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The Fed Throws EMs A Lifeline

Anatole Kaletsky | GaveKal | 18 September 2015

The Federal Reserve's decision to keep on procrastinating over a rate hike should have come as no surprise to anyone who has paid attention to the comments of Janet Yellen. And, indeed, it didn't come as much of a surprise to the markets, to judge by their reaction. After a brief flurry of activity following the announcement, the US equity market closed little changed on the day. Currency and bond markets proved a bit more excitable but even there the moves seemed to be driven more by the removal of hedges put in place to guard against an unexpected tightening, rather than by any major reassessment of economic activity or US dollar liquidity in the months ahead.

Now that Yellen has confirmed what should have been obvious all along - that the Fed is not indifferent to international financial stress and that its risk-management approach remains strongly biased in favour of "lower for longer" - a move in October must almost be out of the question. That means investors can stop wasting their efforts on pointless debates about the precise timing of the first US rate hike and focus instead on what really matters about US monetary policy today.

Here, four issues are frequently misunderstood.

Firstly, it is clear that the Fed will simply ignore the eloquent arguments for a return to more "normal" interest rates presented by Charles and the many other economists concerned about misallocation of capital and financial bubbles. Yellen may be right or wrong in her determination to keep interest rates much lower for much longer than in any previous economic cycle, but there is no point in imagining that she is about to change her mind.

Secondly, the reasoning behind the Fed's easy money policy is worth trying to understand, even if one does not accept it. The Fed sees no appreciable upside risks to inflation over the medium term and is totally unworried about the decline of unemployment to what used to be regarded as its "natural" rate of around 5%. The Fed's own economic models assume that inflation will start to accelerate once unemployment falls into a range of 5.2% to 4.9%, which it has now done. But, the Fed is still in no rush to tighten, partly because its economists can simply reduce their estimate of the NAIRU or "non-accelerating inflation rate of unemployment" (as they have already done three times in the past year), but mainly because Yellen actually wants to see accelerating inflation.

This leads to a third widespread misunderstanding about Fed policy. Most analysts assume that the Fed will want to raise interest rates well before inflation accelerates because monetary policy works with long and variable lags and thus interest rates will have to rise more drastically if the Fed "gets behind the curve" of rising inflation. Such pre-emptive monetary tightening is a fair description of how the Fed and other central banks used to work in the 1980s and 1990s. But in the post-2008 world, the assumption that the Fed - or any other central bank - wants to pre-empt rising inflation is simply wrong. Far from getting ahead of the curve of rising inflation, central banks all over the world are now determined to do the opposite. Not only do they want inflation to accelerate, but they want to see higher inflation firmly embedded in business and financial expectations - exactly the opposite of the policy that Paul Volcker pursued from 1980 to 1987. This may sound like heresy but it is a point the Bank of Japan keeps repeating explicitly and that other central banks now clearly imply.

Which brings us to the fourth misunderstanding about US monetary policy - and the one most relevant to financial markets. If the Fed is determined to remain behind the curve of rising inflation, many of the market movements caused by expectations of US monetary tightening will prove unjustified. Persistently low US interest rates may or may not be positive for equities (depending whether Charles's arguments about capital misallocation outweigh the Fed's conventional view that low interest rates stimulate demand), but a persistently dovish Fed is definitely not bullish for the US dollar. And, a weaker than expected US dollar removes one of the main reasons for the panic in emerging markets. Barring some new shocks from China, a rally in the emerging markets therefore seems a reasonable expectation in the next few weeks.

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