US Federal Reserve lifts interest rates

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The statement accompanying Wednesday's decision by the US Federal Reserve Board to increase its base interest rate by 0.25 percent to 2.5 percent could be summed up as "all quiet on the financial and economic front."

The Fed noted that its monetary policy remained "accommodative" and was providing "ongoing support to economic activity". Output appeared to be growing at a "moderate pace", while inflation and longer-term inflation expectations were "well contained." Looking to the future it said that "policy accommodation" could be removed at "a pace that is likely to be measured"—the phrase used since the Fed began lifting interest rates last June.

Behind the bland official statements, however, there are concerns that 2005 could well see increased financial turbulence.

The chief problems are the US balance of payments deficit and the growing credit bubble that has resulted from the Fed's easy money policy implemented following the rapid stock market decline in 2001.

The balance of payments deficit hit a record high of $164.7 billion for the third quarter of 2004, meaning that the US is spending 5.6 percent more every day than produces, that is, $1.8 billion.

The growth in US indebtedness appears to be troubling at least some members of the Fed's Board of Governors. According to the minutes of its December meeting, released last month, "a number of participants voiced concerns about domestic and global financial imbalances" and expressed doubts that "such imbalances would be reduced in the near-term."

A significant turn around in the US balance of payments position would require a large increase in the growth rates of Europe and Japan—thereby boosting demand for US exports. But no one on the Fed Board holds out much prospect of that. As the minutes note: "Such a strengthening seemed unlikely in the near term given the recent softening in the economies of several important industrial countries." Since that discussion, the outlook for the Japanese economy has worsened while German unemployment has topped 5 million for the first time since the 1930s.

Given these worsening international conditions, the US is more dependent than ever on the inflow of capital from the rest of the world to cover its payments gap. This appears to be one factor behind the Fed's push to lift interest rates even as inflation remains low.

Another concern voiced at the December meeting was that low interest rates may be creating a new financial bubble, especially in the carry trade where financial institutions borrow money at low rates in US markets and then use it to invest in riskier financial assets in the rest of the world, particularly so-called "emerging markets".

According to the Fed minutes, "some participants believed that the prolonged period of policy accommodation [record low interest rates] had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets."

While financial markets appear not to be too concerned with the prospect of interest rate rises—Wall Street remained up after the latest announcement—it may not be plain sailing in the coming months. According to Morgan Stanley chief economist Stephen Roach, "investors are largely unprepared for some big changes in the global landscape in 2005."

Even after the continuous hikes since last June, he noted, the Fed was still running a zero real short term interest rate, and would have to lift rates by at least a further 2 percentage points to reach a neutral level. In other words, there would have to be "good deal more tightening" if the Fed were serious about containing the speculative risks cited in the December minutes.

And continued interest rate rises in the US could produce aftershocks around the world, for, as Roach noted, “extraordinary monetary accommodation has been the glue that has held a post-bubble US economy together” over the past five years.

The increasing financial instability of the US economy has been further highlighted by the announcement from the credit rating agency Standard and Poors that it is considering reducing debt issued by General Motors—one of the corporate world’s biggest borrowers—to junk bond status. GM’s financial rating is threatened by rising healthcare costs and falling income.

Commenting on what it called the “unprecedented” move to downgrade a borrower of GM’s size, a *Financial Times* editorial published on Tuesday drew attention to the wider issues. Not only had investors tended to view corporate credit with a “rosy tint” in recent times, but measures of “investors’ risk tolerance in all asset classes are close to record highs.”

“In the relentless search for higher returns, many are prepared to buy riskier assets—from emerging market debt to oil futures.” The relatively small difference between the yields on the most secure assets and the riskier ones reflected the “current benign environment” with worries over terrorism and geopolitical risk evaporating.

“But a shock could turn sentiment overnight. The corporate bond market is looking more and more like a credit bubble.”

In 1994, when the Fed began to tighten interest rates, the financial markets were unprepared, leading to major losses and the bankrupting of Orange County in the US. More than a decade on, the financial position of the US has worsened and the economy has become dependent on continuous injections of liquidity. This could lead to a situation where only a relatively small rise in interest rates has major consequences.