

US Fed gripped by uncertainty as war dominates the economy

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The US Federal Reserve yesterday kept interest rates on hold, as expected, but indicated that it has no real idea about the direction of the US economy flowing from the disruption caused by the US war on Iran and the hike in oil prices.

In their economic projections, known as the dot plot, in which Fed officials indicate where they think interest rates will move, 12 of the 19 members indicated at least one rate cut by the end of the year, with seven indicating there would be no reduction.

As the turmoil from the war increases, the overriding impression from the press conference of Fed chair Jerome Powell is that the central bank is like an animal trapped in the headlights of a massive truck hurtling towards it and not knowing which way to turn.

Powell said that in view of the uncertainty flowing from the war in the Middle East, any predictions in the dot plot were largely meaningless.

“The thing I really want to emphasize is that nobody knows. The economic effects could be bigger, they could be smaller, they could be much smaller or much bigger. We just don’t know.”

On the predictions of Fed officials, he said: “People are writing something down that seems to make sense to them, but they have no conviction.”

Powell said the committee had discussed the possibility that the Fed’s next move could be a rate increase, but “the vast majority of participants don’t see that as their base case.”

However, he did indicate the circumstances under which this could change. Central banks did not generally respond to energy price hikes because their effect on inflation was judged to be temporary. But that approach was dependent on the public continuing to expect that inflation will come down.

The key issue, however, is not the general “public”

perception but the specific reaction of the working class in response to major price hikes. If this leads to a development of strikes and a movement for wage rises in response to the major cuts in real wages now underway, then the Fed will respond with interest rate hikes.

Powell has long expressed his admiration for the actions of Fed chair Paul Volcker, who drove interest rates to record highs in the 1980s, inducing a recession and major unemployment to suppress wage struggles.

In his assessment of the US economy, Powell was upbeat, saying that available indicators suggested economic activity had been expanding at a solid pace. But even before the impact of the war, there were clear indications that inflation is on the rise.

The Fed’s preferred measure of inflation, which strips out the effects of volatile food and energy prices, rose to 3.1 percent in January after going as low as 2.6 percent in April.

While trying to focus on the one-off effects of oil price increases, Powell was forced to acknowledge that “higher energy prices will push up overall inflation.”

And by raising costs across the economy—from manufacturing and transport to agriculture—they will deliver a significant hit to economic growth which has already been showing signs of weakening.

The growth rate for the fourth quarter of last year has been revised down from an initial estimate of 1.4 percent to 0.7 percent and the US economy lost 92,000 jobs in February, which wiped out almost all the gains of the previous month.

In an interview with the *Financial Times* (FT), Trump’s one-time pick to head the Bureau of Labor Statistics, EJ Antoni, issued a warning about the state of the American economy.

“I don’t think this is an economy that is going to be

able to handle \$100 a barrel for oil, it's just not. The economy is weaker than we thought it was, and inflation is worse than we thought it was," he said.

If the reaction on Wall Street to yesterday's meeting and decision is anything to go by, that kind of sentiment is spreading as costs rise, supply chains are disrupted, transport is hit by higher diesel costs and a range of products derived from the use of oil and natural gas, such as fertilizers and plastics, are impacted.

With the Fed making it clear that lower interest rates are off the table while the war continues, the S&P fell 1.4 percent, the Dow dropped 768 points, 1.6 percent, and the NASDAQ slid 1.5 percent.

In remarks earlier this week to introduce its Quarterly Review, Hyun Song Shin, head of the economics and monetary department of the Bank for International Settlements (BIS), warned of the global impact of the war, not least on the financial system.

"If the conflict is prolonged, financial amplifications could magnify the macroeconomic impacts," he said.

"A spike in interest rates could put pressure on rich asset price valuations. Rising financing costs for governments and the need for more debt could undermine fiscal sustainability given already strained public finances in many countries."

Even before the war, there have been growing concerns over the stability of private credit markets in the US, which have engaged in a lending binge to software companies that are now being threatened by the development of artificial intelligence (AI). From \$8 billion in 2015, such lending has risen to more than \$500 billion.

The BIS warned that higher borrowing costs and a slowdown in the economy could add to tensions in private credit markets from which big investors have been seeking to withdraw billions of dollars.

This week, Tony Yoseloff, chief investment officer at the credit hedge fund Davidson Kempner Capital Management said, as reported by the FT, that a "substantial portion" of the private equity system was already "stressed or distressed" and that this was not a problem five years on, but today.

Earlier this month, the governor of the Bank of France, Francois Villeroy de Galhau told a conference in Paris he was increasingly concerned about private equity markets and their connections to the broader

financial system.

"Debt strategies relying on complex, opaque and increasingly leveraged financing structures, notably in private credit can also conceal the vulnerabilities of some borrowers. These vulnerabilities may be amplified by the rising interconnectedness between private markets and other financial institutions."

Those vulnerabilities have only increased in the days since these remarks were made as the crisis resulting from the war has deepened, creating the conditions for the formation of a vicious cycle in which the hit to the real economy creates financial turbulence that in turn reacts on the economy as a whole.



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