Fed sets the stage for lift-off later this year

Hawks, doves seem united on taking action soon

Darrell Delamaide, US Editor

Conventional wisdom is that the Federal Reserve will take its initial step in raising rates at one of the policy-making meetings followed by a press conference, so that Fed chair Janet Yellen can provide context.

This is why anticipation was high for the September meeting, and inaction then has now shifted the focus to December, the next Federal Open Market Committee meeting with a press conference scheduled to follow.

But Yellen has been at pains to provide the context for the rate hike ahead of time and it is conceivable that lift-off will take place in October, even without a scheduled press conference. If she felt a need to communicate further context, she could do so via a conference call with journalists or an ad hoc press conference.

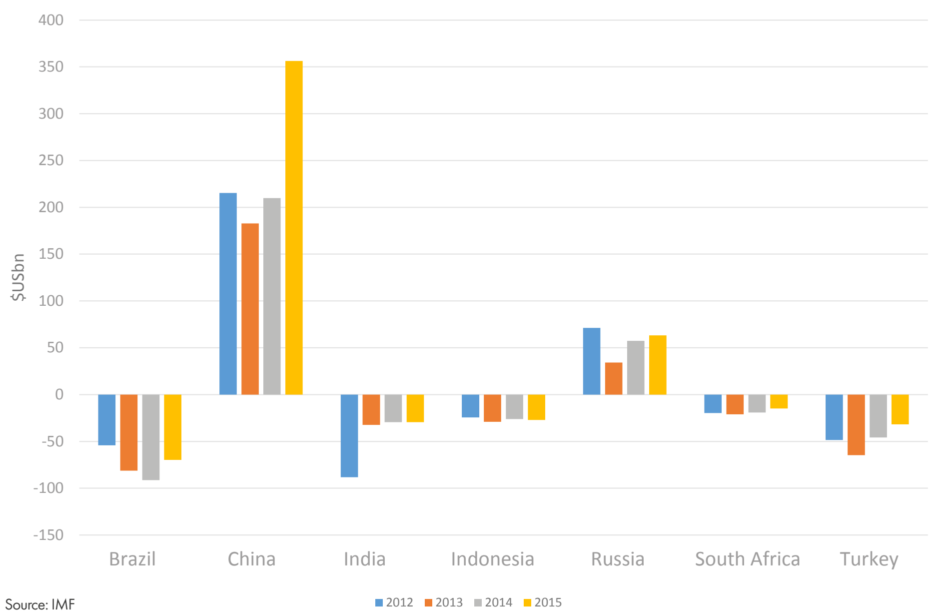
It seems from her remarks and those made by other Fed policy-makers after the September meeting that they have been taken aback by the negative reaction to the panel's non-decision. There has been a growing unison across the hawk–dove spectrum that it is time to begin the process of normalisation. Though Yellen indicated in her September press conference that market volatility resulting from lower growth prospects in China gave the Fed pause, recent remarks from policy-makers suggest that this concern will not keep them from acting. A number of developing countries, even those with current account deficits that need financing, appear to be resigned to Fed action (Chart 1). In any case, Yellen has set the stage for lift-off with her nuanced remarks at the September press conference and in a major address at the University of Massachusetts in Amherst toward the end of the month.

What her Fedspeak boils down to is that the central bank feels the need to overshoot the mark on lowering unemployment in order to speed up the process of bringing inflation up to its 2% target. At the same time, it cannot delay monetary tightening too long because it wants to proceed at a measured pace and not be forced into more abrupt – and disruptive – action if inflation catches up too fast.

So, Yellen said in her Amherst speech, FOMC participants expect the jobless rate to sink below the target of around 5% and inflation to move back towards 2% once 'temporary' dampeners, such as lower oil prices, abate. She concludes that this expectation is why 'most of my colleagues and I anticipate that it will likely be appropriate to raise the target range for the federal funds rate sometime later this year'.

Chart 1: Developing economies poised for impact of a US rate hike

Current account balance ($bn)



Source: IMF

Richmond Fed President Jeffrey Lacker was the lone dissenter at the September meeting. In a comment explaining his dissent, Lacker noted that real short-term rates are below negative 1%. 'Such exceptionally low real interest rates are unlikely to be appropriate for an economy with persistently strong consumption growth and tightening labour markets,' he said. 'Even after a quarter-point increase, interest rates would remain exceptionally low, providing ample support for economic growth.'

He acknowledged that the recovery has been 'disappointing' compared to historical averages. 'Nevertheless, US economic conditions have improved quite significantly over the last six years,' he said. 'It's time to recognise the substantial progress that has been achieved and align rates accordingly.'

St. Louis Fed chief James Bullard (non-voter), who has urged action sooner rather than later for most of this year, emphasised in a presentation in St. Louis that 'once normalisation begins, policy will remain extremely accommodative through the medium term'. He complained that judging by the market reaction the Fed's failure to act in September 'created rather than reduced global macroeconomic uncertainty'.

The case for normalisation is strong, he argued, for the simple reason that 'the committee's goals have essentially been met, but the committee's policy settings remain stuck in emergency mode'.

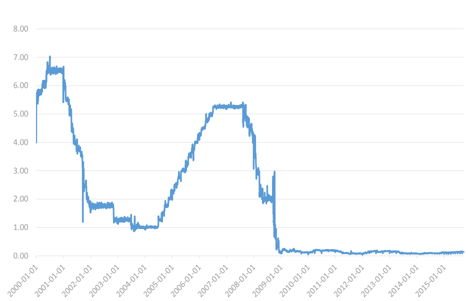
And even John Williams (voter), the head of the San Francisco Fed who is as dovish as they come, came down in favour of action soon, dismissing some of the 'hand-wringing' over China as 'downright apocalyptic'.

'I don't see the situation as dire,' he said in New York. On the US front, he noted 'we're in a very different place now than when we first instituted extremely accommodative policy in 2009'. Given that there are long and variable lags in monetary policy, 'an earlier start to raising rates would allow us to engineer a smoother, more gradual process of policy normalisation'.

Delaying and raising rates too late, he added 'would force us into the position of a steep and abrupt hike, which doesn't leave much room for manoeuvre'. ■

Chart 2: Time for a rise?

The Fed rate 2000–15



Source: FRED

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