CARRY ON RAISING, THE LAST OF THE '*CARRY ON FILMS*' STARRING FED POWELL IN THE LEAD ROLE.

This article takes a close look at inflation and how this influences central bankers. It examines whether the FED understands inflation in the first place and how this affects their decisions.

Watching Powell live on Bloomberg being questioned by the Press following the FOMC (Federal Open Market Committee) meeting was fascinating. Not because of Powell but the market reaction to his words as he ploughed on incoherently, reversing track and contradicting himself, thereby jerking the market around. If he was doing a presentation at university he would get an F for inconsistency. F in this case standing for floundering rather than fail, clearly a conflicted Chair subject to opposing pushes and pulls.

The Dow began the day up 400 points, but immediately fell by 600 points when Powell uttered the fateful words "*rate hikes had more ways to go*", only to rise when he then said "*may slow down rate rises by the next meeting",* only to fall once more when he said "*that it was premature to pause rates*" and so it went. Investors made stupid by greed, hanging on to his every word engaging in high frequency trading. And they are the ruling class.

Why anyone would pay attention to a Chairman who began the official statement with this line: *Recent indicators point to modest growth in spending and production. Job gains have been robust in recent months, and the unemployment rate has remained low.* And who can believe his promise of fidelity to the labour market. "*The Committee seeks to achieve **maximum employment** and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 3-3/4 to 4 percent*." The whole point of rapidly raising interest rates this way is to undermine the labour market, to make it too expensive for employers to employ, in short to upend the labour market in order to save it for the future. Seems unemployment is good for the economy.

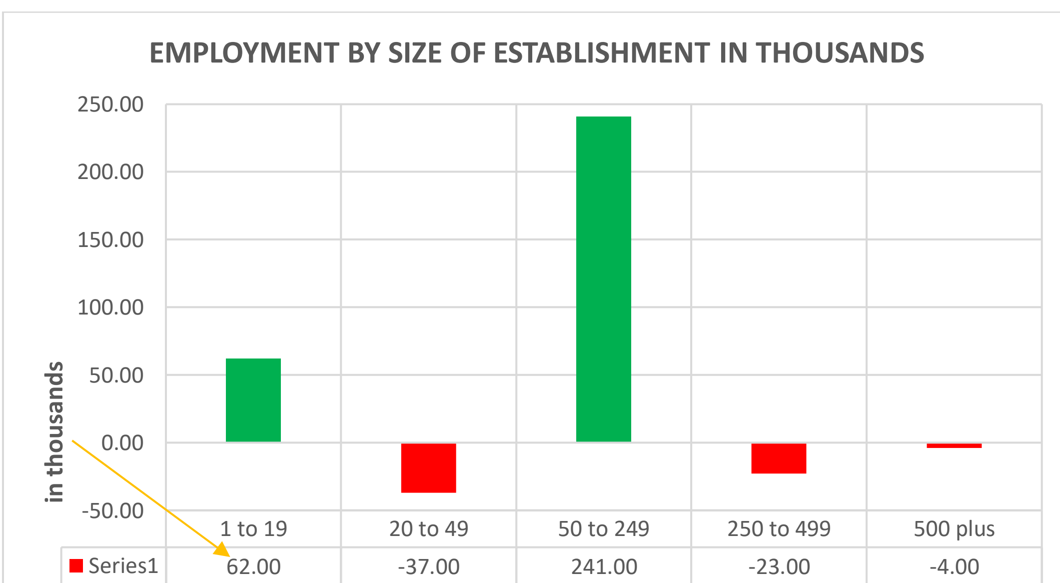
By the time the markets closed the Dow had fallen by over 500 points. JP Morgan said this was the biggest 90 minute rout post a FED meeting in history. Bloomberg was more modest declaring it was the worst rout since January 2021. But as far as Powell was concerned it was job done. The top 10% of income earners consume as much as the bottom 80%, and they are the ones most heavily invested in the share market. Their propensity to spend is significantly impacted by movements in the prices of shares. In October share prices rose at the fastest rate since 1976 on the back of the view that the FED was going to take its foot off the interest rate accelerator. If the FED is going to crush demand, it has to contain the rise in fictitious capital, which Powell did albeit clumsily showing how unsure he is of conditions. The markets must now contend with collapsing outlooks for the 4th quarter and beyond, as well as a more belligerent FED. It is a toxic combination especially as the economic news rapidly becomes increasingly grim.

