US Federal Reserve Set to Lift Key Interest Rate

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Financial markets have priced in as a virtual certainty that the US Federal Reserve will raise its base interest rate when it next meets on December 13–14. Fed chair Janet Yellen lifted expectations of a rate rise when she told a congressional hearing this week that such a move could "become appropriate relatively soon."

Yellen told Congress's Joint Economic Committee that if the policy-setting Federal Open Market Committee were to delay for too long "it could end up having to tighten policy relatively abruptly."

The Fed last increased rates by 0.25 percentage points in December 2015. At that time it was projected that there could have been as many as four rate increases over the course of this year. But at each of its meetings the Fed has decided to keep its base rate on hold.

However the turnaround in bond markets in the last ten days, following the election of Donald Trump to the US presidency, has seen the probability of a rate rise, as reflected in futures markets, escalate rapidly.

The yield on 10-year US treasury bonds reached 2.33 percent yesterday, its highest level for the year. The bond sell-off (the price of bonds and their yield bear an inverse relationship to each other) is on the expectation that inflation in the US will start to rise and that any infrastructure program under Trump will increase government debt—both of which tend to lower bond prices.

The stock markets have been hitting record or near-record highs on the back of expectations that tax cuts, including a reduction in the corporate tax rate from 35 to 15 percent, and a winding back of business regulations, will boost the bottom line.

While it is not anticipated that a Fed rate rise will have a major effect in the US, the international consequences may be significant, with the effects of a rate rise transmitted through a movement of money out of emerging markets to seek higher returns in the US and a rise in the value of the dollar.

The dollar index, which measures the value of the US currency against basket of other currencies, reached a 13-year high at one point yesterday after recording 10 straight days of gains. And it could climb further in the expectation of an increase in official rates next month.

The increase by the Fed last December had a significant effect on emerging markets, which then resulted in major stock markets having one of their worst openings to a year on record. What kind of impact a rate rise will have is not completely clear, but the past weeks have seen major falls in the currencies of emerging market economies and in their stock markets.

According to a report in *Bloomberg*, emerging market bond markets are poised for their biggest losses since the so-called “taper tantrum” of 2013 when there was a rush for the exits after Fed chairman Ben Bernanke had indicated the central bank would ease back on its purchases of bonds.

Bond prices are falling across the board—it is estimated that the global paper losses so far total around $1.5 trillion—but there are significant divergences. While there is a ready market for the bonds of the major economies, the situation is different for emerging markets.

Every increase in the value of the dollar increases the real debt burden of dollar denominated loans and impacts on the balance sheet of the companies that issued them. If investors withdraw cash, then companies and financial institutions will have difficulties in paying back debt.

In other words, emerging markets, which had previously enjoyed dollar liquidity as investors searched for yield in an environment of near-zero and even negative interest rates, could face a dollar shortage as interest rates and bond yields start to rise.

It is also far from clear what will be the impact on the two most important central banks after the US Fed—the European Central Bank (ECB) and the Bank of Japan (BoJ). The governing council of the ECB will next month set out the future of the asset purchasing program which is due to end in its current form in March 2017. ECB president Mario Draghi has indicated that there would be some form of extension, but that was before the rapid rise in bond yields that followed the Trump victory.

Similarly the Bank of Japan faces new conditions. In September, the central bank committed itself to lock in the interest rate on 10-year government bonds at zero as a central plank of its monetary policy. This week the yield went above zero for the first time since the policy was announced. If it now implements its “yield curve control” policy, a situation may well develop where Japanese government bond yields are under international pressure to rise while the BoJ is working to suppress them.

While US markets are enjoying a Trump boost, there are concerns among fiscal and monetary conservatives about the state of the international financial system and the consequences of a sharp rise in the value of the dollar.

In a statement headlined “Trouble Ahead for the Global Economy,” directed to the incoming administration, the right-wing free-market American Enterprise Institute warned that while the balance sheet expansion of the world’s central banks may have helped the recovery from the Great Recession of 2008–2009 it did so by setting the stage for the next global downturn.

“Sadly, that downturn could very well be on a similar scale to the one that followed the September 2008 Lehman bankruptcy,” it said.

It warned that debt had risen to record levels, financial market bubbles had been created, and the position of troubled banks, especially in Europe, had been worsened by the low interest rate regime.

The statement noted the recent International Monetary Fund study which disclosed that global debt has risen to an all-time high of 225 percent of global GDP over the past eight years, with two-thirds of the growth involving private debt.

It pointed to two causes of concern. European governments with high levels of debt, including Greece, Italy and Portugal, are vulnerable to any tightening of monetary conditions. And what it called "excessive borrowing" by emerging market corporations in dollar denominated loans made them "particularly vulnerable to any further dollar appreciation."

But with the Fed set to lift interest rates next month, such a rise may be already in train.