Hiking Interest Rates Protects Financial Assets Of The 1% At Workers' Expense

Gerald Epstein is Professor of Economics and a founding Co-Director of the Political Economy Research Institute (PERI) at the University of Massachusetts, Amherst.

High inflation has returned after more than two decades of very low and stable inflation rates. While in the past, central banks were struggling to bring inflation up to a target of 2 percent, they are now confronted with the opposite task. Raising the interest rate is one way to combat inflation, which is why the Federal Reserve announced in mid-June its largest interest rate since 1994.

Will a hike in interest rates fix the real reason behind today's inflation, which is now a global problem? What does the Fed rate hike mean for average workers and the poor? What other ways are there to combat surging inflation? And why do capitalist governments worry more about inflation than they do about unemployment or inequality? Progressive economist Gerald Epstein sheds light on these and other questions about today's inflationary economy. Epstein is professor of economics and founding co-director of the Political Economy Research Institute at the University of Massachusetts-Amherst and a leading authority in the areas of central banking and international finance. He is the author of many books, including, most recently, *The Political Economy of Central Banking* and *What's Wrong with Modern Money Theory*? *A Policy Critique*.

C.J. Polychroniou: In an attempt to combat high inflation, which rose in the U.S. by 8.6 percent in May, the Fed hiked its interest rate by three-quarters of a point. This is the highest interest rate hike in decades, but it wouldn't be surprising if the Fed took even more aggressive actions in the months ahead as part of its war against inflation. How much of an impact can higher interest rates expect to have on inflation?

Gerald Epstein: It partly depends on how high interest rates are jacked up and how long they are kept up. In general, moderate increases in interest rates — say, 1 or 2 or even 3 percentage point increases — cause only small reductions in the inflation rate, which is defined as the percentage rate of increase of the price of a market basket (collection) of goods and services over a period of time. There are many reasons for this. For one thing, in the first instance, as Wright Patman, the populist congressperson from Texas in the 1950s repeatedly pointed out, increases in interest rates actually *increase* prices! The reason is that interest costs are, among other things, a cost of doing business for companies that borrow money to fund their operations. So, like wages, or gas or other costs, increased interest costs are likely to be passed onto customers by businesses that rely heavily on credit.

As for the price *reducing* impacts of interest rate increases — these occur only indirectly. The main channels are by raising the cost of borrowing by families for houses (mortgages), or credit card purchases, and by raising the cost of borrowing by companies that are planning to build new factories or buy new capital equipment. These reduce the demand for goods and services — houses, appliances, cars, new factories and capital equipment — and the workers that produce them.

It is the next step where possible reductions in prices and the rate of inflation comes in. Companies and workers are very reluctant to lower prices, or even to reduce the rate of increase of their prices and wages. So, what happens next depends on the power that workers and capitalists have to keep their wages and prices up — to wait out the reduced demand for their products and services until demand goes back up.

Typically, firms have a lot of ability to wait out the cutbacks without greatly reducing their prices. This is especially true when firms have a lot of pricing power if they are monopolies or have a big share of the market, as mega corporations often do. Workers, much less so. So as demand for products go down and unemployment goes up, we typically begin to see wages either go down or stop going up. Perhaps housing prices begin to slide or soften. Over time the inflationary pressures might subside.

But this can take a substantial amount of time. Estimates by well-known Yale economist Ray Fair, for example, indicate that a 1-percentage point increase in short-term interest rates reduce the inflation rate by one-half percentage point, but only after 15 months. So, as estimated by macroeconomist Servaas Storm, it would take a 4-percentage point increase in the Fed's interest rate to reduce the inflation rate by only 2.5 percentage points — say from 6 percent to 3.5 percent — far above the Fed's target of 2 percent. And the price tag for this modest drop in inflation would be an increase in the unemployment rate by 1.5 percentage points and a significant fall of GDP.

Even these weak anti-inflation impacts are probably an overestimate of the impact of interest rate increases on current inflation. The reason is that so much of this inflation is due to production disruptions outside the U.S. that increases in U.S. interest rates will have, at best, weak effects.

The libertarian economist Milton Friedman famously said that inflation is caused by "too much money chasing too few goods." He assumed that the culprit here was "too much money" — typically printed by the Central Bank (the Federal Reserve in the U.S. case).

But, historically, most really serious inflations are caused by "too few goods," not too much money: that is, serious disruptions in the supply of goods. Typically, these are associated with wars, droughts and political instability. And this is largely true with our current inflation.

Most of the drivers of our current inflation come from disruption in the supply of key commodities such as oil, gas and food, and other key parts of the "supply-chain" such as microchips for automobiles. Some of these disruptions are still resulting from the COVID pandemic and the shutdowns associated with that disaster; and now, added on are the sharp increases in fuel and food prices stemming from the Russian invasion of Ukraine and the Russian blockage of Ukraine food exports to the world.

According to Servaas Storm, increased prices of imported products to the U.S. account for upwards of one-third of the increased inflation we are experiencing.