There is another hidden agenda or shall we say unspoken agenda to consider. The strong dollar belies its weakness. This can be seen in the US government bond market which at $24 trillion is the corner stone of the global bond market. It used to be the most liquid of markets where large transaction barely moved prices. No longer. Since the FED started QT it has frozen (we will discuss this later and recognise that QT is actually running at half-speed). With China unwinding US debt and Japan unable to buy Dollar debt without depreciating the Yen further, this market is in trouble, particularly at a time when the federal deficit is running hot above 5%. Were the Dollar to fall encouraging further bond selling this could further rock this market. The time may be approaching when the Dollar becomes the USA's problem.

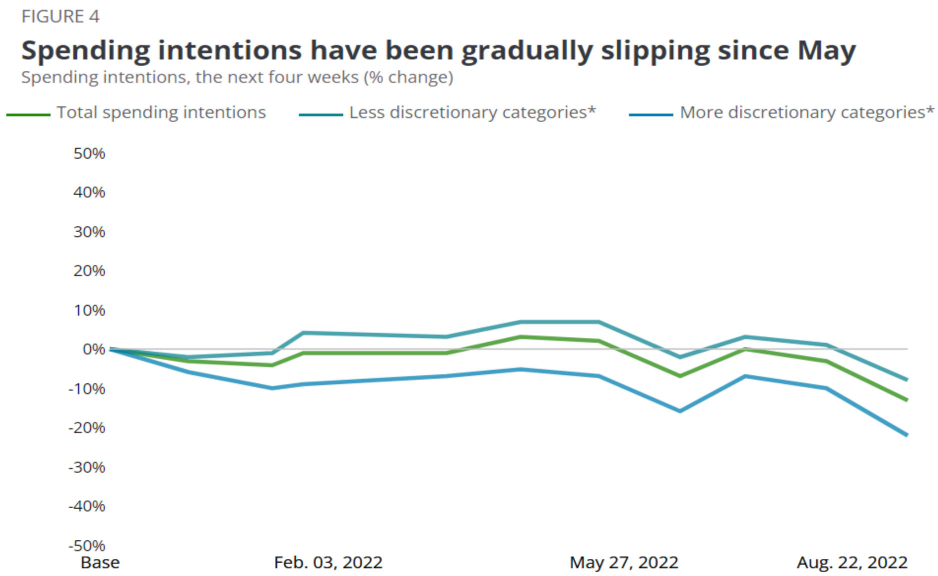
Turning back to the FOMC minutes, recent indicators most definitely do not point to modest growth in spending and production unless you want to be misled by the official data. Here is a taster of the indicators FED Powell is ignoring. Maersk the global shipping line reported on: *"Wednesday that global container demand is expected to contract between 2% and 4% in 2022, down from a previous projection of +1% to -1%, noting that freight and charter rates declined in the third quarter as demand moderated and Chinese Covid-19 restrictions diminished."* Additionally, the report showed the extent of falls in imports into the EU and USA. *"Imports from the Far East are estimated to have fallen by 6% in Europe, and they declined as much as 7.5% in the US. Vacancy rates for warehousing fell to near-historic lows, as businesses scrambled for extra storage space to hold their swelling inventory levels amid a drop-off in consumer demand."* FreightWaves reported how in the second half of September the US freight industry unravelled. Even the GDP data released earlier was weak under the hood. The US economy grew in the second quarter only because imports fell faster than exports. Truly a case of the triumph of gun and gas exports.

