Fed chief admits rate hikes could bring recession

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Federal Reserve chairman Jerome Powell has made his most explicit warning so far that higher interest rates could bring about a recession while all but ruling out a prospect of a so-called "soft landing" for the US economy in testimony to Congress over the past two days.

Responding to a question on recession at a Senate Banking Committee hearing on Wednesday Powell said: "It's not our intended outcome at all but it's certainly a possibility." The Fed was not "trying to provoke a recession, but we do think it's absolutely essential" to bring down inflation, now running at a 40-year high.

Answering a question from Democrat senator Elizabeth Warren, Powell acknowledged that higher interest rates would do nothing to bring down the price of fuel and food, two of the main driving forces cutting the real wages of workers as they fill up their cars or shop at a grocery store.

They are aimed entirely at the labour market, which Powell characterised in his opening statement as remaining "extremely tight" with the "unemployment rate near a 50-year low, job vacancies at historical highs, and wage growth elevated."

With one eye clearly fixed on the mid-term elections in which the Democrats look set to incur significant losses Warren, the self-described "capitalist to the bone" who tries to present herself as a supporter of working-class families, warned continued rate increases could "tip this economy into a recession" without bringing down prices.

Addressing Powell, she continued: "You know what's worse than high inflation and low unemployment is high inflation and a recession with millions of people out of work, and I hope you'll reconsider that before you drive the economy off a cliff."

Powell did not directly respond but his answer was contained in response to another question in which he indicated there could be a worse situation.

"The other risk, though, is that we would not manage to restore price stability, and that we would allow this high inflation to get entrenched in our economy. We can't fail on that task."

The key word here is "entrenched." It refers to a situation in which workers, breaking out of the straitjacket of falling real wages to which they have been confined by the trade unions, break free and begin to undertake independent action in support of wage demands to counter the daily cuts in their living standards.

Powell elaborated further on the Fed's stance in a response to a question when he appeared before the House of Representatives Financial Services Committee yesterday. Asked about the bank's response to a situation in which unemployment was escalating and economic growth was negative, Powell said that hypothetical situation was one in which inflation could be expected to be coming down.

But the added: "I think we'd be reluctant to cut." In other words, as with COVID, the attitude to rising unemployment is "let it rip" so that wages are driven down in the name of "fighting inflation."

Throughout most of last year, the Fed said rising inflation was "transitory." Confronted with economic facts, that narrative has been junked to be replaced by the claim there was a possibility of a "soft landing." But that too appears to have gone by the board.

As *Wall Street Journal* writer Nick Timiraos noted: "During two hours of testimony Wednesday and at a nearly hour long news conference last week [following the Fed decision to lift its base rate by 0.75 percentage points], Mr Powell never mentioned a soft landing and instead only referred to it as a goal when he was asked about it."

Back in March, the last time he appeared before Congress, Powell said it was "more likely than not that we can achieve what we call a soft landing."

The predictions and warnings of a recession and indications of its scale are coming thick and fast from many quarters.

On Monday, former treasury secretary Lawrence Summers who denounced the claims of "transitory" inflation in 2021 warned: "We need five years of unemployment above 5 percent to contain inflation—in other words, we need two years of 7.5 percent unemployment, or five years of 6 percent unemployment, or one year of 10 percent unemployment."

Like Powell, Summers knows the interest rate hikes that produce these conditions will do nothing to bring down prices, except for the price of labour.

In a comment published on Bloomberg, the president of the New York Federal Reserve from 2009 to 2018, Bill Dudley, wrote: "If you're still holding out hope that the Federal Reserve will be able to engineer a soft landing in the US economy, abandon it. A recession is inevitable in the next 12 to 18 months."

He said the Fed's employment mandate was "subservient to its inflation mandate" and noted that the June policy statement had removed language that the labour market would "remain strong."

Amid claims that the US economy remains strong, Dudley noted that the "current economic expansion is uniquely vulnerable to a sudden stop." He said when the tightening monetary policy started to reduce demand—the stated aim of the Fed—"the production adjustment is likely to be abrupt, due to tight financial conditions, restrictive fiscal policy and tapped-out household savings."

Economic history, he concluded, pointed to a "hard landing" with the Fed never having induced an increase in the unemployment rate by 0.5 percentage points "without triggering a recession… Much like Wile E. Coyote heading off a cliff, the US economy has plenty of momentum but rapidly disappearing support."

In his opening statement Powell claimed the American economy was very strong and able to handle tighter monetary policy. But he did note that economic activity had "edged down in the first quarter"—it contracted at an annual rate of 1.5 percent—and that, in contrast to consumer spending, "growth in business investment appears to be slowing, and activity in the housing sector looks to be softening, in part reflecting higher mortgage rates."

Reports from banks and investment houses point to the rapidly growing likelihood of recession.

On Monday Goldman Sachs issued a research note that the risk of recession was rising. It said there was a 30 percent probability of a recession next year, up from its previous forecast of 15 percent.

"We now see recession risk as higher and more front-loaded," lead Goldman Sachs economist Jan Hatzius wrote. "The main reasons are that our baseline growth path is now lower and that we are increasingly concerned that the Fed will feel compelled to respond forcefully to high headline inflation and consumer inflation expectations if energy prices rise further, even if activity falls sharply."

Economist Nouriel Roubini, who warned of the 2008 financial crisis, said in an interview on Bloomberg Television, he expected a recession by the end of the year with measures of consumer confidence, retail sales, manufacturing and housing all slowing sharply as inflation remained high.

Economists at Citigroup have written that the probability of the world economy moving into a recession is approaching 50 percent in a report issued on Wednesday. They said the experience of history was that disinflation often carried meaningful risks for growth. There was a possibility for a "softish" landing, but this required "supply chain shocks to ebb and demand to remain resilient."

However, the signs are pointing in the opposite direction as the Citigroup economists noted that consumer demand for goods was softening.

The overall economic situation points to an intensification of class conflict in the US and globally. Following on the devastation inflicted by COVID—resulting from the "let it rip" policies of all capitalist governments—rising inflation, on top of years of real wage cuts, workers now face the prospect of job cuts and recession.