Proceed carefully with interest rate rise, IMF warns

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The US Federal Reserve Board needs to proceed with caution as it begins to lift interest rates, lest it set off a crisis in global financial markets. That is the view of the International Monetary Fund (IMF), which released its *World Economic Outlook* this week. The Fed should prepare the world economy for higher interest rates to "avoid financial market disruption both domestically and abroad," it said.

These words of caution may well have been one of the reasons US Fed chairman Alan Greenspan included a warning that interest rates would have to rise "at some point" in his testimony to the US Congress on Wednesday.

According to the IMF, while the US still had some "leeway," the ground had to be prepared for future monetary tightening and central banks had to communicate their intentions as early as possible "thereby reducing the risk of abrupt changes in expectations later on."

The expected increase in the Fed's fund rate from its present record low of 1 percent has led to discussion in financial circles over recent weeks about the possibility of a repeat of the bond market crisis of 1994, when the Fed moved from a low-interest rate regime and lifted interest rates more sharply than expected. The most significant impact of the crisis was felt in Mexico when the collapse of the bond market saw the Clinton administration organise a $50 billion bailout for American banks and financial institutions that had invested money in the Mexican market.

While recent commentary has offered reassurances that history will not repeat itself and that conditions are different now, there are concerns that financial institutions and banks may have over-invested in so-called "emerging markets," using funds borrowed at relatively low rates in Europe and the US.

In an article published on April 9, the *Economist* warned: "Flat yields in mature markets make emerging markets look good. But there is more to it than that. The ample liquidity sloshing around the rich world is also an invitation to enter into the so-called 'carry trade.' Carry traders borrow at low, short-term rates. They then invest the proceeds in higher-yield assets. Some simply buy long-dated American bonds. But the more adventurous look further afield, betting on richer-yielding emerging-market bonds with money borrowed at cheap rates in mature markets."

But this situation may not last much longer as interest rates in the major economies start to increase.

In its *Global Financial Stability* report issued earlier this month, the IMF said that while financial markets seemed to be enjoying something of a "sweet spot" at present, largely because low inflation had enabled monetary authorities to maintain low interest rates, there were "fault lines that could impinge on stability some time down the road."

"The main risk to the benign outlook for global financial markets is that such an outlook rests on a very fine balancing of opposing economic forces," it warned. In particular, financial stability depended on the continuation of the "unprecedented gross and net capital inflows into the United States."

However, if this "delicate balance" were to be impaired, leading to a reduction in official and private capital inflows, the US dollar could weaken more than expected, leading to increased market volatility. "This would have a negative spillover effect on other asset markets, including pushing up yields (interest rates) in Europe and emerging markets." Such a development could also "expose remaining structural weaknesses in several emerging market countries, so far masked by buoyant market conditions."

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There were also dangers that the present low-interest rate regime, which has had a major impact in sustaining asset values, could itself become the source of problems. If low interest rates continued there could be a search for increased yield while risk factors were neglected. "There have been anecdotal signs of 'herding behaviour' as investors move to risky assets that may not be familiar to them, but have performed well in the past year." This process could lead to an overvaluation of certain financial assets with a greater potential for "disruptive corrections" the longer it persisted.

The potential for severe disruption in global financial markets arises from the growing imbalances in the world economy and above all in the United States. The US current account deficit—a measure of the rate of increase of international indebtedness—is running at almost 5 percent of gross domestic product, while the budget deficit is expected to be at least $450 billion for 2004. As the IMF noted in its latest *World Economic Outlook*, "from a historical perspective, the speed of deterioration in the (budget) deficit has few parallels." The turnaround over 2000-2004, expressed as a ratio to GDP, is nearly double the previous worst four-year setback experienced at the time of the Korean War.

These deficits are being financed by the inflow of capital from Asian banks, which are purchasing dollars in order to keep down the value of their own currencies and maintain their competitive position in the US market. But the policy is creating massive financial imbalances. It is now estimated that the Asian region (including Japan) holds about $2.1 trillion in official currency reserves, more than 80 percent of the world's total, and three times the reserves that existed at the end of 1998.

So far the Asian purchases have enabled US authorities to continue the low-interest rate regime that has maintained consumer demand in the American market. But the policy cannot continue indefinitely. On the Asian side, the dollar purchases by the central banks, especially China, are pumping large amounts of money into the economy and creating the conditions for an asset boom.

On the US side, the growth of debt is creating the conditions for a debt-induced crisis.

In a comment published in the *Financial Times* of April 14, well-known investment banker Felix Rohatyn warned that the situation facing the United States was "eerily similar" to that confronting New York when the city went bankrupt in 1975 after financial markets "shut down" on the city's bonds. "The US and the dollar," he warned, "could face an equivalent financial crisis for similar reasons."

So far the willingness of the central banks of China, South East Asia, Japan and Europe to finance US deficits "has allowed the administration of George W. Bush and the Federal Reserve to pursue a policy of cheap money, low taxes, large deficits and reliance on a speculative stock market and property bubble to create economic growth." But this cannot last forever and, at a certain point, foreign central banks may be unable to or unwilling to carry US debt. "Some time before that moment is reached, the markets would begin to react: the dollar could fall further precipitously, interest rates would shoot up, and we would have to deal with a national crisis, which could develop into a global crisis."

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