No reason to raise rates now, writes heterodox economist

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Next month, the Federal Reserve Board is—or was, until the November 8 election—expected to raise its benchmark interest rate by a quarter-point. But a new paper from the Levy Economics Institute at Bard College (home of "heterodox" economics") claims that the U.S. economy isn't nearly strong enough yet to merit an uptick in rates.

In the **paper**, "Normalizing the Fed Funds Rate: The Fed's Unjustified Rationale," economist Flavia Dantas of SUNY-Cortland, claims that the U.S. job market is much softer than the official 4.9% unemployment rate would suggest. She estimates that we're million of jobs away from a level of employment that would trigger serious inflation and force the Fed to tighten.

"The urgency and rationale behind the rate hikes are not theoretically sound or empirically justified," Dantas writes. "Despite policymakers' celebration of 'substantial' labor market progress, we are still short some 20 million jobs… Also, there is little empirical evidence or theoretical support for the FRB's suggestion that higher interest rates are necessary to counter 'excessive' risk-taking or provide a more stable financial environment."

Professor Dantas believes that inflation is low because the necessary ingredients for it—high employment levels and upward pressure on wages—are absent from the economy. The real unemployment rate is about 12%, she writes, if you count the 7.7 million people officially unemployed today, the 6.1 million people who are employed part-time but would like full-time jobs, and the 7.4 million unemployed who are implied by the 2.9% decline in the U.S. labor force participation rate since the Great Recession.

Dantas blames that situation not on growth-stifling governmental policies but on the decline of labor unions and the subsequent loss of workers' strength to bargain for higher wages. Only in the unlikely event that employment and wages increase substantially, she believes, inflation will not become a threat and the Fed will have no reason to raise rates.

That could change, she concedes, if the government chooses to spend a lot of money and put a lot of people to work, but "Without a stronger fiscal spending response, the slack in the labor market is likely to remain, as are low levels of inflation."

As for those who believe that low interest rates and the excess reserves that remain in the banking system will foster inflation regardless of developments on the employment front, Dantas, like other heterodox economists, disputes the idea that the banks' ability to lend money necessarily will result in indiscriminant lending and high inflation.

“Easy credit conditions,” she writes, “cannot stimulate the economy or cause a credit boom when the expected proceeds from position taking in real assets are low or the private sector wishes to deleverage their position by retiring their IOUs.”