In addition to the external sources of production and distribution (i.e., "supply-side") disruptions, the U.S. has domestic disruptions as well. Some of the better-known ones include shortages of truckers, inefficient ports and a decline in the labor force relative to pre-COVID trends. The latter is very important but is poorly understood. It could be a combination of COVID health issues, poor pay and working conditions, more family obligations, and other factors.

The point, though, is that interest rate increases will do nothing to solve these problems, and might even exacerbate them by making it more difficult for families to get the health care, child care, etc. that would allow them to go back to work.

In short, even when we are experiencing "plain vanilla" inflation due to too much demand ("demand-pull" inflation), interest rates must be raised significantly and for a long period of time to reduce it, at considerable cost in lower economic growth and higher unemployment. But when the main causes of inflation are supply side factors and, especially, those occurring abroad, the potency of interest rate increases to fight inflation are much, much weakened. This means much more pain needs to be foisted on workers to extract the same gains in terms of lower inflation.

Who wins and who loses from the Fed's interest rate hike?

The current inflation, which is caused by significant disruptions in the supply of key commodities, such as gasoline and food, among other goods, is very negatively impacting poor and working-class people in the U.S. These price increases are like a big hike in sales taxes, which is a "regressive" tax: That is, it most negatively impacts those groups who spend a high percentage of their incomes on these goods. And given that these are necessities, these represent a high percentage of the purchases of these groups. Very rich people spend more on these goods than do working-class people, but this represents a much smaller percentage of their incomes. So, bringing down the cost of these necessities would certainly help poor and working-class people and families.

However, as we have seen, increases in interest rates will not do this, at least not without hurting these very same groups. Raising interest rates will increase unemployment, reduce economic growth and raise mortgage interest rates, which makes housing even more expensive for these people.

The increase in interest rates will primarily help two groups: those with significant amounts of financial wealth, and financial institutions that lend money and will now be able to charge higher amounts of interest and whose financial assets will retain more of their value if inflation falls.

Now, those who have seen the stock market drop in recent years will question whether wealthy investors will benefit from higher interest rates. It is true that one impact will be a reduction in the value of financial assets like stocks; at the same time, the rates of return on newly invested income will be higher. Moreover, to the extent that, in the longer run, the higher interest rates limit inflation, it will reduce the possible erosion of the real value of the wealthy's considerable wealth.

There is another group that potentially benefits from the high interest rates that will raise the unemployment rate: the capitalists who employ workers.

The Fed and capitalist governments in general worry more about inflation than they do about unemployment, poverty and economic inequality. Why is that?

The simple answer to this question is that capitalists of various stripes tend to be harmed by substantial inflation, and they tend to benefit from unemployment, poverty and economic inequality. All of these reduce the power of workers and increase the power and wealth of capitalists. The Fed and capitalist governments, who tend to be disproportionately influenced by (if not controlled by) various capitalist segments, conduct policies that reflect these preferences. An (overly) simple way to think about this is to think of capitalists as being divided between two groups: financial capitalists (bankers, rentiers, financial operatives) and non-financial capitalists (auto producers, internet, agrobusiness, etc.). Of course, this is overly simple since there is often a big overlap among these groups.

But to continue: The financial capitalists and rentiers are especially phobic about inflation because unexpected increases in inflation erode the purchasing power of their financial assets. The non-financial capitalists, for their part, are phobic about their workers having too much power which they can wield to get higher pay, better working conditions and even more control over the decisions of the firms. Karl Marx noted the fact that capitalists adore the ability to "discipline" workers so they can't exercise their power, and the main mechanism that capitalism has to do this is to throw workers out of work — that is, create unemployment. Marx called this the "Reserve Army" of the unemployed. In *Das Kapital,* Marx noted that capitalism requires the periodic replenishment of the reserve army of the unemployed to keep the workers in line.

The non-financial and financial capitalists typically are united with respect to monetary policy when unemployment is low and inflation is high: the Fed should raise interest rates to throw workers out of work, prevent them from raising wages, and thereby put downward pressure of prices and inflation in order to protect the real value of their wealth and increase capitalists' profits.

So, the previous question asked who benefited from higher interest rates in this current situation? The bankers and the non-financial capitalists.

What does today's inflation and Fed policy teach us about capitalism?

The bankers, banker-friendly economists such as Larry Summers and his associates, and pundits in the press are all pressing the Fed to take extreme measures to reduce inflation, even if those measures will significantly injure those that they purportedly are designed to help by throwing them out of work. Summers, among others, has been claiming that the Fed must raise interest rates dramatically in order to stem a "wage-price spiral," blaming workers' wage increases for sustaining the higher inflation rates. This is false since workers' average wage increases have only been a small fraction of the increases in prices.

The implication of this is that workers in the U.S., who have basically had a very little if any pay raise in 40 years, cannot be allowed to have any pay raise now, despite the fact that the incomes and wealth of the top 1 percent has gone up more than 10-fold in the last several decades. This call for higher interest rates is particularly damaging to African Americans and other people of color who only are able to get ahead during periods of very low unemployment. These calls are taking place in the context of what economists at the Roosevelt Institute, Economic Policy Institute, and elsewhere have identified as a significant "profit push" component to our current inflation: Mega companies with substantial pricing power are using the supply chain shocks and Russian war in Ukraine as excuses to flex their pricing muscles and raise their profit margins to 70-year highs.

