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USA

Labor market picture backs rate hike

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The US Fed meets next week to discuss its monetary policy and present updated economic projections. Given the steeper-than-expected drop in the unemployment rate and a stable US economy, a rate hike would be appropriate. It might produce reactions on global capital markets and emerging market currency markets. Panic is unlikely to ensue, however, since the Fed has provided plenty of guidance – capital flows to emerging markets have already gone into reverse -- and the rate increase would most likely be limited to 25bp. Moreover, it was ultra-low interest rates that supported strong short-term capital inflows into many emerging markets, where they contributed to an unsustainable buildup of debt. Further delays in tightening are unlikely to stabilize the situation in these countries. Instead, the prevailing uncertainty would continue. If the Fed is perceived to have waited too long, the ensuing corrections in financial markets would likely be more violent. It remains to be seen how the Fed will weigh up the risk of reacting too late against the risks from the recent volatility on global financial markets. The scope to remain on hold looks limited.

Against the backdrop of the steady improvement in the labor market, the Fed has been signaling for some time that it might start pushing up policy rates this year (current target range: 0-0.25%). Accordingly, the Open Market

Committee has issued guidance in recent months that an increase in the federal funds target rate will be appropriate when it sees further improvement in the labor market, given reasonable confidence that inflation was heading back to the target figure of 2% over the medium term.

In the statement following the last FOMC meeting on 29 July the forward guidance was modified to state that “some” further improvement in the labor market needed to be seen.

The unemployment rate in the US has indeed fallen further of late. At 5.1% in August, it was already below the fourth quarter 2015 level expected in the Fed’s June’s projections (5.25%). It has also now reached a level the Fed deems in line with the non-accelerating inflation rate of unemployment – a drop below this level could go hand-in-hand with a pickup in inflation. Although inflationary pressure – measured by the price index for personal consumer expenditures (excluding food and energy) – has remained low so far, the Fed has stressed in its communication that it will be guided by its inflation forecast and not by the actual level of inflation reached to date. It will not wait until the inflation rate stands at 2% before starting to normalize monetary policy.

The latest indicators point towards a sustained firming of the economy, which is likely to have positive repercussions for the labor market. Although inventory corrections are likely to temporarily dampen growth following the substantial increase in overall output in the 2nd quarter (annualized rate of 3.7%), domestic final demand continues to head upwards. Car sales, for instance, have surged to a new high for the current cycle. And the signs are good that equipment investment is set to pick up after a disappointing first half-year. The rise in aggregate hours worked has been driven of late by an increase in the average weekly hours per employee. Since a rise in working hours often precedes vacancies being filled, this is a further positive sign for future job growth. In this respect, there is a good chance that the unemployment rate will drop below 5% in the foreseeable future.

Against the backdrop of the better-than-expected labor market developments and with broad confirmation of the assessment that inflation is picking up gradually, an initial rate hike at the next meeting of the Open Market Committee would be logical and appropriate. Increasing the key interest rate would underpin the message to date that the normalization of monetary policy would be gradual. This should not spook the financial markets too much, since they have been bracing themselves for such a scenario for some time now. A marked upward trend in longer-term US yields and the US dollar is therefore not to be expected. At the same time, the euro is likely to drop back into a range of USD/EUR 1.05-1.10. However, the main factor here will be not only the decisions taken by the Fed, but rather hints from the ECB that further expansionary measures are conceivable should inflation remain well below the price norm of close to 2%. The likelihood of major stock market wobbles appears low if bond markets remain sanguine. However, should the Fed wait still longer, this could fuel market expectations that it was 'behind the curve'. In this case, corrections on the financial markets would be much sharper.

The warnings from the International Monetary Fund and the World Bank with regard to an early rate hike by the Fed were made with an eye mainly on the risks to the emerging markets. The slowdown in China, the slide in commodity prices and the withdrawal of capital from numerous emerging markets were not the right setting for an increase in US interest rates. But when would this moment be reached? China's problems are largely of a structural nature and will not look totally different in just a few weeks' time. A moment at which a rate hike can be enacted in a completely stable economic environment and harbor no risks whatsoever will not come around so quickly. To wait for that would mean delaying the interest-rate decision indefinitely.

It should also be borne in mind that the emerging markets' current problems stem in part from the years of capital inflows into these countries, fueled by the zero interest-rate policy of the major central banks. There as well, the influx of capital led to low interest rates and a steep rise in private sector debt. A reversal of the major central banks' interest rate policy will also have repercussions for capital flows, but these have to some extent already taken place in recent months once the Fed about-turn hove into view.

It remains to be seen how the Fed will weigh up the risks in the next few days. Opinion on the committee is likely to be divided, meaning that a postponement of the rate hike decision cannot be ruled out. But we see limited scope for the Fed to remain on hold.

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