing to the decline in business investment, noting that despite improvements in the job market and consumer spending, this essential barometer of economic health remained “soft.” The other crucial measure of economic strength, labor productivity, is also in decline, having dropped in the US for three straight quarters, the first time that has occurred since 1979. The sharp slowing of labor productivity is bound up with the depression in business investment, an essential catalyst for increasing the rate of output.

The seriousness of the underlying crisis was reflected in Yellen’s further comments on the neutral interest rate. “By some calculations,” she said, “the real neutral rate is currently close to zero, and it could remain at this low level if we were to continue to see slow productivity growth and high global saving. If so, then the average level of the nominal federal funds rate down the road might turn out to be only 2 percent.”

While conceding that a continuation of ultra-low interest rates and massive subsidies to the financial system “might inadvertently encourage excessive risk-taking and so undermine financial stability,” the Fed chair concluded, “Despite these caveats, I expect that forward guidance and asset purchases will remain important components of the Fed’s policy tool kit.”

In fact, these policies have already produced financial and asset bubbles that are unsustainable, and there are increasing signs of financial instability and crisis. There are growing warnings that the spread of negative interest rates is leading to a new financial meltdown even worse than the disaster that struck eight years ago.

Fed Vice Chairman Fischer was more blunt in a speech he gave on August 21 to a conference of the Aspen Institute in Colorado. He noted that the “decline in estimates of the neutral interest rate” was “related to the fear that we are facing a prolonged period of secular stagnation.” The latter term denotes a state of indefinite economic stagnation and slump, in which low interest rates are ineffective in boosting growth.

Noting that real growth in the US gross domestic product over the past year is estimated at only 1.0 percent to 1.25 percent, he focused on the role of what he called “exceptionally low productivity growth.”

He pointed out that “output per hour increased only 1.0 to 1.25 percent per year on average from 2006 to 2015, compared with its long-run average of 2.0 to 2.5 percent from 1949 to 2005.” He called a 1.0 to 1.25 percent point slowdown in productivity growth a “massive change.”

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