Inflation and threat of interest rate rise send tremor through financial markets

Nick Beams
23 January 2022

There are increasing signs of nervousness in financial markets, as inflation surges and central banks move to tighten monetary policy, compounded by concerns in corporate circles of a wages push by workers as price rises cut living standards.

Last week global stock markets experienced their biggest falls in more than a year, led by a sharp decline in Wall Street's tech-heavy NASDAQ index, which dropped by 7.6 percent for the week. It was the biggest decline since March 2020 and the financial crisis at the start of the pandemic that led to the multi-trillion intervention by the US central bank.

The decline was led by Netflix which fell 22 percent on Friday after it reported subscriber growth was expected to slow. The streaming group lost $49 billion of its market valuation.

The NASDAQ index has now fallen by more than 10 percent since it reached its record high last November and is now designated as being in "correction" territory. But the sell-off goes beyond the high-tech sector.

The S&P 500 index, the broadest measure of the $50 trillion US stock market, lost 5.7 percent for the week. The *Financial Times* reported that more than two-thirds of the companies in the index had lost 10 percent of their value since recording their record highs, with 1,490 stocks declining 20 percent or more.

The FT reported that its All-World index, covering developed and emerging markets, fell 4.2 percent for the week, its biggest decline since October 2020.

There have been sell-offs in the market over the past year and more, but they have been followed by a rise to new record highs as big investors and speculators "bought the dip," confident that the flow of ultra-cheap money from the Fed would ensure the continuation of the stock market rise.

However, with inflation in the US now running at 7 percent and threatening to go higher, and the Fed getting ready to lift interest rates with possibly as many as four rises this year, each of 0.25 percentage points, this strategy is being called into question. A few months ago, the expectation was there would only be one rise in 2022.

Another indication of tightening monetary policy is that the Fed decided that besides winding down its asset purchases at an accelerated rate—ending them completely by March—it would start discussing reducing its holdings of financial assets. These have exploded to $9 trillion as a result of the support given to financial markets since the market meltdown of March 2020.

In some circles the reduction of asset holdings is regarded as more significant than interest rate increases. There was a violent market reaction at the end of 2018 when this program was last on the agenda—forcing a swift reversal.

Of the major central banks, both the Fed and the Bank of England are committed to rate rises. In the UK the inflation rate hit 5.4 percent in December, its highest level in 30 years, with further increases expected and predictions that it could go as high as 7 percent.

However, the European Central Bank appears to have ruled out interest rate increases for the immediate future. This is not because inflation is less in Europe. The data for December show inflation was at 5 percent—the highest level since the creation of the eurozone and well above the ECB's target rate of 2 percent.

However, ECB president Christine Lagarde, in a radio interview on Thursday, ruled out an immediate rise, saying the cycle of "economic recovery" in the US was ahead of that in Europe, so the ECB has "every reason not to act as ruthlessly as one might imagine with the Fed."

The reason for Lagarde's caution is that a rate rise—favoured by northern European countries—could create what three German economists described in an article this week as "serious problems for highly indebted eurozone members." Italy is the main country that would be affected.

The chief concern of the central banks and the financial oligarchy more broadly is not inflation as such, but its effect on the class struggle as workers are compelled to fight for higher wages.

Speaking to a House of Commons committee last Wednesday, the governor of the Bank of England, Andrew Bailey, commented: "It is a very tight labour market and that is a concern ... and it's got the potential to put a lot of pressure on earnings and on wage negotiations."

These concerns were echoed in a major editorial last week by the FT, the voice of British and global finance capital. It said the US inflation rate of 7 percent was the highest since 1980 when then Fed chair, Paul Volcker, lifted interest rates to record highs, inducing the most severe recession to that point since the 1930s, in order to crush workers' wage demands in the name of bringing down inflation.

The FT editorial canvassed the possibility that such measures may be necessary again.

"While there are some signs from surveys of manufacturing companies that bottlenecks are easing, cost pressures are becoming visible in the jobs market," it said. "That risks creating the kind of self-sustaining inflation, driven by expectations of price increases, that led Volcker to take such drastic measures more than four decades ago."

The editorial noted that quit rates in the US have spiked and "if wage growth is sustained it may begin to compensate for 40 years or so of stagnation." Here the editorial was pointing to one of the key mechanisms that, apart from the flow of cheap money from the central banks, has sustained the stock market boom: the suppression of workers' wages, enforced by the trade union bureaucracies, and the transfer of wealth into the coffers of the financial oligarchy.

Other comments go in the same direction. In an interview with the FT last week, David Solomon, the chief executive of Goldman Sachs, one of the chief beneficiaries of the financial boom, said there was "wage inflation everywhere."

"The pressure everywhere comes from the enormous amount of monetary and financial stimulus that's changed dynamics. It comes from the fact that we're really operating with nearly full employment."

Solomon did not go as far as the FT editorial, but the implication of his remarks was clear. If wage rises cannot be contained, despite the strenuous efforts of the trade unions to ensure this, then Volcker-type measures will be needed.

A similar scenario was set out in a *Wall Street Journal* article on January 12 headlined "Watching for a Wage-Price Spiral."

"What the Fed doesn't want to see is an environment where wage increases are pushing prices significantly higher, while a tight labour market and expectations of higher inflation are leading workers to command outsize wage increases." That could force the Fed to "raise interest rates sharply, and risk a recession."

It could also lead to a collapse of the financial house of cards that has been created by the past policies of the Fed to pump trillions of dollars into the financial system, going back to the decision by Fed Chair Alan Greenspan to provide continuous support for Wall Street in the wake of the October 1987 stock market crash.

The unprecedented level of speculation since the market bailout of 2020—the explosion of cryptocurrencies, meme stocks, special purpose acquisition companies, the increase in riskier leveraged loans, the rise and rise of figures such as Elon Musk, the head of Tesla, to name but a few examples—is the surest indication of a disaster in the making.

Last week, long-time investor Jeremy Grantham repeated earlier warnings that a crash is in the pipeline. There were simultaneous bubbles across the major asset classes, he wrote.

These were: the broadest and most extreme global real estate bubble in history; the most exuberant, ecstatic and even crazy behaviour in the stock market; and the highest priced bond markets in the US and around the world and correspondingly the lowest interest rates in history. And on top of this overpriced commodities, including food, were at a record high.

Grantham first issued a warning a year ago but since then, he wrote, "the bubble advanced to the category of a super bubble."

He warned that when pessimism returned to Wall Street "we face the largest potential mark down of wealth in US history" possibly wiping out as much as $35 trillion in market value.

It is not possible to predict the course of the markets, but one thing is for certain: if they experience anything approaching a major collapse it will be accompanied by an onslaught against the working class as indicated by the warnings being sounded in leading financial circles about workers' wage demands.