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Fed must stop dithering and take action

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Increasing distortions of low rates threaten to collapse into crisis

Janet Yellen recently told Congress: "I do not agree a rules-based policy is a better way to go." Though the Federal Reserve chair was referring to a different rule, her words also apply to the immediate need to schedule a press conference after the October 27-28 Federal Open Market Committee meeting.

It has been nearly two years of dithering since the Fed began to taper its bond purchase programme, a move some anticipated would swiftly presage a tightening of policy. Hope had soared that the September 17 FOMC meeting would bring an announcement of the first interest rate rise since June 2006, although to say the time had come was offensive to any casual market observer witnessing financial markets' acute vulnerability.

The truth is the time has probably come and gone. But that should not have swayed Fed policymakers. The evidence is abundant that the ability of monetary policy to spur economic growth is exhausted.

More concerning are increasing distortions in the economy and financial system that threaten to collapse into crisis. The financial markets may not be fully on board with rising interest rates, but any further kowtowing to investors promises to strip the Fed of its last vestige of credibility.

Financial stability has crept in as a de facto third mandate but the meaning has been perverted since former Fed chairman Alan Greenspan first cut interest rates to prop up financial markets in 1987. "Stability" has become a euphemism for buoyant as it pertains to risky assets, the home of runaway inflation.

In the meantime, Fed policy has facilitated bad behaviour. Corporate chieftains, a breed long plagued with short-termitis, have been encouraged to trespass further by the siren call of cheap money. Why bother investing in the long term when it is so much more fun, to say nothing of more lucrative, to buy back shares, reduce share count and puff up profits?

The build-up in capacity across a wide swath of industries is also damaging. The corporate bond market has not suffered a full default rate cycle in generations, such is the fear of policymakers of allowing market forces to weed out the chaff from the viable wheat. Is it any wonder capacity utilisation has yet to recapture its 30-year average of 79.5 per cent?

At least many companies have taken advantage of this unprecedented era of low interest rates to extend the maturity of debt on their balance sheets, insuring against potential damage the next time capital markets seize up.

Many developed and developing countries have similarly indemnified their nations' balance sheets against another global recession by issuing 50-year or 100-year bonds. If only the same could be said of the US Treasury. Instead, the US government continues to borrow short-term — as if the world is going to end tomorrow.

The Fed deludes itself with manufactured inflation metrics that insult the average US household buckling under the strain of untenable healthcare burdens, runaway housing costs and steep higher education expenses.

The Fed's other formal mandate, to maximise employment, necessarily runs counter to maintaining price stability. Easy monetary policy has been along for a nice ride back to a low rate of unemployment but the numbers say so little. What does a 5.1 per cent unemployment rate mean when the labour force participation rate is near a 40-year low?

Model-driven monetary policy that constantly redefines itself by reducing the requisite unemployment rate and ignoring rising inflation will not succeed. Meanwhile, excesses continue to build in the global financial system; pensioners and savers are more exposed than ever to inappropriately risky investments. Fanciful notions that the US economy has decoupled from the world yet again are just that — fanciful.

Normalise interest rates and reinstate the incentive to save. Introduce a generation of millennials to the sensation of earning interest. Might the interim be harsh? Possibly. But the alternative, lower for longer yet, is a price the country can ill-afford to pay again.

Members of the FOMC: call a press conference at the conclusion of the October FOMC meeting and give the country a gift that, in time, can keep giving. Own up to the fact that not taking action is more harmful to the country than finally taking a stand and acting in its best interests.

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