Interest Rates and the US Economy. The Capitulation of Federal Reserve Chairman Jerome Powell

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This past week, on March 20, 2019, Federal Reserve chairman Jerome Powell announced the US central bank would not raise interest rates in 2019. The Fed's benchmark rate, called the Fed Funds rate, is thus frozen at 2.375% for the foreseeable future–i.e. leaving the central bank virtually no room to lower rates in the event of the next recession, which is now just around the corner.

The Fed's formal decision to freeze rates follows Powell's prior earlier January 2019 announcement that the Fed was suspending its 2018 plan to raise rates three to four more times in 2019. That came in the wake of intense Trump and business pressure in December to get Powell and the Fed to stop raising rates. The administration had begun to panic by mid-December as financial markets appeared in freefall since October. Treasury Secretary, Steve Mnuchin, hurriedly called a dozen, still unknown influential big capitalists and bankers to his office in Washington the week before the Christmas holiday. With stock markets plunging 30% in just six weeks, junk bond markets freezing up, oil futures prices plummeting 40%, etc., it was beginning to look like 2008 all over again. Public mouthpieces for the business community in the media and business press were calling for Trump to fire Fed chair Powell and Trump on December 24 issued his strongest threat and warning to Powell to stop raising rates to stop financial markets imploding further.

In early January, in response to the growing crescendo of criticism, Powell announced the central bank would adopt a 'wait and see' attitude whether or not to raise rates further. The Fed's prior announced plan, in effect during 2017-18, to raise rates 3 to 4 more times in 2019 was thus swept from the table. So much for perennial academic economist gibberish about central banks being independent! Or the Fed's long held claim that it doesn't change policy in response to developments in financial markets!

This week's subsequent March 20, 2019 Fed announcement makes its unmistakenly official: no more rate hikes this year! And given the slowing US and global economies, and upcoming election cycle next year, there's essentially no rate hikes on the horizon in 2020 as well.

Central bank interest rate policy is now essentially 'dead in the water', in other words, locked into a ceiling at 2.375%, which makes it now a useless tool to address the next economic downturn around the corner.

The US Economic Slowdown Has Arrived

For those who believe the business press and government 'spin' that the US economy is doing great, and recession is not just around the corner, consider that US retail sales have fallen sharply in recent months. In December they declined by -1.6%, the biggest since September 2009. Residential and commercial construction has been contracting throughout 2018. In January, manufacturing, led by autos, dropped by -0.9%. The manufacturing PMI indicator has hit a 21-month low. Despite Trump's early 2018 multi-trillion dollar business-investor tax cuts, investment in plant and equipment growth by year end slowed by two thirds over the course of 2018. Recent surveys show CEO business confidence has declined the last four quarters in a row—i.e. a bad omen for future business spending on equipment and inventories. Despite Trump's 'trade wars', the US trade deficit finished the year at a record $800 billion in the red. Service sector revenues rose a paltry 1.2% in the fourth quarter 2018 compared to the same period a year earlier.

And word is out that the US GDP for fourth quarter 2018 will soon be revised downward. Initially posted at 3.1%, in February it was reduced to 2.6%. Next week, in April, it will be reduced still further, to 1.8% or less, according to JP Morgan researchers. Meanwhile various bank research and other independent sources are predicting a 1st quarter 2019 US GDP of only 1.1%, and possibly even less than 1%. The economic scenario predicted by this writer a year ago is thus materializing.

Trump's economy is clearly in trouble. And now he's on an offensive to get the central bank not only to halt rate hikes, but to start lowering interest rates before the end of this year. And if Powell doesn't comply, watch for the Trump and right wing to push for firing Fed chair, Powell, as well.

To head off Trump-Investor offensive against the central bank, Fed chairman Powell held an historically unprecedented public interview with the national 60-minutes TV show in early March. He attempted to placate Trump and the growing attacks. Only Fed chairman, Ben Bernanke, held a similar public interview—during the worst depths of the collapse of the US economy in 2008. Trump's latest tactic has been to nominate Steven Moore as a Fed governor. Moore is one of those right winger economists affiliated with the Heritage think tank. He publicly called for Trump to fire Powell during the December near-panic over the US stock market's plunge. Watch Powell and the Fed therefore drift over the course of 2019, toward not just freezing Fed rates, but lowering them as well by year end.