As for the unstoppable labour market take a look at the breakdown of the data from ADP on Wednesday. ADP surprised the markets with an estimated rise in private employment of 239,000. Graph 1 gives a breakdown as to which kind of company categorised by size did the employing. If an employer employs under 20 workers they increased employment by 62,000 and if they employed between 50 to 249 workers they really went on a hiring spree increasing their employment by 241,000, but if they fell outside these categories they ended up cutting their workforce by 74,000. Over the longer term, it is the biggest not the smallest companies that hire most. So which sectors increased employment besides energy; it was Trade, Transportation, and Utilities, together with Leisure and Hospitality. Utilities I can understand, must be all those additional debt collectors as millions of households struggle to pay their utility bills. But leisure & hospitality employment jumping in October, a time when the weather has turned, and when three out of four consumers are cutting back on this *most discretionary of sectors* as Graph 2 by Deloitte's shows! Finally, as I pointed out in Graph 8 in an earlier post, the National Federation of Independent Businesses representing companies typically employing <500 workers shows sentiment to be so pessimistic it has falling back to 2008 levels. All of which is not conducive to a hiring spree.

Graph 1.



Graph 2.



Now the serious stuff. What causes inflation.

To answer this question we have to go back 150 years to the transition from the classical economists (Smith, Ricardo, Marx) to the neo-classical economists (Marshall, Walras, Friedman). This moved theory previously centred on production to being centred on exchange and therefore from prices being determined by the actual costs production (exchange value) to prices being determined by the act of exchange itself where use value makes an appearance. Once the capitalist class abandoned a cost-based approach to prices it opened up the way for all the latter-day **subjective** theories on inflation, namely that inflation was demand-led culminating in its most vulgar apostle – the monetarist. They even coined the term *inflation psychology* which by feeding on itself accelerates demand. From then on economists, including the Keynesian variety, lost the ability to explain inflation except in extreme cases.

However, the cost based approached to pricing over time has always proven to be correct. What caused prices to fall prior to the pandemic - the so-called secular trend - was the international restructuring of the division of labour coalescing around China which let to a dramatic fall in the cost structure of global production. All the central bankers and all the monetarists could huff and puff as much they wanted to, to inflate prices, but try as they could they could not blow down this emerging cost structure.

The fact is that prices orbit in the gravity well created by value, orbits which are continuously disturbed by the restless movement of capital under the influence of the galactic phasing of the industrial (business) cycle. This basically sums it up, prices no matter how much disturbed, ultimately cannot escape this gravity well.

As a result of the pervasive influence of neo-classical economics the emphasis on restraining price rises falls on the demand side including the liquidity underpinning demand. But as Marx pointed out, it is not the supply of money that drives circulation but circulation which sucks in money. An analogy will suffice. Take the relation between the petrol tank and the car engine, where the former represents the stock of money and the latter circulation. Now the petrol tank can't force petrol into the engine making it go faster, if it did the advice would be for all the occupants in the car to jump out. Instead what really happens is that the engine sucks in petrol via the carburettor, and the amount it will suck in depends on how big the cylinders are (the amount of value) and how quickly they are moving (velocity of circulation). This is a function of the pressure on the accelerator (investment in circulating and fixed capital). So demand in the end is a response to the productive (investment) and unproductive consumption of the capitalist class, given that most workers consume what they earn because they tend to live pay cheque to pay cheque.

The spike in inflation following the pandemic has four causes. Firstly, endemic supply disruptions now abating, restructuring of supply chains now accelerating, geopolitical factors (the war in the Ukraine) and Solar 25. All of these are on the supply side, the production side. None of them have anything to do with demand, in fact each of these factors is negative for demand, given their impact on investment.

This is not to deny there was a brief episode on the side of demand fuelled by Covid Support Funds colliding with falling production. But that is over. It is not often I applaud an article written in the Financial Times, but Paul Donovan's *Market Insight article,* titled '*FED Must be Clear That Inflation Is Spurred by Profits'* is worthy of that applause. He points out that while the Covid induced rise in the prices of durable goods was the fastest ever, prices have now reversed and are falling at the fastest rate since the 1950s.

What remains is residual inflation in services such as owner occupier rents and more consequentially, longer-term contracted costs such as those found in freight, shipping and energy which still need to expire. What there is not, is wage-push inflation. Powell admitted as much in his press conference on Wednesday, when he said there was no evidence of a wage spiral yet. However he added the cautionary caveat that by the time one is seen it is too late so steps need to be taken in advance to prevent it.

