Fed set to lift interest rates amid concerns over “very, very tight” labour market

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The US Federal Reserve has signalled its intention to lift its base interest rate in March in the first hike since 2018 and to begin winding down its $9 trillion balance sheet in response to inflation now at its highest level in 40 years.

Its chief concern on the inflation front is that workers will continue to push for higher wages to compensate for the loss of income as inflation hits 7 percent, with expectations it will rise further.

Speaking at the press conference following the two-day meeting of the Federal Open Market Committee (FOMC) yesterday, Fed chair Jerome Powell said: “In light of the remarkable progress we’ve seen in the labour market and inflation that is well above our ... goal, the economy no longer needs sustained high monetary policy support.”

He said the FOMC was “of a mind to raise the federal funds rate at the March meeting assuming that conditions are appropriate for doing so.”

In his prepared remarks Powell continually focused on the state of the labour market as the reason for a tightening monetary policy.

For most of last year, as prices began to rise, Powell and other members of the Fed’s governing body maintained it was “transitory” and associated with problems in re-opening the economy, particularly supply chain bottlenecks. But in November the Fed warned it was spreading more broadly and becoming entrenched. Since then, the focus has been on what the response will be in the working class under conditions of a tightening labour market.

Noting that the labour market “by many measures was very strong,” Powell said that with “constraints on labour supply, employers are having difficulties filling job openings and wages are rising at their fastest pace in many years.”

He said that, while the drivers of higher inflation had been predominantly connected to dislocations resulting from the pandemic, “price increases have now spread to a broader range of goods and services. Wages have also risen briskly, and we are attentive to the risks that persistent real wage growth in excess of productivity could put upward pressure on inflation.”

The Fed would use its tools to “prevent inflation from becoming entrenched” and in answer to a question referred to a “very, very tight” labour market.

Since the start of the year, the expectation of higher interest rates and a tightening of monetary policy has resulted in significant falls on Wall Street with major indexes close to or exceeding a decline of 10 percent—so-called “correction” territory.

In the past days there have been major swings with the market falling and then being followed by upward movements, with the Dow moving by more than one thousand points during a day.

These gyrations are the outcome of two different assessments among investors and speculators as to the direction of Fed policy. The upward movements are the result of “buying the dip” by sections of finance capital confident the Fed will back off from monetary tightening if the market falls.

They have considerable reasons for this belief because this has been the response of the Fed ever since the October 1987 stock market crash when the then Fed chair, Alan Greenspan, guaranteed the central bank would back Wall Street.

The so-called “Greenspan put” was in operation in the last round of Fed tightening at the end of 2018 when Powell reversed course after significant market turbulence in December of that year.

On the other side, the assessment is that, while the Fed will continue to prop Wall Street, the previous conditions no longer apply because of the elevated levels of inflation and the necessity to clamp down on wage demands.

Speaking to the business channel CNBC this week, Peter Boockvar, chief investment officer at the Bleakley Advisory Group, pointed to the "circular nature" of the Fed's monetary policy.

"It gooses asset prices when they are pedal to the metal, and asset prices fall when they back off. The difference this time is they have rates at zero and inflation is at 7 percent. So they have no choice but to react. Right now, they are not going to roll over for the markets just yet."

Goldman Sachs chief economist Jan Hatzius was more explicit, telling CNBC it would be difficult to have wage increases of between 5 and 6 percent without causing "meaningfully high" inflation. The pace of wage rises, which even at 6 percent are still below inflation, needed to slow down and this is what the Fed and the financial markets had to focus on, he said.

Hatzius was echoing remarks of his boss, Goldman Sachs CEO David Solomon, who told the *Financial Times* in a recent interview that "there is real wage inflation everywhere."

These two conflicting assessments of the direction of Fed policy—one that it will back down from monetary tightening because of its impact on stock prices, the other that it will be forced to press ahead because of inflation and wage demands—were in evidence in Wall Street's reaction to the Fed's meeting.

The market rose when the Fed's policy statement was released at 2pm because it was assessed to be "dovish" but then started to fall during Powell's press conference as his remarks, particularly with regard to the persistence and scope of inflation, were deemed to be "hawkish."

The other issue of concern for financial markets, possibly greater than interest rate increases, is the winding down of the Fed's asset holdings.

From a level of around $800 billion before the global financial crisis of 2008, they expanded to just under $4 trillion in its aftermath. They have since leapt again to almost $9 trillion as a result of the Fed's measure to prop up Wall Street following the market meltdown of March 2020, which threatened to go even beyond that of 2008.

The FOMC has begun discussions about how to begin to reduce its asset holdings, which now play a central role in the financial system, and has released a statement outlining the principles on which such a reduction will be undertaken.

The statement said changes in the Fed rate would be the primary means of adjusting the stance of monetary policy.

During his press conference Powell said when the asset reduction began it would remain in the "background." But that is not the view within the financial markets because it is considered that the Fed's asset holdings are one of the chief means for the provision of ultra-cheap money that has sent the stock market to record highs during the pandemic.

It was noted that during the Powell's press conference they were some 23 references to the issue of the Fed's balance sheet. During the market turmoil at the end of 2018—before the further massive injection of funds in response to the pandemic—the reduction of the Fed's holdings, which Powell had described as being on "auto pilot," was of greater concern in some quarters than planned interest rate rises.

Asked about financial stability concerns at the end of his press conference, Powell maintained that asset bubbles were not a risk and there was financial stability in banks and businesses but there were some "issues" in the Treasury market the Fed was looking at.

What happened in March 2020 was more than an "issue." The $22 trillion US Treasury market—the basis of the global financial system—basically ceased to function. The Fed may have examined the problem but nearly two years on it has not devised any solution and the underlying instability remains.