In other words: this says that American capitalism seems incapable of delivering increases in the standard of living to the bulk of its population. Critics often refer U.S. capitalism as “neoliberal capitalism.” I think of it as “rapacious capitalism.”

Now, this is a statement in particular about U.S. capitalism, not necessarily all capitalist countries. Capitalist countries, such as the Nordic countries (Norway, Sweden, Denmark) where workers, unions and social democratic parties have had significant power in the aftermath of the Second World War, have, for a number of decades, been able to “tame capitalism” to the extent that income distribution was more equal and real gains have been made by the working class and poor. To some extent, these gains have been recently eroded, but they nonetheless remain.

But this drive to have the Federal Reserve raise interest rates to bring down this inflation no matter what the cost reflects the “rapacious capitalist chorus” which has far too many powerful members.

What other methods are available to fight inflation besides contractionary monetary policy?

There are numerous other tools which are available to fight this mostly supply- and profit-driven inflation, but most require some coordination between the Federal Reserve and the government overall. Clearly, something must be done. This supply-driven disruption is having significant negative impacts on the standards of living of millions of people — in the United States and around the world — because it is raising the cost of a number of key goods that people need to live and thrive: fuel, food, housing, transportation.

So, what to do? I have already noted what the Fed should *not* be doing: raising interest rates sky high. To figure out what the Federal Reserve can contribute is to identify what the goal of policy should be. The goals of Federal Reserve Policy should be three-fold:

1. To protect the standard of living of the bulk of the population, and especially those who are most vulnerable, not primarily the bankers or the non-financial capitalists.
2. To help where possible to relieve the supply-side problems, and certainly not do anything to make them worse.

3. To facilitate where possible the needed transition to a non-fossil fuel-based economy, and not do anything that makes that transition slower or more difficult. This will help deal with the longer-term causes of inflation, namely climate change.

To achieve these goals, the Fed will not be able to operate on its own. Just as it did during the great financial crisis and then, even more so, in the wake of the COVID pandemic, the Fed should cooperate with a general government plan to deal with this cost-of-living problem. In those instances, the Fed developed multiple new and creative mechanisms primarily to bail out the banks and financial markets.

This time, the Fed should use the same effort and creativity to control inflation without imposing the costs on workers or the future possibility of controlling catastrophic climate change.

The Biden administration has attempted to lower the cost of fossil fuels. A better approach, suggested by Jim Boyce and Bob Pollin, among others, is to tax oil profits and return the receipts to people. This will retain the incentive to switch from fossil fuels to green energy, while helping workers and the poor with the hit to their standard of living.

The government should tax excessive corporate profits and use the returns to expand subsidies for food and other necessities for the poor and working class.

Isabella Weber and James Galbraith, among others, have suggested temporary price controls on key commodities to break the inflationary dynamics in these commodities.

Among the pressures affecting these dynamics has been an increase in financial speculation that has driven up these prices faster and higher than would be the case from simple supply and demand. Here the Federal Reserve, along with other financial regulators, should monitor and enforce rules to limit such speculation that is helping to drive some of this commodity inflation.

As I indicated before, the Fed allocated billions of dollars to bail out the banks and financial markets in 2008-2009, and again in the spring and summer of 2020. Now the Fed should devise special credit facilities to provide financing for the expansion of green energy, credit to expand day care and community health facilities, to help expand the effective labor force, and new initiatives for ecologically appropriate farming to provide foodstuffs. All of these would help to reduce bottlenecks. The Fed could do this by providing lines of credit, insurance and other facilities from community banks, special agricultural loan funds, affordable housing institutions and other similar financial institutions that have experience and a track record in funding these key goods… all of which are implicated in the current inflation.

In other words, since this is primarily a supply-side problem, the Fed should focus on helping to expand the supply, rather than on throwing workers out of work to limit demand at their expense.

C.J. Polychroniou is a political scientist/political economist, author, and journalist who has taught and worked in numerous universities and research centers in Europe and the United States. Currently, his main research interests are in U.S. politics and the political economy of the United States, European economic integration, globalization, climate change and environmental economics, and the deconstruction of neoliberalism's politico-economic project. He is a regular contributor to *Truthout* as well as a member of *Truthout's* Public Intellectual Project. He has published scores of books and over 1,000 articles which have appeared in a variety of journals, magazines, newspapers and popular news websites. Many of his publications have been translated into a multitude of different languages, including Arabic, Chinese, Croatian, Dutch, French, German, Greek, Italian, Japanese, Portuguese, Russian, Spanish and Turkish. His latest books are *Optimism Over Despair*: *Noam Chomsky On Capitalism, Empire, and Social Change* (2017); *Climate Crisis and the Global Green New Deal*: *The Political Economy of Saving the Planet* (with Noam Chomsky and Robert Pollin as primary authors, 2020); *The Precipice*: *Neoliberalism, the Pandemic, and the Urgent Need for Radical Change* (an anthology of interviews with Noam Chomsky, 2021); and *Economics and the Left*: *Interviews with Progressive Economists* (2021).