Fed’s concern over prospect of a wages movement jolts markets

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Indications by the new chairman of the US Federal Reserve, Jerome Powell, that the Fed could lift interest rates as many as four times this year in response to concerns over a possible wages push by US workers led to sharp sell-off in financial markets on Tuesday and Wednesday.

The Dow was down by 380 points Wednesday in volatile trading, with markets falling sharply towards the close of trading.

Powell’s indication of faster than expected interest rate increases came in a question-and-answer session after he had delivered his prepared testimony at a semi-annual hearing of the House Financial Services Committee on Tuesday. Powell will appear before the Senate Finance Committee today, where he will be questioned further on his outlook for the US economy and the Fed’s monetary policy.

The markets did not respond to Powell’s prepared testimony, but then moved sharply down, with the Dow finishing lower by almost 300 points for the day on Tuesday, in response to his replies to questions.

Powell noted that in December the balance of opinion on the Fed’s policy-making Open Market Committee was for three rises in 2018. “But since then,” he said, “what we’ve seen is incoming data that suggests a strengthening in the economy. We’ve seen continuing strength in the labour market. We’ve seen some data that will, in my case, add some confidence to my view that inflation is moving up to target. We’ve also seen continued strength around the globe. And we’ve seen fiscal policy become more stimulative.”

Powell said that when it came to projecting future rate increases at the Fed’s upcoming March meeting, at which a quarter percentage point rise is almost certain to be announced, he and other members of the Open Market Committee would be “taking into account everything that’s happened since December.”

These remarks sent the yield on the benchmark 10-year Treasury bond to over 2.9 percent, compared to about 2.4 percent last year, and raised market expectations that there would be at least three rises this year and possibly four.

One of the key aspects of Powell’s question-time comments was his view on the “continuing strength in the labour market.” When the market entered a period of turbulence earlier this month it was triggered by a report that the annual increase in wages had come in at a higher-than-expected level of 2.9 percent.

As we noted at the time, while the rise was relatively small, “it triggered a major response in financial markets because of fears of what it could signify: a resurgence of class struggle, as workers in the United States and around the world begin to push back against the decades-long suppression of wages and decline in working class living standards.”

The continued suppression of wages has been at the very centre of the profit accumulation process for major US corporations, and the Fed is particularly sensitive to any signs that a fall in unemployment will lift labour costs.

The first line of defence for the corporate elites is the trade union bureaucracy, but if that fails, then the Fed has indicated it stands ready to use the weapon of higher interest rates.

The nervousness on the financial markets may have been compounded by news that striking teachers in West Virginia were denouncing a sellout agreement announced Tuesday by teachers’ union leaders and planning to defy their call for a return to work on Thursday.

Concerns over a possible wages push were also expressed in a Fed report released in conjunction with

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Powell's testimony. It noted that the labour market had continued to strengthen since the middle of last year, with a fall in the official jobless rate from 4.3 to 4.1 percent and other measures of labour utilization suggesting that "the labour market has tightened since last summer."

Further elaborating on the crucial labour market question, the report said that while there was no way to know with precision, "the labour market appears to be near or a little beyond full employment at present." The unemployment rate was somewhat below most estimates of its long-run normal rate, while the labour participation rate was relatively close to many estimates of its trend.

In an article headlined "Powell's first problem: Taming the job market," the *Wall Street Journal* drew attention to these passages in the Fed report.

"If the Fed really thinks the labour market might be 'a little beyond full employment,' it may think it needs to lean against the labour market in order to prevent problems later."

In other words, interest rates will have to be lifted in order to cut back economic expansion and increase the jobless rate, so as to put downward pressure on wage demands.

Another significant aspect of Powell's testimony was that he steered away from expressing any concern about inequality, in contrast to his predecessor Janet Yellen, who had made reference to it.

As expected, Powell also indicated that the Fed will loosen some of the limits on the activity of banks—an issue that has been pushed by Wall Street—with one of the changes allowing them to reduce their capital requirements, thereby enabling large banks to increase their holdings of borrowed money. He said the aim of the changes was to reduce the burden of regulation "without losing any safety and soundness." Regulations on smaller banks would also be lessened.

Powell brushed aside concerns in some financial circles that the continued rise in the share market is creating a bubble that could lead to a crisis, saying that while the Fed had to be alert to the build-up of financial imbalances, the risk did not appear to be high.

He said that while there was also a risk of recession at some point in time, it was not "at all high at the moment."

However, there are fears that over the longer term the ultra-low interest rates since the global financial crisis of 2008 may leave the Fed without sufficient fire power to combat any significant downturn in the US economy, and so it should start raising rates now.

As an article in the *New York Times* noted: "The Fed's benchmark rate is in a range to 1.5 percent, and the Fed does not expect it to rise much higher than 3 percent in the current economic expansion. That's a problem given that, in the last four downturns, the Fed has cut rates by an average of 5.5 percentage points to stimulate renewed growth."

These problems are compounded by the fact that since the 2008 crisis, the Fed's holdings of financial assets have expanded by nearly five-fold, from $800 billion to more than $4 trillion. This means that in contrast to the situation in 2008, when it stood to a certain extent outside the financial markets, it is now a central player in them and would itself be significantly impacted by any crisis.

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