Why are the capitalists so terrified of wage push inflation? This has everything to do with the capitalist perception of cost price or what is the same thing those costs of production they have to pay for. It is important to bear in mind that one capitalist's output price is another capitalist's input price. Thus if output prices are rising so too must input prices. The importance of this observation is established when we recognise that the total prices of intermediate sales (inputs) is three times larger on average when compared to the total prices of final sales. Thus because of its scale, cost price plays a decisive role in the eyes of the employer. However, while there is nothing they can do about the price of inputs, they do have a variable cost they can control – wages. The only way to reduce their cost price is by reducing wages.

There is another aspect that concerns the employing capitalist. Wage settlements last a year, during which time prices can change. Also, this year's settlement provides the stepping stone for negotiations in next year's round which means next year's round of negotiation kicks off at a higher point should workers have achieved a significant pay rise this year. Thus the effect of wage rises is enduring. This is why some employers have been offering a one-off cash sum together with a lower increase in wages to avoid this.

Consequently employers' control over cost price is limited to their control over their wages and benefits bill. As soon as employers lose control over pricing (selling prices), which is happening now, they have to bear down on their cost prices to preserve their profit margins. What scares the employing capitalist more than anything, is any loss of control on the cost side due to the growing resistance by workers.

Which brings me to the Phillips curve. Michael Roberts wrote an excellent post on this subject, to which I wrote a regrettable comment too dismissive of this curve. In that post Michael showed the dissociation between the Curve and inflation quoting a BLS spokesperson by the name of Palatino musing that: *"Over* *the last 20 years, the Phillips curve relationship has nearly completely broken down in the United States".* In reality what has broken down is the class struggle.

Inflation is a barometer of the class struggle. Over the last 20 years the class struggle has been muted. The result is that wages have lagged productivity rises and even price rises rendering the Phillips Curve irrelevant. But that can change. Should workers' struggle re-emerge out of necessity following the cost of living crisis then the Phillips Curve will become relevant again because wage rises will track price rises. Under those circumstances there will be a positive association between the Phillips Curve and inflation, not because wages are **causing** prices to rise but because wages are now **tracking** price rises.

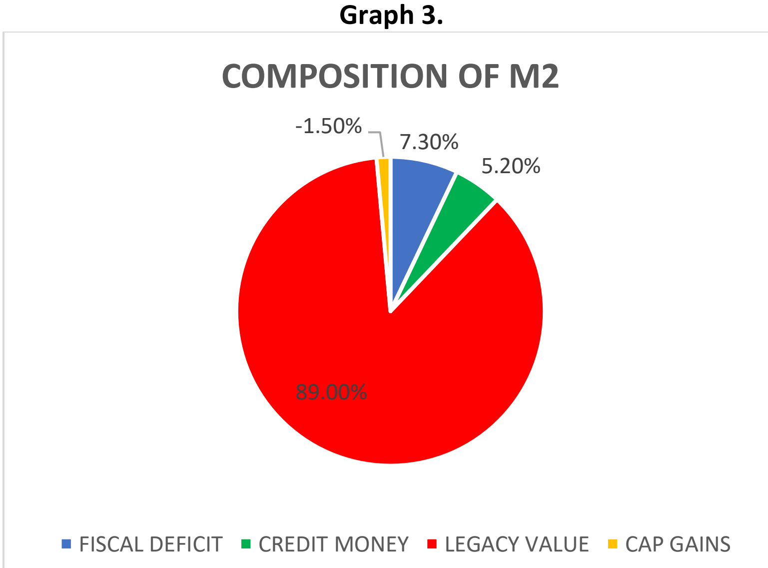
The Modern Marxist Monetary Theory or MMMT.

This theory was developed in response to the confusion over token money. How can a valueless item circulate valuable items, when an exchange is typified by value being given up in return for value being received. MMMT explains this. I showed what was really being exchanged was legacy value for currently produced value via the agency of this state backed token. For more on MMMT go to here, here and here. Money takes legacy value in one hand and current value in the other before swopping hands.

