Fed moving for bigger interest rate hike to hit wages

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4 April 2022

The fear that a "very tight" US labour market will fuel wage demands is producing a consensus in Fed policy-making circles on the need for a 0.5 percentage point rise in its base interest rate at its next meeting in May, with possible further hikes of that magnitude at subsequent meetings.

The president of the San Francisco Fed, Mary Daly, is one of those adding her voice to what is a growing chorus for a bigger rate rise than the 0.25 percent (25 basis points) the Fed instigated at its meeting last month.

In an interview with the *Financial Times* (FT), Daly said the case for a half percentage point rise in May had grown. She was commenting in the wake of the latest data from the Labor Department showing the unemployment rate had dropped to 3.6 percent, the lowest since before the pandemic.

The remarks by Daly are significant because she is generally regarded as one of the more "dovish" members of the Fed's governing body.

"The case for 50 [basis points], barring any negative surprise between now and the next meeting has grown," she told the FT. "I'm more confident that taking these early adjustments would be appropriate."

As with all her counterparts in the Fed, starting with the chair Jerome Powell, Daly is focussed on the issue of the labour market. The fear in ruling circles is that inflation is leading to upsurge in demands by workers for pay rises to compensate for the losses over the past two years and more.

Daly said the latest data showed the labour market is "very strong" and "tight to an unsustainable level."

Her views echo previous remarks by Powell who has made clear he is prepared, if necessary, to take the road of former Fed chair Paul Volcker in the 1980s who lifted interest rates to record highs, inducing a deep recession, to crush wage demands.

Daly did not go that far but, according to the FT, she acknowledged the economy may have to slow to bring inflation back into line with the Fed's 2 percent target.

The Fed's interest rate moves have nothing to do with bringing down price hikes. They will not reduce the price of oil, lower the price of food and other necessities, or free up global supply chains, impacted by the refusal of governments internationally to take action to eliminate the pandemic.

Higher interest rates are aimed entirely at the working class, with the objective, as Powell has put it, of bringing back the demand for labour in line with supply—that is, by slowing the economy and lifting the jobless rate.

Other members of the Federal Open Market Committee, the Fed's interest rate setting body, want to go further than a one-off 50 basis point rise. Their ground was staked out by James Bullard, president of the St Louis Fed, who dissented from the 25 basis point increase in March and called for a rise of 50.

In an article last week entitled "Expectations grow that Fed will deploy jumbo-sized rate rises," the FT noted predictions by Morgan Stanley that the Fed will deliver back-to-back 50 basis point rises starting in May, followed by 25 basis point adjustments at each of the four subsequent meetings for the year. These rises will accompany moves by the Fed to start winding back its holdings of nearly $9 trillion of financial assets which will add to upward pressure on market interest rates.

Citigroup has forecast four 50 basis point increases by the Fed at each of its next four meetings, so that the Fed rate reaches 3 percent by the end of the year.

Summing up the expectations last week, Simona Mocuta, chief economist at State Street Global

Advisors, told the FT: “The signalling clearly has been very much on the hawkish side for some time, but that has gotten to a fever pitch in recent days.” State Street Global Advisors is the investment management division of the State Street Corporation, the world’s fourth largest asset manager.

The expectation of higher Fed rates has led to the phenomenon of yield curve inversion where the rate on shorter-term Treasury bonds rises to a level higher than that on the 10-year bond. Under normal circumstances the rate on the longer-term debt is higher than the short-term rate because lending longer term involves greater risk and uncertainty and therefore demands a higher rate of return.

But last Friday the rate on the two-year Treasury bond reached 2.44 percent while that on the 10-year was 2.38 percent.

Yield curve inversion is regarded by many market analysts as a warning of a forthcoming recession as investors consider that the Fed has pushed up interest rates to levels that will induce a credit squeeze, leading to a recession and lower rates in the longer term.

Previous recessions have often been preceded by a yield curve inversion. Whether it takes place on this occasion remains to be seen. Experience is an increasingly uncertain guide because of the transformation of the US financial system as the result of 15 years of “quantitative easing” (QE). The Fed has pumped in trillions of dollars into the market, first after the crisis of 2008 and then following the market meltdown of March 2020 at the start of the pandemic.

The Fed is now treading a fine line. On the one hand it wants to raise rates to clamp down on a wages upsurge, while on the other it is fearful that a too rapid rise will bring down the financial house of cards it has created by its low interest rate and QE regime.

The actions by the Fed will have international ramifications as central banks around the world also move to lift rates to counter wage demands. It will also exacerbate the already large debt servicing problems for many developing economies and so-called emerging markets.

The class agenda driving central bank and monetary policy was indicated by former Treasury secretary Larry Summers in an interview with Bloomberg over the weekend.

Summers, who often indicates the thinking in financial circles—he was one of the first to take issue with the Fed’s claim for much of 2021 that inflation was “transitory”—pointed to the effect of higher rates on government debt.

He began by denouncing the call for a so-called billionaire tax as a “bad idea whose time will never come” and then turned to the issue of government debt. The very low interest rates being used to calculate its impact “look comical today.” With the ratio of government debt to GDP now at more than 100 percent, Summers said using more realistic rates would likely add 5 percent to the debt to GDP ratio.

This raises the ever-growing question of how the debt will be paid and, having ruled out tax rises, Summers left no doubt about where the axe should fall.

“We’re moving towards a moment when we’re going to have to start to think about fiscal policy as well as monetary policy as an anti-inflationary tool,” he told Bloomberg.

The cuts will come not through any reduction in military spending which has risen to record highs, a move Summers fully supports, but on vital social spending which hits the working class.