Monetary Policy Tools Collapsing?

The current peaking of the Fed's rate at 2.375% compares to a Fed peak interest rate of 5.25% in 2007 just before the onset of the last recession; a 6.5% peak on the eve of the preceding recession in 2000; and the 8% peak rate just before the 1991 recession. In other words, Fed rate policy effectiveness has been deteriorating over the longer run for some time, and not just recently.

That deterioration is traceable to Fed policy since the 1980s, which has been shifting from using interest rates to stabilize the economy (low rates to stimulate economic growth/higher rates to dampen inflation) to a policy of ensuring long term low interest rates as a means for subsidizing banks, businesses and capital incomes in general.

Chronic, low rates subsidize business profits by lowering borrowing costs and, in addition, by incentivizing corporations to also issue trillions of dollars of new (low cost to them) corporate bond debt. Money capital from the record profits and the cheap debt raised are then distributed to shareholders and managers via stock buybacks and dividend payouts—which have averaged more than $1 trillion a year every year since 2010 and in 2018 alone hit a record $1.3 trillion. But the chronic, low rates are the originating source of it all, i.e. the 'enabler'.

While Fed (low) rate policy has become a major means for subsidization of capital incomes, after each business cycle the rates cannot be restored to their pre-recession levels—leaving the Fed now with its mere 2.375% rate level as it enters the next recession. The rate level at the end of the cycle ratchets down. In other words, the Fed's interest rate gun is reloaded with fewer bullets. It is now close to being out of ammunition.

Beyond Quantitative Easing, QE

The declining effectiveness of interest rate policy has forced the Fed, at least in part, to develop another monetary tool the past decade, so-called Quantitative Easing (QE). The introduction of QE in 2009 in the US (and earlier by the Bank of Japan which originated the idea) should be viewed in part, therefore, as a desperate attempt to create a new tool as interest rates have become increasingly ineffective at stopping or even slowing a business cycle contraction or at stimulating an economic recovery from recession. With QE the central bank goes directly to investors and buys up their bad debt by providing them virtually free money at ultra-low (0.1%) rates. QE is therefore about the Fed transferring the bad debt from investors and banks' balance sheets directly onto the Fed's own balance sheet. But that subsidization via debt off loading and low long term rates also reduces the effectiveness of monetary policy performing its historic role of economic stabilization—i.e. stimulating economic growth or dampening inflation.

During the period 2009 to 2016 the Fed's QE program transferred between $4.5 trillion to $5.5 trillion from investors to its own balance sheet. And if one counts other major central banks in Europe, Japan, and China the amount of debt offloaded from bankers and investors to central banks amounted to between $20 to $25 trillion.

To prepare for the next business cycle crash and recession, the Fed and other central banks in recent years announced they would begin to 'sell off' their bloated balance sheet debt. The purpose was to 'clean up' the central bank's balance sheet so it could absorb and transfer even more corporate-investor bad debt to itself during the next crash. (This debt sell off was called 'Quantitative Tightening' or QT). The Fed was first among central banks to begin the sell off, with a token $30 billion a month. Other central banks in Europe declared they too would do so but have since abandoned the pretense. The Bank of Japan with its $T to $5T debt never even pretended. So the world's central banks remain bloated with tens of trillions of dollars equivalent in off-loaded corporate-investor debt from the last crisis of 2008-09 and face the prospect of even tens of trillions more—and possibly much more—in the next crisis.

However, Powell further announced on March 20 that the Fed will also halt, by September 2019, its QT sell off. Like interest rate policy, QE/QT policy, is also likely now 'dead in the water'.

Can the Fed add $5T to $10T more in QE come the next crisis? (And the world's major central banks add another $30T more in addition to their current $20T?) Perhaps, but not likely.

