Financial markets hang on wording of US Federal Reserve statement

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In ancient times, the Greeks gathered to seek guidance from the oracle at Delphi, where the priestess muttered incomprehensible words that were then interpreted into common language by various scribes as prophecies.

Today, thousands of words will be written by journalists and financial analysts around the world as they seek to provide an interpretation of the statement to be issued by the Federal Open Market Committee of the US Federal Reserve and the pronouncements of its chairwoman, Janet Yellen, at her press conference. The interpretations of the utterings from the modern day financial oracle will centre on the presence or absence of one word--“patient.”

The Fed will leave its benchmark interest rate at the historically low level of 0.25 percent. The key question, pointing to its future actions, will be whether it chooses, in the accompanying statement, to retain the affirmation that it can be “patient in beginning to normalise the stance of monetary policy.”

Removal of the word “patient” will be seen as a signal that the Fed is likely to start gradually lifting interest rates as early as June, though, according to some interpretations, it will not necessarily mean that this will be the case.

Last month, in testimony before a US Senate committee, Yellen indicated, using carefully chosen words open to various interpretations, that any modification in the language “should be understood as reflecting the committee’s judgment that conditions have improved to the point where it will soon be the case that a change in the target range could be warranted at any meeting.”

The Fed is fearful, on the one hand, that any sudden move on interest rates will produce a violent reaction on financial markets, as their supply of cheap money begins to be restricted. On the other hand, there is concern that keeping interest rates at their present levels cannot continue indefinitely because it reduces the ability of the Fed to return to what was once considered to be “normal” policy, where changes in interest rate settings are used to regulate the business cycle.

However, the days of “normalcy” ended with the eruption of the global financial crisis in 2008. With the injection by central banks of more than $5 trillion, the financial markets have entered a kind of inverted world. Economic downturns are welcomed because they are interpreted as meaning interest rates will remain near zero and the flow of cheap money will continue, while ostensibly good news on the economy produces a negative reaction because it increases fears that interest rates will start to rise.

Profits are increasingly being made through parasitic speculation--buying and selling shares and government bonds, betting on commodity prices, and trading in currencies--rather than through investments in the real economy and the expansion of production.

Whatever decision the Fed makes, it is unlikely it will end global divergences in monetary policy, and may even increase them. Either as a result of so-called “quantitative easing,” in the case of the euro zone and Japan, or through cuts in official interest rates in other countries, the value of virtually all currencies around the world is depreciating against the US dollar.

According to calculations made on the basis of a trade-weighted index, the US currency rose by 7.7 percent in the third quarter of last year, 5 percent in the last quarter, and 10.5 percent thus far in the current quarter. Such divergences carry with them the potential for significant turmoil, if not another full-scale financial crisis.

Speaking in Mumbai, India on the eve of today’s Fed decision, International Monetary Fund Managing Director Christine Lagarde warned that so-called "emerging markets" faced a new period of turmoil if interest rates started to rise. She pointed to the "taper tantrum" of 2013, when money flooded out of these markets in response to indications by the Fed that it was going to start winding back its "quantitative easing" (i.e., money-printing) program.

She also warned of the impact of the rising US dollar on corporate balance sheets in emerging markets when major companies suddenly find that their interest and debt burdens have increased. In India alone, the dollar-denominated corporate debt had risen "very rapidly" in the past five years, nearly doubling to $120 billion.

"The appreciation of the US dollar is … putting pressure on balance sheets of banks, firms and households that borrow in dollars but have assets or earnings in other currencies," she said.

In a comment published in the *Financial Times* last month, well known financial analyst Satyajit summed up the present situation as follows: "Mark Twain reputedly stated that history does not repeat but it rhymed. In an eerie parallel to 1997-98, falling commodity--especially oil--prices, a rising US dollar and potential increases in US interest rates may presage a new financial crisis."

The 1997-98 financial crisis began with the collapse of the Thai baht and then swept across the Asian region, producing a downturn as significant as that resulting from the Great Depression in the advanced capitalist nations. While it was dismissed as merely a "blip" on the road to globalisation by US President Bill Clinton, the Asian crisis led to a debt default by Russia and the collapse of the hedge fund Long Term Capital Management in the US, requiring a major intervention by the New York Federal Reserve to stave off a wider crash.

Since then, Asian governments have sought to avoid the dollar-denominated loans that played a major part in spreading the financial contagion as investors pulled their money out. But it is a different story in corporate markets.

Already, the index of emerging market currencies compiled by JPMorgan Chase is at a record low, meaning the dollar-denominated debt burden for corporations has risen in real terms.

It has been estimated that foreign borrowings in US dollars have expanded to $9 trillion, compared to $2 trillion in 2000. The share of emerging markets, mostly in Asia, has doubled to $4.5 trillion since the eruption of the financial crisis in 2008.

Last December, the Bank for International Settlements (BIS), sometimes known as the central bankers' bank, issued a warning about the growing volume of debt held in the American currency, noting that a rise in the dollar's value could expose financial vulnerabilities.

Laying out what he called the increasing fragility beneath apparent market buoyancy, the head of the BIS monetary and economic department, Claudio Borio, said: "Should the US dollar, the dominant international currency, continue its ascent, this could expose currency and funding mismatches by raising debt burdens. The corresponding tightening of financial conditions could only worsen once interest rates in the US normalise."

In the three months since these comments, the ascent of the dollar has accelerated. From July last year, the dollar index has risen by more than 23 percent, a steeper rise than that which took place in the mid-1990s, setting off the Asian financial crisis. Against the euro, the dollar has increased by 16 percent in the past three months, and by about 25 percent over the past year.

A continuation of this trend will not only hit emerging markets, but will start to have a significant effect in the US. While exports comprise about 13 percent of US gross domestic product, they are far more important for major corporations. It is estimated that foreign-generated revenues account for 46 percent of sales by S&P 500 companies, with information technology the most highly-dependent on foreign sales.