The Fed is creating a new equilibrium

The decision taken by the Fed during meetings on June 18 and 19 to reduce its asset purchase program has been met with mixed feelings. Yet, the change in strategy to a less accommodating stance is hardly surprising. The Fed’s Chairman Ben Bernanke indicated that this was a possibility as early as May 22 when he addressed the American Congress. But the ambiguous tone could have given the impression that it would happen much later.

Nonetheless, changes to thresholds set by major central banks are always seen as too hasty, especially when a tougher stance is taken. A new equilibrium must be found and different way of assessing financial assets with, necessarily, tough and often excessive adjustments over the short term.

Fed gearing up to change threshold

The goal of the Fed’s announcement is to adopt a two-phased approach to avoid having to employ emergency measures. During the first phase, to lessen the impact of its strategy changes, Ben Bernanke clearly indicated that the asset purchase program would first be reduced, probably during the fall. Then, purchases would be stopped once unemployment had dropped to 7%, which according to the Fed’s scenario, should be around mid-2014. During the second phase, when unemployment had fallen to 6.5%, that is, several months later, the Fed could increase its benchmark interest rate. The process of ending a very accommodating policy will probably require 2 years.

The scenario behind the Fed’s altered threshold hinges on the US economy’s gradual return to equilibrium. This will be led by an improvement in activity indicators: reduced unemployment and a rise in core inflation, which according to the Fed’s preferred indicator currently stands at 1%, well below the objective of 2%.

This scenario and its validation reflect the risk reduction mentioned by Ben Bernanke during his press conference. The Fed believes that the financial crisis which began in summer 2007 is in the resolution stage. Consequently, the outlook for its monetary policy has changed.

Three persistent questions

In response, three questions concerning the Fed’s strategy are being raised.

1. Is this the right time to intervene?

The Fed’s reading of the labor market may be questioned as other indicators, such as the employment rate, indicate that this market is far from having rallied as robustly as the expected fall in unemployment might imply. The employment rate is nearly 5 points below its pre-crisis position. This points to an imbalance that has not yet been resolved. Furthermore, as employment falls and with no huge labor demand, many Americans are no longer registered with employment agencies. If activity does indeed pick up, these people will return to the labor market, swelling the unemployment rate. This event will not necessarily be as linear as expected.

On another note, immediate indicators pertaining to the American economy are solid, but do not indicate a strong and rapid acceleration that would suggest an immediate intervention was necessary. As such, will this change have little impact on US economic conditions? Yes, according to the Fed. This is where the specter of doubt appears, as its macroeconomic scenario has systematically been overly optimistic since the crisis began. Will it be right this time around? In any case, labor market indicators, such as the employment rate, are confusing.

And finally, the level of inflation is currently low. The price of oil is no longer a contributing factor and internal tensions, measured by the core inflation rate, have dropped (1% in April). While the labor market remains destabilized, it is likely that salary increases will be restricted and consequently, rising inflationary pressure will...
fall. The Fed believes that this movement is temporary and that very soon there will be a convergence towards its objective of 2%.

In other words, if the scenario does not follow the Fed’s optimistic profile and if the economic rebound is slower than expected, its credibility will be questioned. Because despite everything, although Ben Bernanke has not ruled out a reversal in terms of the asset purchase program, there would likely be a loss of credibility if this reversal were repeated.

2 ➔ What are the consequences for the rest of the world?

For the past several weeks, the most noticeable impact has been on emerging countries. Capital exits and a weakening of emerging market currencies in relation to the dollar make them more fragile than before. This inverse capital flow that occurs when the Fed changes its tune hurts, as these countries - which have developed rapidly over the past few years, particularly led by China - are currently in an economically fragile state. Very little change in international trade has impacted their economy and in many countries, central banks have adopted a relatively accommodating strategy to avoid weakening activity excessively.

A new equilibrium will have to be found, with, nonetheless, the risk that the new situation created by the Fed will lead to a downturn in trade for emerging countries. Regarding this point Ben Bernanke stressed that the US would be the “locomotive” for the global economic dynamic. This stimulus effect may be questioned. The US already adopted this role in the past, by first generating a rapid acceleration of American activity in order to position growth on a trajectory that quickly converged towards full employment. In the picture painted by the Fed, convergence is linear and does not generate that upward break. Over the short term, American growth will not have that much effect. Emerging countries need to find their equilibrium as their situation will remain critical over the short term.

For developed countries, it raises the question of whether we are breaking free of a rather homogenous method of operating on the part of central banks. Several weeks ago, the Bank of Japan set the tone by adopting a very aggressive strategy designed to reduce Japanese deflation and facilitate autonomous growth. The Fed has adopted a specific strategy by indicating that as far as it is concerned, the trend is towards the end of the crisis. How will the ECB position itself? If the Fed does not raise its interest rates before 2015, neither will the ECB.

Will global growth outside the US put the brakes on the Fed’s scenario, eventually questioning its credibility? The economy outside the US is not growing very quickly, especially in China, India, Brazil, and even Europe. Upcoming developments will have to be scrutinized carefully, as none of these regions will change profile - due to internal reasons - over the coming months.

3 ➔ What type of financial equilibrium for this new context?

Over the past few weeks, there has been a significant rise in US long-term interest rates. The US 10-year bond rate, which seemed to peak at 2%, has largely exceeded this threshold. Due to the postponement of the Fed’s operations, short term rates will remain very low until 2015. This should help avoid an overly sharp and excessive rise in US long-term interest rates.

Beyond these monetary elements, rising long-term interest rates indicate renewed optimism on the part of American consumers and a return to a growth dynamic based on domestic demand. This was no longer exactly the case up to now. This dynamic, to which the Fed’s scenario adheres, may explain the rally of real interest rates in the US.

However, the outlook for inflation will not climb and there will be no strong inflationary premium to reinforce the observed rise in real interest rates. Long-term interest rates ranged from 1.50% to 2%. It is possible that over the next few months, there will convergence to a range of between 2% and 2.5%. Anything beyond that will require time and will only happen if sustained growth is confirmed and the American profile effectively sticks to or even exceeds the Fed’s scenario.

European equilibrium is not expected to be driven by that situation as there is no activity-related explanation for the rise in real interest rates. The risks of a rapid rise in inflation have been reduced so no spectacular movement in nominal interest rates should be expected in core countries.

And finally, this situation in which the Fed was the first to react will certainly result in a stronger dollar and not simply in relation to emerging countries, as recently observed. The outlook projected by central banks is no longer as homogenous and that should make the greenback interesting.

Conclusion

The Fed wishes to end its overly accommodating period because it believes that the risks which pulled the US economy down receded last fall.

To avoid shockwaves, it has put in place a two-phased strategy designed to allow its crisis resolution scenario to develop without creating an even greater shock than that observed over the past few days. The stakes are high. The path is not without risk given that the global economy outside the US is not faring particularly well. The Federal Reserve’s credibility will be at stake when creating a new equilibrium. For the sake of global equilibrium and to avoid excessive lurching, it would be preferable if the Fed’s scenario proved correct and its stimulus effect on the rest of the world as robust as Ben Bernanke stated during the press conference.