Economic Commentary

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Fed on course to Raise the Overnight Rate to 3.0%, and then What Next?

The Federal Reserve Board Open Market Committee (FOMC) is holding its third regularly-scheduled meeting today and is universally expected to announce another quarter point interest hike in the key policy-setting federal funds rate to 3.0%, from 2.75%. This will be the eighth quarter-point hike in rates in less than a year.

Now that the US economy has healed from its 2001 recession and jobless recovery, Fed Chairman Alan Greenspan is adjusting US monetary policy to a more neutral setting, which means a level of about 4.0 to 4.5 percent. Most economists and market analysts expect that barring any unexpected jump in inflation, the Fed will continue on this course of "measured" increases for the remainder of the year, which means a fed funds rate of 4.25% by mid December.

There are strong reasons why the Fed should go this course. First, consumer headline inflation in the United States has surged last year from less than 2% in early 2004 to more than 3.0% early this year. The latest reading of core inflation has also jumped and now stands at 2.2% in the first quarter, a seven-year high. Producer prices are running at a 4.9% year-over-year rate. Clearly, the central bank needs to act.

But there is another, less mentioned reason why the Fed is on this course. Alan Greenspan, after an eighteen-year reign on the helm of the Federal Reserve is due to retire at the end of 2005. After reducing interest rates to an unprecedented generational low of 1.0% and after having maintained US monetary policy at the most expansionary direction for a longer period than at any other time in US history, he now wants to return the stance of money policy back to a more normal level and in the process safeguard his reputation as the best US central bank chief in history. His record has been truly enviable, having bailed out the US economy from the stock market crash of October, 1987, when equity prices plunged by more than in 1929, and then the meltdown in the U.S. stock market from 2000 to 2002 –the largest in US history, not to mention the 1994 Peso crisis in Mexico, the 1998 South-East Asian crisis and more recently, the 9/11 terrorist attacks, the Iraq War and the deflationary scare of 2002-2003. Through it all, he also managed to preside over the longest economic expansion in US history, from 1991 to 2001 during which the US experienced the greatest prosperity in its history, surpassing even that of the Great Gatsby era of the 1920s and the 1960s period.

However, the underlying health of the US economy is also much weaker than it has ever been and worse of all, its economic prospects for the future have turned, in my opinion, to the worse since 1929, just before the start of the Great Depression. Public statements by leading economists and policy makers notwithstanding, the medium to long-term economic outlook is terrible. Why am I being so alarmist?

The twin US budget and current account deficits are the highest in US history and cannot be resolved through the normal course of economic adjustments. Neither an adjustment to slower growth in the US nor an adjustment to higher growth abroad, especially in Europe and Japan are realistic ways of curing the structural imbalances. Drastic action is required, which can either come pro-actively by policy authorities or forced on the economy through violent reactions from markets.

Second, the strategic thrust of the economic policy of the Bush administration is unrealistic and unattainable. What I mean by this is that no government can wage simultaneously a war and cut taxes all at the same time and expect to come out a winner. Last time this was done in the late 1960s, incidentally also a period when the US economy had enjoyed its longest economic expansion and was the hegemon in the global economy, the Kennedy and Johnson administrations fought the War in Vietnam and the War on Poverty, without raising taxes. What followed created large budget and current account deficits that led in August of 1971 to the de-facto devaluation of the US dollar and the collapse of the Bretton Woods international monetary system. When the energy crisis of 1973 hit, the monetary instability that resulted from the collapse of the gold-exchange standard allowed inflationary forces to get out of control resulting in economic decline in the 1970s and early 1980s.

Third, the US and global housing market are in a bubble, a bubble that is about to burst. Record low short-term and long-term interest rates have combined to push US housing prices to highs never seen before, not even on the eve of the Great Depression. Anybody who thinks that prices will continue to rise and that this is no bubble are deceiving themselves. We have seen similar bubble conditions unfold in the global and US equity market in the late 1990s, and then it burst. We have seen the housing market burst before, most notably in the 1980s. Now, that interest rates are on their way up it is a mathematical certainty that housing prices will fall –just as they rose when interest rates were brought down to record lows. What goes up must come down! Only this time, the fall will be more precipitous, because the market will fall from higher levels, the US consumer is more indebted than ever before having used the last few years to refinance their homes and take out more than a trillion dollars of equity that played the decisive role in ending the 2001 recession and fuelling global economic expansion the last five years. When this happens, the impact on the US consumer will be much bigger than that of the 2000 melt-down in the equity market simply because far more people own a home than they own stocks. This will force a retrenchment in consumer spending, a rise in the saving rate and will precipitate another global recession and economic collapses in many emerging economies from Turkey to the Philippines.

This time around, the US budget balance is not in a surplus position where President Bush found it and used it to bail out the US economy. There is little room to bail out the economy through higher spending and lower taxes this time. The same applies to monetary policy. In 2000, the fed funds rate in the US was at 6.5% and the 10-year treasury yield hovered just below 6.5%. The reduction in the short and long rates to 1.0% and 4.0% respectively played an instrumental role in bailing the economy out of the recession and in engineering a recovery, albeit an anemic one. How far will the Fed be in a position to cut rates this time, that they are already so low, and how much more home refinancing room is left after the binge of the last five years? Clearly, the US policy authorities have used up most of their “reserve” fiscal and monetary ammunition and this time will have much less room to maneuver.

Complicating the above conditions is the huge dependence of the US economy on external capital flows from East Asian central banks to finance the budget and current account deficits. Now more than half of all the financing of the US government comes from few Asian central banks. The money they lend to the US comes from their export surpluses against the US, which means that when the US consumer starts to cut back, US imports will fall which will cut the trade surpluses that these countries enjoy and therefore they will have fewer US dollars to lend back to Uncle Sam at a time when the US will be in even greater need to finance its deficits than it has been until now. The implication, demand for US treasuries will plunge sending long-term interest rates up and complicating further the job of US policy authorities. Although to some extent a flight to quality should moderate the rise in yields, it may not be enough to prevent long-term yields from making a substantial up-ward move to the 5-5.5% range.

Such a scenario will also erode confidence in the United States as a destination of portfolio and foreign direct investment flows and will certainly undermine confidence in the U.S. dollar. The dilemma that such a development will impose on US authorities will be harsh. Do you keep rates low to bail out your domestic economy or do you sustain confidence in the greenback –the world’s reserve currency- by keeping interest rates high? The last time a hegemon confronted such a painful policy choice was Great Britain in 1923 just before it devalued the British pound and the United States in 1933 when it devalued the greenback.

With such a backdrop, when we look at the most recent economic news coming out of the U.S. one can hardly be optimistic. The US growth rate downshifted to 3.1% in the first quarter from 3.8% in the fourth. The purchasing managers’ ISM index came out this morning with a reading of 53.3 down from 55.2 in March and a high of 61.6 in July of last year. Now that the presidential elections in the US are behind us, it is hard to see how and why things can get any better than they did last year and when the economy does inevitably slow down where will be the ammunition to revive it. With all these looming problems, one wonders how long can the Fed keep raising interest rates and if they do –as expected bring them to a more neutral setting- what the impact of this monetary tightening is going to be for the US and by extension, the global economy. The next Fed Chairman who will succeed Alan Greenspan in January of 2006 will have a most formidable set of challenges to meet. Let us hope there are still few rabbits left that he can pull out of the hat this time.

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