The Telegraph

Fed will have to reverse gears fast if anything goes wrong

Janet Yellen has taken a huge gamble raising rates alone in the world, with manufacturing in recession and the dollar already too strong for comfort

Photo: Bloomberg

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The global policy graveyard is littered with central bankers who raised interest rates too soon, only to retreat after tipping their economies back into recession or after having misjudged the powerful deflationary forces in the post-Lehman world.

The European Central Bank raised rates twice in 2011, before the economy had achieved “escape velocity” and just as the Club Med states embarked on drastic fiscal austerity. The result was the near-collapse of monetary union.

Sweden, Denmark, Korea, Canada, Australia, New Zealand, Israel and Chile, among others, were all forced to reverse course, and some have since swung into negative territory to compensate for the damage.

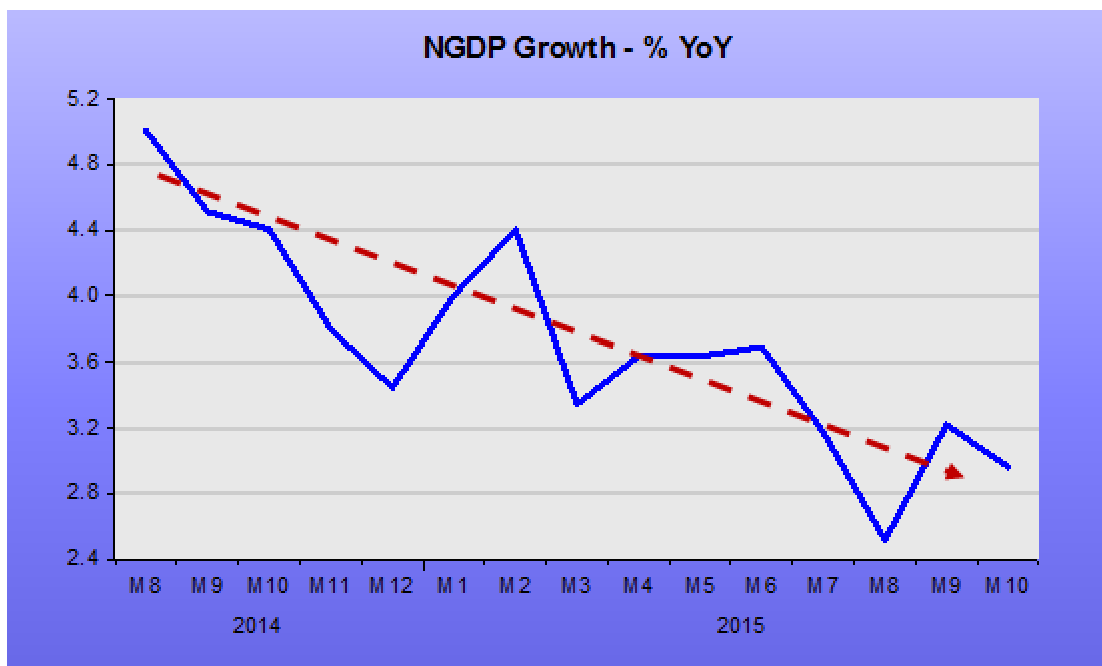
The US Federal Reserve has waited longer before pulling the trigger, and circumstances are, in many ways, more propitious. Four years of budget cuts and fiscal drag are finally over. State and local spending will add stimulus worth 0.5pc of GDP this year.

The unemployment rate has dropped to 5pc. Payrolls have risen by 509,000 over the past two months. The rate of job openings is the highest since the peak of the dotcom boom in 2000.

The M1 and M2 money supply figures have switched from green to amber but are not flashing the sort of stress warnings so clearly visible in mid-2008.

Yet it is a very murky picture. This is the first time the Fed has ever embarked on tightening cycle when the ISM gauge of manufacturing is below the boom-bust line of 50. Nominal GDP growth in the US has been trending down from 5pc in mid-2014 to barely 3pc.

Danny Blanchflower, a Dartmouth professor and a former UK rate-setter, said the US labour market is not as tight as it looks. Inflation is nowhere near its 2pc target and the world economy is still gasping for air. He sees a 50/50 chance that the Fed will have to pirouette and go back to the drawing board.



“All it will take is one shock,” said Lars Christensen, from Markets and Money Advisory. “It is really weird that they are raising rates at all. Capacity utilization in industry has been falling for five months.”

Mr Christensen said the rate rise in itself is relatively harmless. The real tightening kicked off two years ago when the Fed began to slow its $85bn of bond purchases each month. This squeezed liquidity through the classic quantity of money effect.

Fed tapering slowly turned off the spigot for a global financial system running on a “dollar standard”, with an estimated $9 trillion of foreign debt in US currency. China imported US tightening through its dollar-peg, compounding the slowdown already under way.

