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US monetary policy: Courage needed!

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The US Federal Reserve has decided to leave its key interest rates unchanged for the time being (in the range 0.00 % to 0.25 %). There was little surprise at yesterday's decision which had been hinted at in advance. However, in our view, that does not mean it was a good decision. This rather timid hesitation from the Fed comes at a cost – both to the US economy and on the international capital markets. An interest rate increase might have been better from a variety of perspectives.

Robust US domestic economy

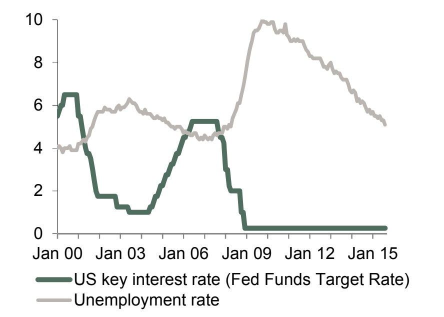
The US economy has been growing steadily at around 2.5 % since 2014. While this is below the average rate prior to the crisis, this low growth is structural in nature and cannot be corrected by monetary policy intervention. One of the fruits of the stable economy has been a (continuing) series of very positive figures in the US labour market. Full employment has now been achieved. The only sticking point is the rather sluggish momentum of wages and salaries.

Any mention of wage momentum has to include what is happening to inflation. This is rather too low for the Fed's liking. However, assessments vary depending on which inflation measurement is used. Supporters of the Fed's hesitant policy point to the excessively low value of the core limit of the PCE deflator (currently 1.2 %). The core rate of the Consumer Price Index, on the other hand, is a great deal nearer the target at 1.8 %.

Overall, the US economy is sufficiently robust to support interest rate increases. Ultimately, this is simply a matter of *beginning* a cycle of interest rate increases in an economic situation in which monetary policy had previously been close to the *top* of its interest-rate curve (Figure 1).

Figure 1: Key interest rates and the labour market

In per cent



Source: Bloomberg

Capital outflows from emerging economies

An argument much used in support of the continuing delay from the Fed is the fear that interest rate increases would harm emerging economies (EEs) by provoking increased outflows of capital. There has been little sign of any such reaction so far, despite the fact that an increase in US key interest rates has been (and still is) on the cards. It is true that EEs have experienced real capital outflows over the last 18 months or so but, if the figures for China are excluded, 2015 has actually seen the return of minor inflows into EEs. The primary reason for the significant outflows experienced by China was a build-up of foreign currency accounts, including inside China itself (Figure 2). Strictly speaking, this increase in receivables counts as an outflow of capital; however, domestic foreign currency deposits cannot be characterised as "hot money" and do not, therefore, really constitute a problem.

EEs not helped

Prospects for the emerging economies have become somewhat gloomier in recent times. This is certainly the case in China, for example, but also in Brazil and Russia – albeit for different reasons and to a different extent. We cannot share the hope that by delaying the start of interest-rate rises some assistance will be given to the economies of these countries. For one thing, raw materials prices play a much more significant role in these countries, while the Fed's hesitation serves simply to increase uncertainty regarding monetary policy in the United States, thus giving rise to even greater volatility on the capital markets and inhibiting investment in the EEs. Central banks in the emerging economies have been preparing for an increase in key US interest rates for several months now, as suggested by a recent comment made by the Deputy Governor of the Indonesian Central Bank with regard to a rise in key US interest rates: "The more certainty there is, the better."

Sharp rise in asset prices

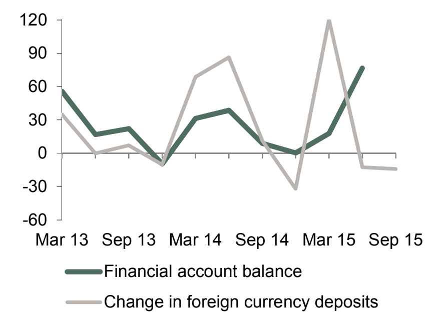
Furthermore, continuing to adhere to this policy of keeping interest rates extremely low is aiding the build-up of economic bubbles – a much-feared prospect in many circles. Indeed, a number of property markets (e.g. those in the UK, Australia and Sweden) have recorded significant price increases since around the middle of 2013. And the same applies in the case of high-yield bond spreads which have been on a clear downward trend since the middle of 2013 as a result of high demand.

The Fed needs more room for manoeuvre

Last but not least, if interest rates were to start heading back upwards, this would gradually return much greater room for manoeuvre to the US central bank, enabling it once again to react in a more nuanced manner to any new economic challenges that come along. The longer the Fed waits, the greater the likelihood that it will not have enough weapons at its disposal when economic times get tough. The Fed is the last institution to find this situation satisfactory – another good reason why it should have raised interest rates. ■

Figure 2: Chinese financial account balance

USD bn (fin. acc. bal.: positive values=outflows)



Source: Bloomberg, CEIC, own calculations