In short, M2 mainly consists of legacy value which has been monetised in the form of revenues held over from previous cycles of production as yet unspent. Since the late 1980s it has represented between 90 and 92% of the stock of money. This legacy value should be seen as the ballast keeping prices stable because that revenue is fixed, it is invariable as it represents value already produced and fixed. It cannot be arbitrarily increased or decreased.

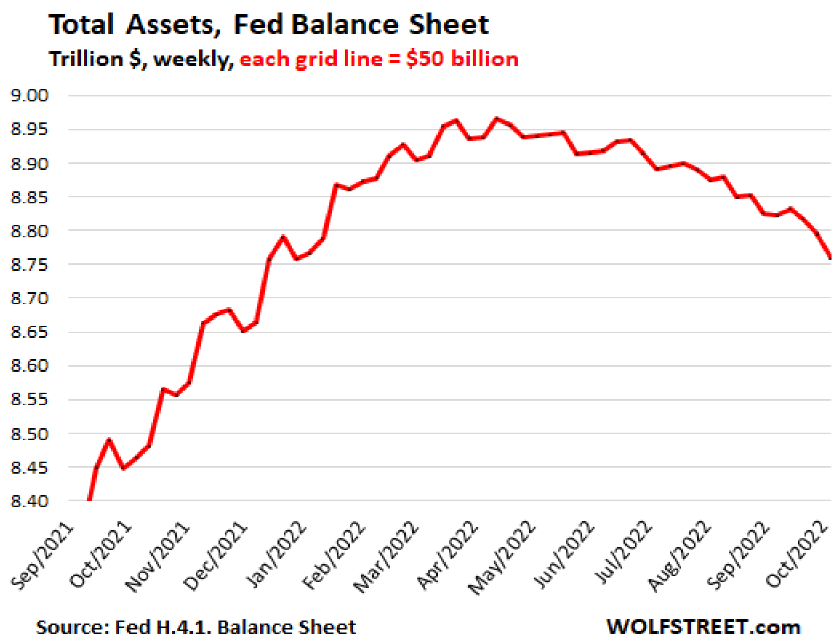
The balance of 10% is made up of temporary money (bank credit which has to be repaid), new permanent money [(1)] (fiscal deficits and QE less QT) and plus or minus the netted-out flows from speculation. Below is a graph showing the present composition of the M2 stock of money in Q3, 2022. Legacy value represents 89% of M2 making money broadly neutral. The fiscal deficit is 7.3% of the total and new credit money is 5.2%. Conversely, capital losses subtracts 1.5%. I base this figure on the research done by the Harvard Business School which shows that about 3.6% of GDP is due to capital gains being spent on personal consumption when share prices are in the ascendancy. I have reversed this for the losses endured in Q3.

Graph 3.



(Note on methodology.) All data is limited to Q3 and not annualized. For longer term data view the last link above. For the fiscal deficit I have deducted Quantitative Tightening from the Fiscal Deficit. In Graph 4 the amount of quantitative tightening can be seen. Running at around half the planned amount, circa $40 billion p.m., it is clear that the FED is cautious about ratcheting up the pace of tightening due to its negative effect on the bond market.

Graph 4.



In conclusion, during the height of the Covid Relief funds, the share of M2 provided by legacy value fell all the way down to 78% because the fiscal deficit increased by 14% tripling its share. Thus demand was not constrained by legacy value and because much of those fiscal funds fell into the hands of those who needed to spend it, the bottom 80% of society, inflation soared. Now the composition of M2 has reverted back to typical parameters, demand will be constrained once more by legacy value.

The outlook for prices.

If it is the case, and it is, that in the end prices are formed by actual costs, that is on the side of supply, how do interest rates affect production? As Michael has shown in the article cited, investment is more sensitive to changes in profits than it is to interest rates. However at the margins, that is insolvent companies, rising interest rates can lead to bankruptcy. Additionally, trade credit is sensitive to interest rates, and as they rise so the propensity to issue trade credit to replace money is diminished. Collectively, systemic interest rate rises can reduce supply by increasing insolvencies and disrupting trade credit or reducing its duration. Now when Powell talks about aligning demand with inadequate supply by reducing demand, supply itself is not immune, it in turn can be reduced creating a looping effect because demand has to be suppressed even further.