It was the delayed effect of this crunch that has caused the "broad" dollar index to rocket by 19pc since July 2014, the steepest dollar rise in modern times. It is a key cause of the bloodbath for commodities and emerging markets.

Mr Christensen said the saving grace this time is that Fed has given clear assurances – like the Bank of England – that it will roll over its $4.5 trillion balance sheet for a long time to come, rather than winding back quantitative easing and risking monetary contraction.

This pledge more than offsets the rate rise itself, which was priced into the market long ago. Chairman Janet Yellen softened the blow further with dovish guidance, repeating the word “gradual” a dozen times.

Markets have taken the rate rise in their stride. Equities are choppy but nevertheless higher. Emerging markets have steadied, almost from the relief that the uncertainty is at last over.

The yield spread on junk bonds - the epicentre of current stress - has dropped by 35 basis points to 6.98pc. The dollar has hardly moved, so far.

Yet the Fed is taking a big gamble by tightening at a time when the ECB and the People’s Bank of China and a clutch of other central banks are still loosening – and arguably doing so in order to drive down their currencies.

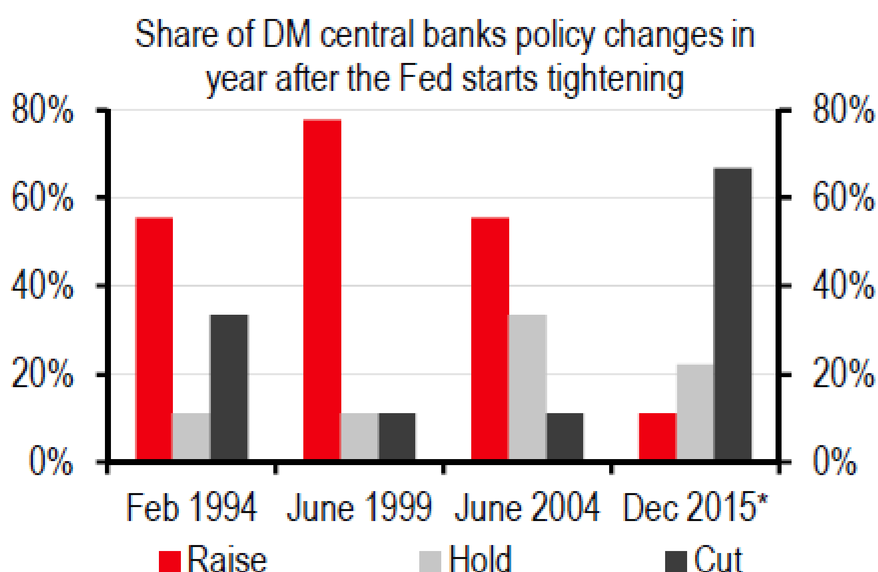
Junk bond spreads have narrowed slightly on the Fed's soothing message

This divergence is almost unprecedented and fraught with risk. Janet Henry, from HSBC, says most central banks followed the Fed rapidly in the past three tightening cycles.

The risk is that the dollar will keep rising to the point where the US economy stalls, leaving America as the “latest victim of the deflationary pass the parcel which has plagued the global economy for a decade”.

Vincent Reinhart, former head of the Fed’s monetary division and now at the American Enterprise Institute, says Mrs Yellen is going along with a rate rise now in order to “**buy credibility**” so that she can then drag out the tightening cycle later.

It is tactical ploy that allows her to be looser for longer, and stretch the cycle. This is how markets seem to have interpreted her move. Futures contracts have priced in just two rate rises in 2016, and two more 2017, half as much as the Fed’s formulaic forecast in its "dot charts".



The optimistic view is that world economy will shrug off the slow-growth malaise of 2015 as the money supply picks up in Europe and Asia, and the latest 36pc jump in Chinese fiscal spending starts to stabilize the commodity markets.

The Fed's emergency policies since 2008 have in one sense been a huge success, though we will never know the counter-factual. A great depression was averted. Output is 10pc above its previous peak. Employment is up by 4.7m.

Yet zero rates and QE set off torrid credit bubbles in the emerging world, pushing up the global debt ratio by 30pc of GDP beyond their previous record in 2008. The Bank for International Settlements calls this a "Pareto sub-optimal" for the world as a whole. The chickens have not yet come home to roost.

Mrs Yellen has no margin for error as she tries to right the ship and slowly restore the US economy to a "Wicksellian" natural rate of interest, without detonating the debt-bomb in the process.

If she fails, the world is in trouble. We have never been in a predicament where a global recession began with rates already near zero. The Fed typically needs 350 basis points of monetary ammunition to fight a downturn.

The only way out then would be "helicopter money", a potent use of QE to fund fiscal spending directly and inject stimulus straight into the veins of the economy. But that is a saga for another day. She has not failed yet.