US Fed targets wage demands as it lifts interest rate

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As anticipated, the US Federal Reserve yesterday lifted its base interest rate by 0.25 percentage points and indicated it expects to raise it by a similar amount at each of the six remaining meetings this year.

It has also said it will start to reduce the Fed's asset holdings of $9 trillion at a "coming" meeting, possibly as early as May, in another move to tighten monetary policy to counter rising inflation, now running at its highest level in four decades.

Prices rose at an annual rate of 7.9 percent in February with predictions the inflation rate could hit double digits because of higher oil prices and price hikes in other basic commodities due to the war crisis in eastern Europe.

The main impetus for the decision was the fear in ruling financial circles that inflation is going to drive a push by workers for higher wages to combat the decline over the past three decades and the rapid worsening of living standards over the past two years.

Fed chair Jerome Powell made clear a clampdown on higher wages was the central issue in his opening remarks to the press conference following the meeting of the Federal Open Market Committee (FOMC).

He said the economy was very strong against "the backdrop of an extremely tight labour market and high inflation." He described the labour market as continuing to "strengthen" and "extremely tight." The demand for labour was "very strong" and "wages are rising at their fastest pace in many years."

He did not mention the fact that even though there have been some increases, the level of real wages is falling behind the present level of inflation, and the expected rises in coming months.

The same themes were repeated in the question-and-answer session following his opening remarks as Powell returned again and again to the wages issue.

In response to one journalist, who noted that many economists were saying inflation could not be brought down without higher unemployment, Powell said there was a "very, very tight labour market, tight to a level that's unhealthy."

In response to another question, he said that wages had moved at a "higher rate than in a very long time." Returning to this theme at a later point, he said wages were moving up faster than is consistent with the Fed's target rate of 2 percent inflation.

The Fed's interest rate increases will make virtually no impact on price rises which are the result of supply chain bottlenecks and now the surge in commodity prices. Rather their aim, as Powell indicated, is to reduce demand in the broader economy and bring down the ratio of job vacancies to job seekers from its present level of 1.7.

In other words, even before workers try to claw back some of the trillions of dollars that have been siphoned off by the corporations over the past decades because of low wages, the Fed will seek to ensure this movement is crushed. This was the content of Powell's repeated assertions that the aim of the Fed was to ensure that inflation did not become "entrenched."

How far Powell is prepared to go was indicated in revealing remarks he made at a Senate hearing on March 3.

Republican senator Richard Shelby asked whether he would follow the example of Fed chair Paul Volcker in the 1980s, who drove up interest rates to record highs, inducing the deepest recession to that point since the 1930s, to drive down wages.

In response, Powell launched into a hymn of praise. After describing Volcker as a great public servant, he concluded: "I would hope history will record that the answer to your question is yes."

There was another remarkable feature of Powell's press conference.

With one exception there were no questions on what effect the turmoil in international financial markets would have on the US and Fed policy. Surging commodity prices and the danger of an imminent Russian default have led to parallels being drawn with the collapse of the hedge fund Long-Term Capital Management in 1998 when Russia last defaulted, and warnings that the global financial system faced a possible Lehman moment.

However, the sole questioner who referred to the financial dangers, asking whether there were any concerns about the effect of the sanctions on Russia, was simply brushed aside.

Powell started by declaring that central bankers were in favour of the sanctions but then said he was reluctant to comment any further because sanctions were the province of governments, and the role of central banks was to provide technical assistance.

After an initial dip, the response on Wall Street was favourable.

The Dow rose by more than 500 points, an increase of 1.5 percent. The S&P 500 was up by 2.2 percent, bringing its rise over the last two days to 4.4 percent, the largest such increase since April 2020. The tech-heavy NASDAQ index was up 3.8 percent, its largest increase since November 2020.

Described by the business channel CNBC as a "relief rally," the rise in the market was largely because the Fed decision did not contain any surprises.

Yesterday's rate increase and those to follow had long been expected and largely "priced in" to market calculations. Wall Street was no doubt heartened by the fact that FOMC member James Bullard was in a minority of one with his call for an immediate 0.5 percentage point hike.

Yields in the bond market went higher, with the rate on the benchmark 10-year Treasury note rising to 2.18 percent, its highest level since May 2019. This reflects a general expectation that the Fed will not pull back from its present course of higher interest rates because of the war crisis.

The Fed's policy, however, may have an impact on financial markets.

Speaking to CNBC, David Kelly, chief global strategist as JP Morgan Asset Management, said: "I just want the Fed to maintain some flexibility. In the long run, we have to get rates back to positive levels. But there's a lot of uncertainty out here, and remember we've got a lot of financial assets which are built on the edifice of super low rates, and you just can't raise those rates up to normal levels overnight and expect nothing bad to happen."

In other words, the US financial system, inflated to an unprecedented degree by the Fed, which has pumped trillions of dollars into it, could be blown over by the effect of interest rises in the US or by major turbulence in international markets.