US Fed set to lift rates

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Federal Reserve Board chairman Alan Greenspan has given the clearest indication yet that the Fed will move to increase US interest rates at the end of the month. And the increase in the benchmark federal funds rate—now at a 46-year low of 1 percent—could be more than the expected rise of 0.25 percent.

Speaking via satellite to the International Monetary Conference in London on Tuesday, Greenspan pointed to a “strengthening economic outlook in the United States.” This meant that the “ample liquidity” provided to the financial system through very low rates “will become increasingly unnecessary over time.”

Greenspan repeated the phrase used in recent Fed statements that tighter monetary policy would be introduced at a “measured” pace, based on the “current best judgment” of how economic and financial forces would move in the next few months. But he concluded his remarks with a warning: “Should that judgment prove misplaced, however, the FOMC [Federal Open Market Committee] is prepared to do what is required to fulfil our obligations to achieve the maintenance of price stability so as to ensure maximum sustainable economic growth.”

The main factor influencing the Fed’s move to increase interest rates is the growth in US employment over the past three months. Figures released last Friday showed that 248,000 non-farm jobs were created in May, bringing the increase in payrolls over the past three months to 947,000. Such an increase is normally taken as an indication of economic recovery, but this may not be the case this time.

Firstly, as Greenspan noted in his speech, “the proportion of increases in temporary workers relative to total employment gains has been unusually large.” Secondly, jobs growth is not providing the same boost to national income as in previous recoveries. According to calculations by Morgan Stanley economist Stephen Roach, real wage and salary payments have increased by a little less than 3 percent from the trough of the recession in November 2001. In the previous six recoveries, the increase over the same 29-month period has been 9 percent. This means that income growth is $280 billion less than it would have been had the previous pattern been followed.

Over the same period, however, consumption spending has risen to 71 percent of gross domestic product [GDP] compared to its 67 percent share in the 1990s. This means that consumption spending is being financed by ever greater levels of debt. Household debt is now at an all-time high of more than 85 percent of GDP, about 20 percentage points higher than a decade ago.

Much of the increased consumption spending has come from the refinancing of home mortgages to take advantage of lower interest rates. Last year $3,500 billion of mortgage debt was refinanced, compared to $2,500 billion in 2002. The previous peak was $750 billion in 1998.

But home buyers could be hit hard if interest rates start to move up sharply in response to increases by the Fed. Rates on a 30-year fixed rate loan are now around 6.3 percent, compared to a low of 5.1 percent in June 2003. The increase in rates over the past 12 months has meant that more homebuyers have turned to variable interest rate loans. This is because the starting rates are lower—5.5 percent for the first five years and adjustable thereafter. Some buyers can even obtain a rate of 4.2 percent for the first year, adjustable thereafter.

This has led to a situation where a growing proportion of homebuyers—estimated to be about 35 percent—have adjustable rate home loans right at the point where interest rates are about to rise.

Besides its impact on consumer debt in the US, an increase in the Fed rate could shake international financial markets. In a comment published in the May 30 edition of the *Financial Times*, Chicago-based international economist David Hale noted that while financial markets had been hit by shocks from the Middle East, rising interest rates could pose greater problems.

According to Hale, the "real risk to world markets is that the speculative bubbles and 'carry trades' that have developed as a consequence of American monetary policy over the past year will unravel as the US Federal Reserve moves to increase interest rates." (Carry trades refers to the process in which money is borrowed at short-term low rates in the US and used to secure higher yields in investments in other markets.)

Hale noted that the policy of east Asian central banks of financing the US balance of payments deficit, now equal to 5 percent of GDP, had encouraged faster monetary growth and a capital spending boom in China, turning the country into the world's largest consumer of many industrial raw materials, leading to a commodity boom that was threatening to increase inflation.

US monetary policy had also resulted in "significant price gains during 2003 and 2004 in emerging market debt, high-yield debt, government bonds and property, as well as equity."

Wall Street, Hale noted, has reaped large profits from bond trading in the past year, as finance becomes an ever more significant component of the US economy. The financial services sector now accounts for 31 percent of the market capitalisation of the S&P 500 index, compared to 10 percent in the 1980s.

This transformation in the US economy is reflected in the position of General Motors. In 2003, the company's finance division, General Motors Acceptance Corp reported a profit of $2.8 billion, compared to a profit of $1.1 billion for the car manufacturing business. In other words, once a manufacturing company with a finance arm, GM has become a financial institution with a car manufacturing division, extremely sensitive to interest rate increases.

Ten years ago when the Fed entered a rate-tightening cycle, there were far reaching consequences, including the bankruptcy of Orange County in California and a financial crisis in Mexico which required a $50 billion IMF-backed bailout to assist US banks and financial institutions. Now there are fears that the global economy has become so dependent on low US interest rates that it will not take very large rises to create similar financial crises or worse.