US Federal Reserve aligns itself closer to market demands

By Nick Beams
17 March 2016

The US Federal Reserve said Wednesday it would keep interest rates on hold and scaled backed forecasts for how rapidly it will lift them for the rest of the year. When the Fed increased its base rate in December last year it appeared to be on course for four rate rises over the next 12 months.

On this occasion, the median projection of participants in the Federal Open Market Committee for the movement of interest rates, comprised from the so-called “dot plot” predictions of individual members, saw the Fed base rate at 0.875 percent by the end of the year, compared to the present level of 0.5 percent. The projection was below earlier forecasts and implied no more than two increases this year.

While it had been expected there would be no rate rise this meeting, it was still thought the Fed could move to tighten rates in June. That may still take place, but its probability has been lowered with the timeline for further rate rises pushed out to September or even December.

While last December’s rise of 0.25 percentage points proceeded with little disturbance, in the first two months of this year markets fell sharply and there was criticism that the Fed’s move to higher rates was out of line with what was being revealed by the gyrations of the financial system.

Consequently, yesterday’s indication that four interest rate hikes for this year had been taken off the table was broadly welcomed, though there was one dissenting vote from a member of the FOMC who wanted to see an immediate rate increase.

The overall response to the decision was that the Fed, in the words of one analyst on the CNBC business channel, had moved “to where the market wants it to be.”

A financial analyst cited by the *Wall Street Journal* remarked: “The Fed and the market being on the same page is somewhat of a relief. It removes one of the tangles we’ve had this year.” Another commented that the announcement “gives some investors a sense of security that they didn’t have.”

In other words, the flow of cheap money, used to finance share buybacks, mergers and acquisitions and other forms of financial speculation is going to continue. The markets duly showed their appreciation as the Dow Jones Industrial Average, which has continued to rise in the past month on the growing belief that the Fed would pull back on interest rate rises, closed up 74 points to reach its highest level for the year so far.

This was another expression of the perverse logic which dominates the markets, namely, that bad news on the real economy is good news for finance.

The Fed statement said economic activity in the US had been expanding at a “moderate pace”, which it expected to continue, with the housing sector on the improve and labour market indicators strengthening. “However, global economic and financial developments continue to pose risks,” it continued.

The statement also noted that “business fixed investment and net exports have been soft.”

The former is significant because investment in new plant and equipment, building and construction is the key driver of the real economy. Exports are also crucial because they comprise a major component of the bottom line for major global US corporations. American firms have been experiencing tougher international market conditions because of the rise in the value of the dollar relative to the value of the currencies of their competitors in Europe, Japan and Korea.

It was not referred to in the FOMC statement, but no doubt one of the factors in the Fed's decision to keep interest rates on hold and slow the pace of further rises was the fear that a move towards tightening would push up the value of the dollar against both the euro and the yen, worsening the position of US firms.

In their recent decisions, both the European Central Bank and the Bank of Japan have pushed interest rates to negative levels and increased the supply of cheap money under their respective quantitative easing (QE) programs.

The lowering of currency values is not a stated aim of European and Japanese QE—all countries maintain an official stance against the launching of currency wars—but both the ECB and the BoJ want to see a reduction in the value of the euro and the yen. That has not taken place in the recent period, largely because of the expectation that the Fed would not raise rates on this occasion. However, had it not indicated a shift away from future rate tightening, the dollar may have resumed its rise, and impacted on the position of US firms in increasingly competitive global markets.

The official statement on the international situation was formulated in bland language with the Fed saying that future assessments would be based in part on "readings on financial and international developments." No doubt behind closed doors, some more pointed language is being used.

The Fed would clearly like to return the US interest rate regime to something resembling what were once regarded as "normal" conditions. But it has been pushed away from that objective by the policies of other major central banks, which are moving further from that situation with expanded financial asset purchases and the introduction of negative interest rates.

In its decision on Tuesday, the Bank of Japan did not further ease its monetary policy, following its surprise decision at the end of January to introduce negative rates. But it did indicate it may go further in that direction later in the year. In his press conference, BoJ governor Haruhiko Kuroda claimed the bank's policy was working but then gave a downbeat assessment of the future. He said that the pick-up in exports had paused while public expectations of future inflation have "recently weakened."

As the *Financial Times* noted: "That language raises the chance of further easing because the BoJ pays close attention to expectations."

Significantly, for the second time in a row, the Fed did not provide a risk assessment in its official statement. Its omission points to the fact that US and other financial authorities have no idea of where the financial system is heading. After welcoming the relatively calm in response to last December's decision, they were totally blindsided by the market turbulence in January and February and clearly fear another round of volatility could take place at any time.

Their decisions are being made in a situation where the policies of the key central banks are on diverging paths and there is an undeclared currency war between the major economic powers, official denials notwithstanding.