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All eyes on Washington: Will the Fed funds rate be raised?

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Interest rate decision by the Fed

Tomorrow, Thursday 17 September 2015, the federal Open Market Committee (FOMC) of the US central bank Fed will be taking an important decision. Is the Fed funds rate to be raised or not? The financial markets have accorded this decision a particularly important role. After all, the rate hike by the most important central bank in the world could cause the degree of instability on the financial market to continue rising.

Regardless of whether or not a rate hike materialises, the Fed will communicate that the interest rate cycle will only be set off very gradually. At the same time, the projection for the final level of the cycle will probably be taken down a bit. If the Fed managed to alleviate the worries of excessive rate hikes, a slight increase of the Fed funds rate on coming Thursday would not upset the financial markets in any sustainable fashion. However, the weakest segments in the emerging countries would come under pressure.

Start, speed, and finish

Much like the economic cycle, the development of the key-lending rate (here: Fed funds rate) is not erratic, but follows trends. The last cycle of rate hikes started in 2004 at 1% and ended in 2006 at 5.25%. The question is therefore whether the Fed funds rate will be raised in September, a bit later, or remain at practically zero in the foreseeable future. This is the signalling effect of the first interest step: the uncertainty with regard to the speed and the final point of the interest rate cycle.

Neutral interest level

Traditionally an interest rate cycle that originates at a low level is referred to as normalisation. This is the process of approximation towards the so-called neutral interest level, which is the level at which the economy is in equilibrium. Numerous estimates suggest an equilibrium bandwidth of 3% to 3.5%. In this model the economic resources labour and capital are used optimally. This goes for the level of goods and services produced (potential output) and for economic growth (potential growth). Put simply, this is a situation of full employment. Also, the rate of inflation is in line with the target of the central bank (2%).

FED Funds Rate 2000 – 2015 (in %)

Improvement on the labour market

The current fed funds rate is within a bandwidth of 0% to 0.25% and was set at the climax of the recent crisis, at the end of 2008. The reason for a near-zero percent interest policy has subsided somewhat in line with the slow, weak, and fragile recovery of the US economy from the Great Recession 2008/2009. Indeed, the unemployment rate is now at 5.1%. Some estimates suggest that therefore an important threshold may have been hit, i.e. the so-called non-accelerating inflation rate of unemployment (NAIRU). In this model, the pressure of excessive wage and price increases rises for values below that threshold. However, there are also other job market indicators that suggest significant amounts of underemployment. Also, at 1.2%, the inflation measure preferred by the Fed, the deflator for private consumer spending exclusive of food and energy (core personal consumption expenditure deflator) fell clearly short of the inflation target of 2% in July on a year-on-year basis. At +2.1%, however, the growth rate of GDP adjusted for inflation exceeded the estimated potential growth rate of about +1.8% in the first half of 2015 (Source: Bloomberg). If the economy continues to grow above its potential, inflation pressure will decline over time according to the aforementioned theory. Given this scenario, numerous FOMC members have recently expressed their tightening bias and thus to be in favour of a rate hike in the foreseeable future.

Problems in the emerging economies

In many emerging countries, which account for a total of about 40% of the global economy, a negative spiral has been set off. Weaker economic growth and at the same time a drastic increase in private debt has caused capital outflows, which in turn have led to the depreciation of currencies and a reduction in liquidity (rising interest rates, more restrictive lending standards of banks, more difficult access to the capital market). Coming full circle, this environment then weighs on economic activity.

Negative spill-over effects

The weakness in the emerging economies also spills over into the US economy. The financial conditions deteriorate: the spreads for the default and liquidity risk and volatility have increased, and share prices have fallen. A further deterioration would burden the US economy significantly and for the longer term. Also, the sentiment of consumers and companies might deteriorate. This would cause private consumption and investment to decline. Thirdly, the emerging markets have been generating pressure for prices to fall (deflation). The currencies of the emerging markets, commodity prices, and the global prices of goods are caught in a falling trend. This has led to declining import and producer prices in the USA, which keep the entire inflation pressure on low levels. And lastly, the direct effects via lower US exports are minimal.

Conclusion

The Fed therefore has to evaluate two spheres that influence each other. The US economic growth is gradually turning self-supporting and causes the economy to edge towards full employment and inflation target. At the same time the weakening in the emerging economies is producing deflation pressure on a global scale as well as an increase in instability on the financial market.

In summary, it is not clear whether or not the Fed funds rate will be raised on coming Thursday. That being said, a push-back would be of very limited help because the opposing developments will probably be picking up. The resulting uncertainty with regard to the starting point of the interest rate cycle would continue to affect the financial markets. The maintenance of the current rate level would only make sense from a rational point of view if the tightening bias were to subside as well – which is not very likely. Regardless of whether or not a rate hike materialises, the Fed will communicate that the interest rate cycle will only be set off very gradually. At the same time, the projection for the final level of the cycle will probably be taken down a bit. If the Fed managed to alleviate the worries of excessive rate hikes, a slight increase of the Fed funds rate on coming Thursday would not upset the financial markets in any sustainable fashion. However, the weakest segments would come under pressure.

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