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Strengthening US economy bolsters case for rate rise

Sam Fleming in Washington


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Federal Reserve

A strengthening economy and gathering momentum in the property market are bolstering arguments for higher interest rates in the second half of the year as Federal Reserve policymakers prepare to meet this week.

The Federal Open Market Committee will convene on Tuesday and Wednesday after Janet Yellen, the Fed chairwoman, told Congress that the US economy needs higher short-term rates and that there were risks in waiting too long.

While the newly resurgent dollar again poses risks to US exports and inflation, other international dangers have lessened — most notably from Greece, which is discussing a new bailout.

No move is likely this week, but the Fed has made it clear it expects to lift interest rates in 2015, marking the first upward move in nearly a decade. The market is putting odds of under 50 per cent on a hike in September.

A key question is whether the Fed will feel any compulsion to formally signal a looming move in this week's statement. While investors are anxious for guidance, policymakers are reluctant to tie their own hands.

“At Yellen’s congressional testimony she did not rule out a September hike, nor did she guide the market toward thinking September was a done deal. We think the upcoming FOMC statement will reflect this non-committal approach,” said Tom Porcelli, an economist at RBC Capital Markets.

In a June press conference Ms Yellen said the FOMC was looking for more “decisive” evidence of strength before pulling the trigger on a hike. She made no reference to that requirement in testimony to Congress this month, instead making an argument for the Fed to move a little earlier to permit a gradual pace of rate hikes.
Since the June meeting the domestic economy has shown renewed signs of strength.
Sales of existing houses are running at their strongest pace since 2007, prices have by some measures recovered to their pre-crash peaks and credit is becoming more freely available. All of this suggests the housing market is set to make a more significant contribution to the recovery in coming quarters.

Official gross domestic product numbers due on Thursday are tipped to show annualised growth of around 2.5 per cent for the second quarter, confirming signs of solid, if unspectacular, progress.

Economists at JPMorgan also expect official statisticians to revise first-quarter growth figures into positive territory this week — to 0.3 per cent growth from a previously estimated minus 0.2 per cent drop — suggesting the economy made a less dreary start to the year.

Meanwhile, jobs market progress continues unabated, with initial claims for jobless benefits last week falling to their lowest level since 1973.
However, the inflation leg of the Fed’s mandate is more uncertain. With oil prices once again falling and the trade-weighted dollar up more than 5 per cent since its May low, it may be difficult for the Fed to convey markedly stronger confidence in the inflation outlook.

Complicating the picture is an inadvertent leak of Fed staff economic forecasts that suggested the central bank’s own economists are less optimistic about the economy than the FOMC itself.

Nevertheless, senior Fed officials have made it clear that a move in September is an option, with William Dudley, the New York Fed chief, saying it would be “in play” assuming signs of stronger consumer spending continue. James Bullard, president of the St Louis Fed, has said there are better than 50 per cent odds of a move at that meeting.

All this has galvanised discussion over whether the Fed will be tempted to give a formal signal this week. That is what it did under Alan Greenspan in 2004, when it last initiated a rate-hiking sequence. In the meeting before the first increase, the Fed said it intended to withdraw monetary accommodation at a “measured pace”, putting markets on warning that a move was likely in the ensuing months.

Minutes from the Fed’s meeting in April of this year showed, however, that most FOMC members wanted to avoid binding themselves by giving markets explicit notice that a hike is looming, with some preferring to signal progress via their description of the economy.

Ms Yellen in February and March went to considerable lengths to wriggle out of existing promises to be “patient” before lifting rates, as she sought to free the FOMC to move when it saw fit. The committee has signalled it wants each meeting to be a “live” one in which rate changes are possible if merited by the data.

“The committee might worry that changing current guidance could be misinterpreted as a commitment to act in September. We therefore do not expect a change along these lines,” said Zach Pandl, an economist at Goldman Sachs — adding that use of such language was still an outside risk.

Being less predictable once hikes start could lessen the dangers of a re-run of the 2004-07 rate-hiking cycle, when the Fed’s monotonously regular pace of rate rises stoked up financial instability and helped pump up a disastrous housing bubble. Presently, the Fed argues that the best way of avoiding asset price bubbles is primarily via tighter financial regulation, rather than higher rates.

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