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Why is the US Fed inducing a recession?

The real reason for trying to slow the economy is to ensure that wages do not rise rapidly. That is why the state of the labour market is key to US monetary policy

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Representative image

On Wednesday, July 27, the US Federal Reserve (Fed) hiked interest rates up by a sharp 0.75 percentage points. Clearly, the Fed is alarmed over raging inflation, which accelerated to an annual rate of 9.1% in June 2022, with year-on-year wage growth at 11% in May, 2022.

Meanwhile, even though GDP growth rate in 2022 has slowed, it has been attributed primarily due to the rising trade deficit. With consumption and investment spending still strong, overall growth is forecasted to average 3.6% for the year. Putting these facts together reveal that this situation is not stagflation, which essentially arises when supply-side constraints (while they may exist) are strong enough to not just inhibit business activity but even diminish it.

The latter seems implausible with some 372,000 new jobs added in June 2022, overriding expectations. Basic macroeconomic theory suggests that the present situation is predominantly because of the strong demand that has been buoyed by expansionary fiscal policies implemented during the pandemic.

The willingness of the Fed to induce a slowdown, or even a recession, therefore emanates from conscious utilization of economic policy to do so. This can be inferred from US President **Joe Biden's** remark, 'no country is better positioned than America to bring down inflation, without giving up *all of the* economic gains we have made over the last 18 months.' It implicitly implies that *some of the* gains could be given off to bring down inflation. The Fed's Chairman, **Jeremy Powell** is more categoric on what these gains are: 'the labour market is extremely tight, inflation is much too high … Our goal is to get wages down … to get wages down without having to slow the economy and have a recession and have unemployment rise materially. There's a path to that.' This almost sounds as if the Fed has the tools to precisely ensure that there is only one person applying to fill in one vacancy, because according to **Powell** wages rise when 'you have two job vacancies, essentially, for every person actively seeking a job.'

The renowned macroeconomist, Oliver **Blanchard**, in a recent tweet supported this view, 'when inflation comes from overheating … unemployment has to increase to control inflation.' The most definitive directive, however, comes from **Larry Summers**, former US Treasury Secretary: 'We need five years of unemployment above 5% to contain inflation — in other words, we need two years of 7.5% unemployment or five years of 6% unemployment or one year of 10% unemployment.'

Monetary policy came to be recognized as an effective tool for inflation control when the second oil-shock of 1979 in the wake of the Iranian revolution resulted in growth slowing down while inflation soared. Considering the latter unacceptable, Paul Volcker, then Chairman of the Fed, raised interest rates to an all-time high of 19% in 1980 that induced a severe recession – with an unemployment rate of 11% – to finally suppress inflation. It might be relevant to add that **Powell** is a great admirer of Volcker: 'I think he [Volcker] was one of the great public servants of the era — the greatest economic public servant of the era', and might be seeing an opportunity here to emulate his legacy.

While discontinuing of convertibility of dollars to gold and the end of Bretton Woods, the financing of the Vietnam war, the crop failures in the mid-1970s, increases in oil prices and even deceleration in productivity, were identified as likely causes of inflation in the 1970s, the moot question is why did monetary policy – particularly Volcker – target wages as the most important variable that had to contained to bring it down? Similarly, in today's context, inflation has been attributed to supply-side bottlenecks, rising oil prices, the Russia-Ukraine war, and higher price marks-ups by monopolistic corporations, but ultimately Powell and Summers target wages and tight labour markets as the key parameters to be controlled.

Volcker answered the question in a speech that he made in 1983: 'it is labour costs that make up the bulk of the value of what we produce — of all costs accounting for about two-thirds.' Supported by economic models, the necessity to break the vicious wage-price spiral became the overriding policy to 'solve' the inflation problem. The Fed is willing to pull the string so hard (raising interest rates) that aggregate demand contracts, slows down growth and causes enough unemployment (although no one knows exactly how much) to stop wages from rising.

Ground **reports** from the US, however, shed light on the present cause for concern over rising wages and tight labour markets. Companies across the board, from retail to banking and manufacturing to tourism, are reporting the inability to get labour to meet the demand for their own output and must inevitably raise wages. If labour costs eat into corporate profitability, companies with sufficient market power have the capacity to pass on the increased labour costs to consumers – the reason why some heterodox economists argue that inflation may be on account of companies unwilling to forego their quantum of profits. After all, the ratio of worker compensation to corporate profits has declined sharply in the US from a high of eight in the 1980s to just about five in 2020, but rising to six in 2021.

When Senator Elizabeth **Warren** recently asked: 'Chair Powell, will the Fed's interest rate increases bring food prices down for families?', his answer was 'I wouldn't say so, no.' And to the question: 'Chair Powell, will gas prices go down as a result of your interest rate increase?', his answer was once again: 'I would not think, so no.' If the direct responsiveness of prices to interest rate hikes remains so ambivalent, the goal of the interest rate hikes to keep wages in check by creating slack in the economy cannot be dismissed off as secondary. Given the stagnation in real wages since the 1980s and rising inequalities in the distribution of income and wealth evident in the US, do tight labour markets, rising wages and an increase in labour's share of total output warrant the necessity to induce a recession?

Volcker may in fact have known the answer all along in spite of relentlessly doing otherwise: 'The gains [from controlling inflation] have been achieved in the midst of recession, with strong downward pressures on prices and costs from weak markets. We cannot build a successful policy against inflation on continued recession.'

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Views are personal and do not represent the stand of this publication.

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