Of course governments could have stepped in to increase supply by creating a state investment bank and enacting laws against hoarding supply, but that would have meant stepping on their masters' toes, the multinationals and that is not allowed. Or they could have ended the war they started in the Ukraine but that is not allowed either, less it hinder their masters' march on Beijing.

Globalisation, defined as the cheapest unhindered international supply chain possible, is dead. The secular trend of falling prices for goods is over for good. The hegemonic struggle unleashed by the USA in the form of an economic war on China has disrupted the complex and fragile web of supply chains established over the last two decades. Planning for resilience, friendshoring and reshoring production, despite technical advances, will be much more expensive. It will raise the actual costs of production particularly if the global economy fractures into two economic architectures. As a result we are closer to the conditions of the 1930s than we were pre-1914.

However, we will not experience the rise in prices because the world economy is entering the deepest slump since the War. Or what is the same thing, an extensive crisis of realisation of value because of the depreciation of prices. Such periods are associated with deflation not inflation. What has happened to the prices of goods is a harbinger of what will happen to general prices.

However, what will be evident will be the collapse in profit margins caused by rising costs of production colliding with depreciating selling prices. One of the factors behind the rising cost of production will be the rise in the value of labour power because of the crisis in food production due to global warming exacerbated by Solar 25. Food inflation will be worse in 2023 than in 2022. Already the winter wheat planting season which supplies two thirds of the annual crop has been disrupted by drought in North America. The same adverse climatic conditions exists in Australia and Argentina at the other end of the growing cycle as they approach harvest time. The 'Great Hunger' can only become more acute in the years to come.

Another factor is the lack of resilience. Capitalism is as prepared for a spike in global temperatures as it was for a pandemic. The disruption Solar 25 will produce when El Nino replaces La Nina is unquantifiable but it will be highly problematic and dangerous. Capitalism will finally be forced to face up to the cumulative monetary costs its greedy recklessness towards nature has brought about.

Although the war in the Ukraine should be over by the end of winter with Russia holding the upper hand, it is unlikely that sanctions against that country will be lifted. After all the war was not about the Ukraine, but using Ukraine to break Russia at great cost to humanity. Thus the cost pressures resulting from these embargoes will remain though it cannot be ruled out that in a deep crisis, Western ranks could split, with the EU softening its approach to Russia.

Conclusion.

In his Press Meeting Powell said he was aware of current surveys of business activity but did not give them the same weight as the official data which he said was broader and took into account current conditions. On the face of it he was vindicated. On Friday the Establishment Employment data came out above expectations. No surprise there. I will not dignify these figures by commenting on them. I will say however, that the relationship between the soft and hard data, that is between surveys and official data, does indicate the direction of travel for the economy. When surveys rise above the official data the economy tends to expand and when they fall below, as is happening now, they tend to indicate a contracting economy. Further, it is inconceivable for capitalist employers to hoard workers or even employ more workers in the face of compressing margins, ebbing orders and overstocking. It just does not make sense from the profit point of view which is the only view the capitalist acts on. The employment and production data simply flies in the face of capitalist behaviour.

There is a final consideration. Diagnosis is 90% of the cure. The appropriate remedy requires accurate information. Recently the data coming out of the Department of Commerce has been suspect. I will not go into the reasons for this here but they are both political and methodological. The point is this, if Powell and his FOMC are acting on inflated data, then the interest rate path they are executing, within their own terms, is far too steep. This being so, the possibility of a soft landing is ruled out. This is on top of the fact that rising interest rates do not correct supply issues, but can even exacerbate them.

US imperialism is like a cowboy trying to draw his gun, only to shoot himself in the foot. Unprepared for the pandemic. Provoking a war in a world still reeling from the pandemic. Reversing globalisation by trying to cut out China and importing capital to make the USA more self-sufficient. Zero resilience in the face of spiking global temperatures over the next three years. An increasingly unhealthy working class. This is what imperialism in decline looks like.

It should be put down before it does more damage.

(1) It is all this money generated by QE which remains in circulation until it is mopped up by QT which explains the healthy balance sheets of the rich despite the losses on markets this year.

Brian Green, 3rd November 2022.