QNB Economics
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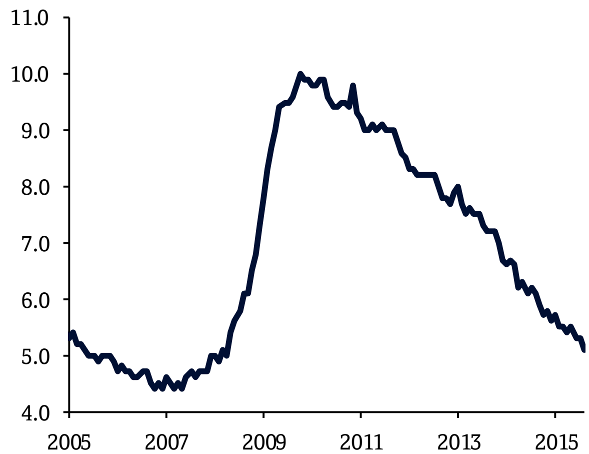
# Markets could tilt the Fed towards postponing its rate hike

The meeting of the US Federal Reserve (Fed) on 16-17 September 2015 is promising to be a landmark meeting, even by the Fed's recent high-profile standards. Having kept interest rates at near-zero for seven years and engaged in multiple rounds of quantitative easing, the Fed will, for the first time since the global financial crisis, seriously consider the case for raising interest rates. Commentators are divided on whether they think the Fed will actually pull the trigger in this meeting. Markets seem similarly unsure. We evaluate the case for and against a Fed rate hike ahead of the historic meeting on Thursday.

The main reason supporting the case for a rate hike now is the performance of the US labour market. The unemployment rate has been rapidly and steadily falling since it peaked at 9.9% in April 2010. In August this year, unemployment fell to 5.1%, below the Fed's forecasts of where it was expecting it to be at year-end. The strong showing of the US labour market is also reflected in the economy more broadly. Real GDP growth reached 3.7% in the second quarter and is tracking 2.5-3.0% in the third. The stellar performance of the economy and the labour market suggest that the Fed should act now in order to keep any future inflationary pressures in check.

But, opponents of the hike argue that there is not much inflation in the economy right now. The Fed's favoured measure of core inflation (which excludes volatile items like food and energy) reached 1.2% in July, well below the Fed's target of 2%. With inflation this low, shouldn't the Fed keep rates low until inflation is back up near its target? Not necessarily. Because of its dual mandate, the Fed needs to pay attention to both unemployment and inflation. The Taylor rule, which prescribes the central bank interest rate based on the amount that inflation and unemployment are deviating from their target, is currently recommending that the interest rate should be at 0.75%, 50 basis points higher than their current level.

**US unemployment rate**
(%)



Sources: Bureau of Labor Statistics and QNB Economics

The International Monetary Fund has recently argued that given the mixed signals from inflation and unemployment, the Fed should actually wait until there is "no uncertainty, neither on the front of price stability, nor on the front of employment and unemployment, before it actually makes that move". The Fed seems unconvinced by this view. In the words of its Vice Chairman, Stanley Fischer: "There is always uncertainty, and we will just have to recognise that". "When the case is overwhelming, if you wait that long, you will be waiting too long", Fischer added.

What could convince the Fed to postpone its rate hike, however, is that markets are not ready for it yet. Financial markets are pricing in only around 35% probability of a rate hike in September. So any move by the Fed to increase interest rates will come largely as a surprise. The Fed does not like surprising markets, certainly not in a tightening cycle. The last time it did, in 1994, it turned out to be a policy mistake. The surprise tightening of interest rates sparked wild moves in financial markets and the global economy. These moves resulted in the infamous bankruptcy of Orange County, a county in the US State of California. They also had cross-border implications as capital flight led to the Mexican debt crisis in the same year.

The Fed probably does not want to repeat this historical episode, especially in light of the recent market turmoil in August and the slowdown in emerging markets—notably in China. The Fed will probably not want to add fuel to the fire. It generally wants its take-off to be as low-key and predictable as possible.

Overall, it really does not matter much whether the Fed raises rates by 25 basis points this month or three months later. Far more important, is the speed of subsequent rate hikes as this could make the difference between a rate of 1.0% or 3.0% at end-2016, for example. On this more important issue, the Fed, financial markets and commentators are all in consensus: the Fed's normalisation of monetary policy will be slow and gradual.

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