The Mindful Economist

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Inflation and Backshock at the Fed

It is now familiar to hear someone say that something is "unprecedented" or that they have "never seen anything like this before." "Record heat waves," "largest wildfires ever," "possibly indicting a former president," "worst inflation rate in decades." Or "the biggest interest rate jump in the history of the Federal Reserve." On July 27th this year, the Fed pushed up their benchmark Federal

Jerome Powell

Funds Rate three-quarters of a percentage point. The Fed board has made this jump twice in the last two months, and they have never pushed up rates this much in such a short span of time.

Why are they doing this? The short answer is that this is the only means at their disposal to fight price inflation, which as of this month, was clocked at 9.1 percent. The Fed Chairman, Jerome H. Powell, defended the rate increase by asserting that it is a necessary measure to cool off the inflationary heat.

But there is a deeper reason for this move. Banks hate inflation. Given the Federal Reserve System's structure, their principal constituency is corporate banks. A banker's income derives from charging interest on loans and bonds. When their borrowers make their interest payments at a time when there is rapid inflation, the lenders are getting paid back in dollars that are worth less than they were before. It is like lending a neighbor a ladder and when it is returned it is shorter than before. The rate of deterioration that occurs with inflation is now much greater than the rates the banks charge—bad news for banks.

Will the Fed plan work? No one can say for certain, but it can relieve some inflationary pressure in a brutish a sort of way.

The Fed is the leader in what amounts to a price-fixing scheme in the banking sector. By setting the Federal Funds Rate at a particular target, it signals to the big Wall Street banks to adjust the prime interest rate accordingly, which is usually three points above the Fed rate. Tacit collusion among the banks establishes the prime rate, which is then announced in the *Wall Street Journal* as the new rate that all other rates are scaled against. The current target Fed rate is 2.5 percent, so we can expect the prime rate to be fixed by the corporate banks at 5.5 percent above the current 4.75 percent. The jump in the prime rate from 4.75 to 5.5 is about a 16 percent increase in the cost of credit. This is a major shock to the economy, or what I call the "backshock" against supply-shock inflation.

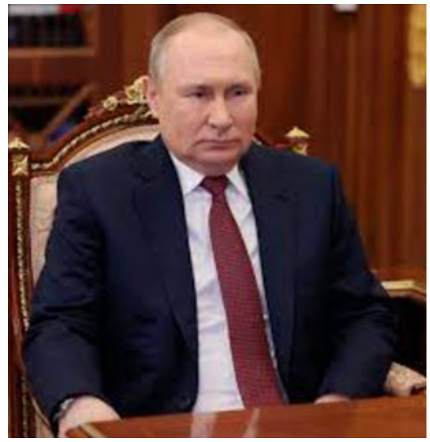
By raising the cost of credit, any sector in the economy that relies on credit for sustenance will be the first to be affected. This includes housing, housing construction, home equity debt spending on big ticket items, auto retail, and such. Theoretically, as these sectors slow down because of higher costs, the price growth of their goods and services will slow down proportionally. As people get laid off in these sectors, labor markets loosen up and this should slow wage and salary growth. Not to get overly technical here but raising interest rates can also strengthen the dollar relative to the euro and other currencies. With a stronger dollar, the cost of imported goods will decrease.

In theory, these intended effects should slow down runaway prices.

There are a number of problems with this Fed strategy, nonetheless. The first and most important thing to keep in mind is this trend is global. This means that the problem extends beyond the reach of the Fed, or any other central bank for that matter. Also, the sectors most affected by the rate hike are not the parts of the economy that are responsible for the current inflationary trend.

Since the onset of covid, the weaknesses in the highly integrated global economy are exposed. A covid-related disruption in one part of the world can send shock waves through the system of manufacturing, distribution, and logistics upon which every economy in the world has come to rely. Since it is a pandemic, the disruptions are everywhere. Virtually all things are harder to come by and that makes them more expensive.

Another inflationary factor is Russia's war on Ukraine. Russia is one of a handful of major oil and natural gas exporters in the world. The country is under the control of a sociopathic authoritarian leader who decided to take Ukraine by military force.



Vladimir Putin

Russia's president, Vladimir Putin, ordered his military to launch a major invasion of the sovereign territory of Ukraine in an attempt to bring it to heel. Putin is seeking violent imperial domination by leveraging his control of massive amounts of oil and gas reserves as well as the pipelines leading into Europe. This has sent shock waves through the global economy by way of energy markets. Energy prices of all kinds soared in fear of the World War Two conditions brought to Europe by Putin's delusions of grandeur. Weaning off Russia's energy exports is a very slow and long-term process, but the turbulence Putin has created is immediate and severe.

Adding to all of that is price gouging or "greedflation." As businesses witnessed prices rising from the covid and other disruptions, some saw an opportunity to push up prices by more than what was needed cover higher costs. It is impossible to measure which companies are price gouging, but we can see it is happening from the many comments made by corporate leaders about how these last two years have presented a good climate for pricing strategies.

Does wage growth drive up prices? This is a favorite argument fashioned by right-wing, anti-labor policymakers. It is true that cost of living adjustments are always business costs as working people demand higher wages to keep up with the cost of food, housing, etc. Even so, the moving average monthly wage growth fluctuated between an *annualized* 3 and 7 percent in 2021 while the Consumer Price Index (CPI) increased by 9.1 percent for the 12 months ending in June 2022, the largest 12-month increase since 1981. Price inflation is a heavier burden for working people who struggle to make ends meet, whereas the wealthy have more options to hedge their wealth against inflation with investments and spend a lower percentage of their income on consumer goods. But if wage growth cannot keep up the cost of living, it is a disingenuous argument to say prices to pushed higher by higher wages.

The Biden Administration's American Rescue Plan has been attacked by conservative Republicans and Democrats who argue it has led to inflation. It is possible that large-scale deficit spending by the federal government can cause overspending and push up prices. But in this case the government was offsetting consumer spending as huge numbers of American workers were furloughed during the worst months of the covid pandemic.

The Federal Reserve is using monetary policy as a hammer to beat down spending in the areas of the economy that are not responsible for the massive price increases we have experienced in the last two years. The effect is to punish those who are most vulnerable while acknowledging that this is the only means available to combat covid-related, Putin-caused, supply-shock inflation.

We have experienced supply shocks in the past when oil prices went through the roof for various reasons. The result is an economic double whammy called "stagflation," which is simultaneous price inflation and economic contraction. On July 28th, the National Bureau of Economic Research (NBER)—the organization that tracks growth and recession cycles—announced that the economy contracted by .90 of a percent in the second quarter of 2022.

Once again, supply shock stagflation is here, and the Fed apparently has no choice but to make it worse for those who are most affected. Food prices, utilities, fuel, and pretty much everything else become more expensive as people lose their jobs.

The Department of Justice and Trump

Just a quick note on the DOJ and the criminal investigations on the January 6th movement to overturn the election. It is quickly becoming evident that Donald Trump committed crimes as he tried to nullify the will of the voters. Many pundits in the media look at opening an investigation into Trump's crimes as "unprecedented" and "politically complex with ramifications" As if that would be discouraging. What would be worse, however, would be to do nothing as the ramifications are already there.

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