Doubling QE and Fed balance sheet debt is not any more likely than the Fed significantly lowering interest rates come the next crisis. Even less so for the Europeans and Japanese, whose interest rates are already less than zero—i.e. negative.

Central Banks as Capital Incomes Subsidization Vehicles

What's becoming increasingly clear is that in the 21st century capitalist economies—the US and others—are having increasing difficulty generating profits and real investment from normal business activity. Consequently, they are turning to their Capitalist States to subsidize their 'bottom line'. Central banks have become a major engine of such subsidization of profits and capital incomes. But that 'subsidization function' is in turn destroying central banks' ability to perform their historic role to stimulate economic growth and/or dampening inflation. The latter historic functions deteriorate and decline as the new subsidization of profits and capital incomes become increasingly paramount. The historic functions and the new function of central banks as engines of capital subsidization are, in other words, mutually exclusive.

The same subsidization by the State is evident in fiscal policy, especially tax policy. Once the Fed started raising rates in late 2016 the policy shifted from monetary tools to subsidize capital in comes to fiscal tax policy as primary means of subsidization.

Since 2001 in the US alone business and investor and wealthy households have been provided by the Capitalist State with no less than $15 trillion in tax reductions. Like low rates & QE, that too has mostly found its way into stock buybacks, dividend payouts, mergers & acquisitions, etc. which have fueled in turn unprecedented financial asset market bubbles in stocks, bonds, derivatives, foreign exchange speculation, and property values since 2000. And by such transmission mechanisms, the accelerating income and wealth inequality trends in the US and elsewhere.

Business-Investor Tax Cutting as Subsidization Vehicle

While subsidization via tax cutting has been going on since Reagan, it accelerated since 2000 under Bush and continued under Obama. But it has accelerated still further under Trump. The impact of the Trump tax cuts is most evident on 2018 Fortune 500 profits. No less than 22% of the 27% rise in 2018 in Fortune 500 profits has been estimated as due to the windfall of the Trump tax cuts for businesses and corporations. The total subsidization of business-investors over the next decade due to the Trump tax cuts is no less than $4.5 trillion—offset by $1.5 trillion increase in taxes on middle class households and Trump's phony assumptions about GDP growth that reduces the $4.5 trillion further to a fictitious $1.5 trillion negative hit to the US budget.

The subsidization via tax cutting has also generated record US budget deficits and national debt levels that have been doubling roughly every decade—from roughly $5 trillion in 2000 to $10-$11 trillion by 2010, to $22 trillion by 2019, with projections to $34-$37 trillion or more by 2030. Roughly 60% of the US budget deficits and debt are attributable to tax policy and loss of tax revenues.

Bail-Ins: Next Generation Monetary Tool?

Long touted by mainstream economists as 'tools of stabilization and growth', in reality both central bank monetary policy (rates, QE, etc.) and government fiscal policy (business-investor tax cuts) have been steadily morphing into means of subsidization of capital incomes. Having become so, the ability of both monetary (central bank) and fiscal policy to address the next major crisis could prove extremely disappointing.

Monetary policies of low interest rates and even QE are now 'played out', as they say. And with US debt at $22.5 trillion, going to $34 trillion or more by 2027, fiscal policy as means to stimulate the economy is also seriously compromised.
So what are the likely policy responses the next recession? On the monetary side, watch for what is called 'bail ins'. The banks and investors will be bailed out next time by forcing depositors to convert their cash savings in the banks to worthless bank stock. That's a plan in the US and UK already 'on the books' and awaiting implementation—a plan that has already been piloted in Europe.

On the fiscal-tax side, watch for a renewed intensive attack on social security, medicare, education, food stamps, housing support and all the rest of social programs that don't directly boost corporate profits. The outlines are clear in Trump's just released most recent budget, projecting $2.7 trillion in such cuts. And of course Trump & Co. will continue to propose still more tax cuts, which has already begun in a number of forms.

In other words, as both monetary and fiscal policy become increasingly ineffective in the 21st century as means to address recessions and/or restore economic growth, they are simultaneously being transformed instead into tools for subsidizing capital incomes–during, before, and after economic crises!

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