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## Why the Fed Should Start Tightening

**If the Fed wants to wait for economic circumstances that are perfectly balanced for a rate rise, that day might never come.**

By [Michael Heise](#), September 15, 2015

Will it or won't it? The question whether the U.S. Federal Reserve will raise interest rates later this week keeps markets in nervous suspension — and economic pundits in the news.

Against the background of seemingly mixed economic news from developed countries and clear weakness in China and other emerging markets, most analysts now predict that the Fed will wait.

Key institutions, including the IMF and the World Bank, also warn against the risks of premature tightening. There are, however, many good reasons why the Fed should start raising rates.

Economic fundamentals are the most important argument. They are also the gauge that the Fed uses in its official guidance. The Open Market Committee has said that it will increase rates when it sees further improvements in the U.S. labor market and once inflation is heading back to the 2%-target over the medium term.

Unemployment fell to 5.1% in August, which is already below the level that the Fed has forecast for the last quarter of 2015 and in line with Fed estimates of the rate below which unemployment would reignite inflation.

### **Inflation forecast considered**

Although consumer price inflation (excluding energy and food) has remained low so far, the Fed has stressed that it is not actual inflation, but inflation forecasts that will guide its policies. It will not wait until inflation hits 2% before normalizing monetary policy.

Recent economic data indicate that the U.S. economy continues to improve, which should also lead to further job creation. In the second quarter of 2015, the annualized rate of GDP growth reached 3.7%.

And although reduced inventory accumulation will probably dampen the U.S. expansion a bit, domestic demand continues to strengthen. Car sales, for instance, have reached their highest level since the recovery began.

And there are signs that capital investment will pick up after disappointing numbers in the first half of the year. Moreover, working hours are rising, which is usually a precursor to new hiring, so unemployment might well drop below 5% soon.

### **Right time now?**

Better-than-expected developments in the labor market and broad signs that inflation is stabilizing would make a first rate hike next week both logical and appropriate. It would underpin the Fed's message that the normalization of monetary policy will be gradual.

The risk that financial markets descend into panic appears low, since investors have been bracing themselves for monetary tightening for months. Therefore, neither longer-term U.S. bond yields nor the dollar should jump upwards in the event.

The euro might well weaken against the dollar. However, the main reason for that is not Fed tightening, but hints from the European Central Bank that it might loosen policy further in case eurozone inflation remains far below its target.

Meanwhile, if bond markets remain calm, gyrations in equity markets also look unlikely.

### **The downside to no action**

If, on the other hand, the Fed remains on hold, it might create the impression that it is falling behind the curve. Eventual market corrections could then be much more violent.

Many economists, including those at the IMF and the World Bank, are particularly worried about the impact a U.S. interest rate hike might have on emerging markets.

They argue that China's slowdown, sliding commodity prices and capital outflows from many emerging markets are not the right setting for U.S. monetary tightening.

But when exactly would the conditions be right? China's problems are largely structural. They will not be resolved in a few weeks or months, — and perhaps not for years.

It is simply not realistic to wait for the day on which the economic environment is so balanced and stable that a rate hike would involve no risks whatsoever. That day might never come.

### **Need for capital outflows**

Those who worry about emerging markets would do well to remember that it was the ultra-low interest rates of major central banks that fueled the capital inflows that now make these countries look so fragile.

This influx of capital pushed down local interest rates and enticed households and companies into a borrowing binge. A rate hike in the U.S. might well trigger further capital outflows from many emerging markets.

But since such outflows started months ago, once investors began to see the U.S. rate hike on the horizon, they are unlikely to turn into a stampede.

It remains to be seen how the Fed will weigh up the risks in the next few days. Opinions in the Open Market Committee are likely to be split, which makes a delay of the rate hike decision conceivable. But delay is by no means the only, or even the most sensible option.