Federal Reserve lifts interest rates and indicates further hikes

By Nick Beams
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The US Federal Reserve has lifted its base interest rate for the third time this year and indicated that it plans a further increase in December.

The base rate was set at a range between 2 and 2.25 percent, the first time it has gone above 2 percent since 2008. The rise was the eighth in the current cycle after the Fed began to lift its rates in 2015.

In its statement accompanying the announcement, the Fed dropped the word "accommodative" from its outlook, a move which Chairman Jerome Powell said did not signal a change in the policy path but that the term had lost its usefulness as the US economy strengthened.

The decision brought criticism from President Trump who told a press conference in New York he was "not happy" about the decision. Trump, who criticised an earlier decision to raise rates, said he would rather see the paying down of debt.

Asked about the criticism at his press conference, Powell brushed it aside. "We don't consider political factors or things like that," he said.

Outlining the decision, Powell said the economy was "strong." Unemployment was down, wages were up, while inflation remained low.

For the first time since the Fed began its low-interest rate regime following the financial crisis of 2008, its base rate is now above the level of inflation.

The Fed's statement made no reference to the growing tensions with China and the impact of Trump's tariff measures. Powell said that while there had been a "rising chorus" from companies concerned over trade and it was possible tariffs could be passed on through increased prices there was no evidence of that so far in the data.

However, he did express concerns over the growth of tariffs and the shift to a more protectionist world, saying it would be "bad" for the American economy and the Fed was "watching it very closely."

The Fed's forward projections of interest rate rises indicated that in addition to a likely rise at the end of the year there would be three increases in 2019. This is despite the fact that inflation continues to remain below 2 percent and there is no sign that it will increase in the immediate future.

In the past the Fed has indicated that the inflation rate is its main indicator in determining rate rise. But in conditions of low price rises its main concern is the increase in wages and the fall in the official unemployment rate. Wages have risen by the highest levels in nine years but the year-on-year growth of 2.9 percent is still well below levels experienced in previous "recoveries."

Stagnant and even declining wage rates, a result of the restructuring of the US economy in the years following 2008, have been a key factor in sustaining the growth of corporate profits and the stock market surge and the Fed is clearly determined that downward pressure on wages needs to be maintained. As *Financial Times* commentator John Authers noted in a recent article, "[W]age inflation is central to the Fed's reaction function."

While the interest rate increase is unlikely to have an immediate significant impact on the US economy, it has implications for the world economy as a whole, particularly in so-called emerging markets with high levels of dollar-denominated loans. The rise in US rates and the consequent upward movement of the US dollar increases the debt and interest payment burdens in these countries, with Argentina and Turkey experiencing significant currency turmoil in the past months.

The International Monetary Fund yesterday increased

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its lending to Argentina by $7.1 billion on top of the $50 billion bailout program previously announced. IMF director Christine Lagarde said the revised plan would be "instrumental" in seeking to restore market confidence in Argentina as it goes ahead with "reform" plans involving cuts to its budget.

The growing problems in emerging markets was the main theme of a press briefing by Claudio Borio, the Head of the Monetary and Economic Department at the Bank for International Settlements, as he released its latest quarterly review on Sunday.

Divergence, he said, is the "name of the game" and that while "US financial markets powered ahead, emerging markets faced mounting pressures." While "on average" financial markets continued to improve that average was not particularly meaningful, likening it to a person whose temperature on average was fine, "except that their head was on fire and their feet freezing."

He noted that since the global financial crisis US dollar lending to non-bank emerging market entities had more than doubled, rising to some $3.7 trillion and this figure did not include dollar borrowings through foreign exchange swaps which could be of a similar order.

He said the growing turbulence in emerging markets, recalling the so-called "taper tantrum" of 2013, when the Fed first indicated it was going to start to pull back on its "quantitative easing" program, and the disturbances caused by the fall in the Chinese currency in 2015, could be attributed to three factors.

The first was the combination of a tightening US monetary policy and US dollar appreciation. The second was the escalation of trade tensions which have hit equity markets in emerging economies. The third was signs that the Chinese economy could be weakening, with China having become "critically important" for commodity producers and emerging market economies.

According to Borio, the volatility in emerging markets is the symptom of a "broader malaise." The "highly unbalanced" post financial crisis recovery had overburdened central banks. While the "powerful medicine" of unusually and persistently low interest rates had boosted economic activity, side effects were inevitable and the "financial vulnerabilities that we now see are… an example."

He warned that financial markets in advanced countries were "overstretched" and, above all, there was too much debt in the world economy with its overall level in relation to gross domestic product "considerably higher" than before the financial crisis.

With central bank balance sheets "still bloated as never before"—as a result of their asset purchasing programs—there was "little medicine left in the chest" in case of a relapse.

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