Financial FAQs: Should the Fed Raise Rates?

By **Harlan Green** / Special to Voice

IT'S INCREDIBLE THAT JANET YELLEN'S FED should even be talking about raising interest rates in June or July. The Fed predicts no more than 2.5 percent GDP growth in Q2, after Q1's 0.8 percent growth rate. And the May unemployment report was the worst since 2010 with just 38,000 nonfarm payroll jobs created.

"It's appropriate – and I've said this in the past – for the Fed to gradually and cautiously increase our overnight interest rate over time," Yellen said last Friday during remarks at Harvard University in Cambridge, Massachusetts. "Probably in the coming months such a move would be appropriate."

Really? Most industries cut jobs last month, the first time that's happened in several years. The increase in hiring was also the smallest since the fall of 2010. Economists polled by MarketWatch had predicted an increase of 155,000 nonfarm jobs.

This happened even though the unemployment rate fell to 4.7 percent from five percent to mark the lowest level since the month before the Great Recession began in December 2007. But the decline owed almost entirely to 458,000 people leaving the labor force.

Adults over 25 without a high-school diploma accounted for about two-thirds of the drop in the labor force, about ten times the impact they should have had given their share of the population. More than half of those who dropped out were people over 55 years old. Most of them were white.

What is the Fed and Yellen thinking? Inflation expectations are way down, as well as consumer sentiment (one of their red flags for incipient, future inflation that Fed hawks love to cite in their push to raise interest rates – read the banking lobby).

The expectations component for future business looks better, up 7.3 points from April to 84.9, and that ultimately reflects confidence in the jobs outlook. But the one year inflation outlook fell another one tenth at month's end to 2.4 percent for a major decline of four tenths from April. Like the decline underway in business investment, the decline in inflation expectations could also derail chances for a June hike.

The real problem is the severe drop in capex, or capital expenditures, due in large part to declining oil production. Without business investment, jobs cannot continue to grow and full employment should be the primary goal of Fed policy, rather than fighting non-existent inflation.

A historical rule of thumb is that a two percent inflation rate means two percent growth, whereas three percent inflation usually means three percent plus growth, and we should be shooting for a three percent plus growth rate, as in past decades.

This is while new orders for core capital goods, a reading that excludes defense goods and commercial aircraft, fell a very sharp 0.8 percent for the month of April. It is the third straight decline and the fifth out of the last six months in a string that has taken this reading to a five-year low. Year-on-year, orders are squarely in the negative column at minus five percent and are down 12 percent from their cycle peak in September 2014.

We need to encourage a bit more inflation, in other words, which in turn should improve profits and so encourage more job creation.

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