Fed lifts interest rate in the face of growing signs of economic slowdown

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As expected, the US Federal Reserve lifted its base interest rate by 0.75 percentage points (75 basis points) yesterday and indicated further rises are to come, even as the economy shows signs of slowing and a recession.

In his opening remarks to the press conference at the conclusion of the two-day meeting of the Fed's policy setting committee, chairman Jerome Powell pointed to signs of the slowdown, noting that indicators of spending and production had "softened."

"Growth in consumer spending has slowed significantly, in part reflecting lower real disposable income and tighter financial conditions. Activity in the housing sector has weakened, in part reflecting higher mortgage rates. And after a strong increase in the first quarter, business fixed investment also looks to have declined in the second quarter," Powell said.

He then went on to outline the key determinant of the Fed's interest rate decisions—a clamp down on workers' wage demands in the face of rising inflation, now running at more than 9 percent.

Powell noted that despite signs of a slowdown, "the labor market has remained extremely tight, with the unemployment rate near a 50-year low, job vacancies near historical highs and wage growth elevated."

In fact, while there have some increases in wages, they fall well below the level of inflation. But the Fed is demanding that this gap be widened still further in the name of fighting higher inflation.

Powell said the Fed was determined to take the necessary measures to bring inflation down to its 2 percent goal and "this process is likely to involve a period of below-trend economic growth and some softening in labor market conditions."

Underscoring this assessment in response to a question at his press conference, Powell said the Fed believed "we need a period of growth below potential in order to create some slack."

Signs of that are already appearing with announcements by the major car companies Ford and General Motors, together with other large firms, that they intend to cut back on hiring.

As Powell himself has previously acknowledged, the Fed's interest rate increases in and of themselves will do nothing to bring down prices, which are the result of supply side constrictions caused by the COVID-19 pandemic, exacerbated by the US-led NATO war against Russia in Ukraine.

Market reaction to the Fed decision was in two parts. There was little change on Wall Street when the decision was first announced, but there was a sharp rise in the major indexes during Powell's press conference.

This was on the back of his remarks that although further rises were in the pipeline, they may not be of the order of 75 basis points.

Powell said that while "another unusually large rise could be appropriate at our next meeting [scheduled for the end of September], that is a decision that will depend on data we get between now and then." As monetary policy tightens further, he stated, "it likely will become appropriate to slow the pace of increases."

This was music to the ears of Wall Street investors and speculators with the interest rate sensitive and tech-heavy NASDAQ index moving up by 4.1 percent, its biggest single-day jump since November 2020.

The belief in the markets is that the next rise will be 50 basis points followed by increases of 25 basis points at the two subsequent meetings for the year.

But there is considerable uncertainty and, as happened after Fed meetings in May and June, the rise in the market could be followed by a sharp fall.

Bloomberg reported on a note by two Citigroup economists who read Powell's press conference as "more hawkish than the market's interpretation." They said that inflation readings will "push the Fed to hike more aggressively than they or the markets anticipate" with another 75 basis-point move in September.

One thing is certain: the Fed will not ease back on signs of a recession, even if the data for second quarter gross domestic product, due out today, shows that the US economy has slowed markedly or even contracted as it did in the first three months of the year.

Whatever the future path of US interest rates, the latest Fed decision will tighten monetary conditions globally and increase the recessionary trends, highlighted in the International Monetary Fund (IMF) economic outlook update issued on Tuesday.

The IMF reported that global economic output had contracted in the second quarter as it revised down its forecast for growth this year to 3.2 percent and 2.9 percent for 2023, reductions on the previous estimates by 0.4 and 0.7 percentage points respectively.

In a blog post, Pierre-Olivier Gourinchas, the IMF chief economist, said the global economic outlook had "darkened significantly" since April. "The world may soon be teetering on the brink of a global recession, only two years since the last one," he wrote.

Gourinchas noted that despite slowing economic activity, the IMF had revised upwards its forecast for inflation due to rising food and energy prices to 6.6 percent in advanced countries and 9.5 percent in emerging market and developing economies, an increase of 0.9 and 0.8 percentage points respectively. This, he wrote, "is expected to remain elevated longer."

"Inflation has also broadened in many economies, reflecting the impact of cost pressures from disrupted supply chains and historically tight labour markets," Gourinchas added.

But the slowdown in growth and the escalation of inflation could be even greater than forecast because "the risks to the outlook are overwhelmingly to the downside."

In an interview, he said the situation would test the "mettle" of central banks as they continue to raise rates.

"We are in a very critical moment here," Gourinchas said. "It's easy to cool off the economy when the economy is running hot. It's much harder to reduce inflation when the economy is close to recession."

The risk of recession was "particularly prominent" in 2023 because growth would bottom out in a number of countries and "even small shocks could cause economies to stall."

But the message from the IMF, representing the interests of global capital, is that central banks must stay the present interest rate course, essentially to drive down wage demands—advanced under the banner of preventing inflation from becoming "entrenched"—whatever the consequences.

Bringing inflation back to central bank targets had to be "the top priority for policymakers," Gourinchas said in his blog post.

The synchronized global monetary tightening was "historically unprecedented" and its effects were expected to "bite." They would "inevitably have real economic costs," but central banks that had started tightening "should stay the course until inflation is tamed."

The implications are clear: having created the crisis in the first place by pumping trillions into financial markets and refusing to take action to deal with COVID, leading to the inflationary supply chain breakdown, capitalist governments and central banks are striving to make the working class pay for it.