Federal Reserve hikes key rate, signals faster monetary tightening

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The US Federal Reserve on Wednesday announced a widely anticipated quarter-percentage-point hike in its benchmark short-term interest rate, the first increase since last December and only the second since 2006. While the financial markets had expected the rise in the federal funds rate from 0.25–0.50 percent to 0.50–0.75 percent, they were surprised by the Fed’s projection of three further quarter-percentage-point increases in 2017.

The previous Fed outlook, released after the September meeting of the central bank’s policy-setting Federal Open Market Committee (FOMC), had predicted only two increases in 2017. The projection issued Wednesday similarly increased the number of rate hikes to three a year in 2018 and 2019.

As a result, the median projection made by Fed governors and Fed bank presidents for the federal funds rate—the overnight lending rate between banks—rose from 1.1 percent to 1.4 percent for 2017 and from 2.6 percent to 2.9 percent for 2019.

The response of the financial markets to this indication of a faster-than-expected tightening of the Fed’s monetary policy was a significant sell-off on the stock market and a sharp rise in bond yields and the dollar. US stocks have risen explosively since the election of Donald Trump on November 8, repeatedly setting new record highs. The Dow Jones Industrial Average was surging earlier in the week toward the giddy plateau of 20,000.

On Wednesday, however, the Dow fell 118 points to close at 19,792, a decline of 0.60 percent. The broader Standard & Poor’s 500 index dropped 18 points, or 0.81 percent, and the tech-heavy Nasdaq shed 27 points, a fall of 0.50 percent.

The Dow has shot up since Election Day on the basis of President-elect Trump’s pledges to slash tax rates for corporations and the wealthy, lift regulations on banks and corporations, sharply increase military spending, and provide tax incentives for companies to invest in infrastructure. His appointment of a cabinet of ultra-right billionaires, CEOs, generals and opponents of social spending and government regulations has further fueled a mood of euphoria within the financial and corporate elite.

Even with the losses registered Wednesday, the Dow has gained 1,459 points in the five weeks since the November 8 vote. This amounts to an increase of 7.96 percent, or 83 percent on an annual basis.

However, the rise in inflation and debt implicit in Trump’s policy has driven up government bond yields, which move inversely to price, and sent the dollar to new highs against the euro, the British pound, the Japanese yen and other world currencies. Bond prices have fallen by more than two percent since Election Day.

On Wednesday, the yield on 2-year Treasury notes, the government bonds most sensitive to Fed moves, shot up to a seven-year high of 1.27 percent. The 10-year Treasury yield, which was 1.867 percent on November 8, rose to 2.54 percent Wednesday afternoon. The dollar index also surged, jumping 1.2 percent to 102.24.

In its statement on Wednesday, the Fed’s FOMC repeated its previous language promising to raise rates only gradually and maintain them “for some time below levels that are expected to prevail in the longer run.”

Until the Fed’s quarter-point rate increase last December, the US central bank had kept its benchmark rate at near-zero since the height of the Wall Street crash in December of 2008. It had supplemented this flood of virtually free credit to the banks and financial markets with trillions of dollars in bank bailouts and "quantitative easing" bond purchases.

The Fed was then joined by all of the major central banks—the European Central Bank, the Bank of England, the Bank of Japan, the People's Bank of China—in providing unlimited cash to prop up the financial system and prevent the world economy from descending into a full-scale depression. They are continuing to hold rates at record lows and pump funds into the markets via bond purchases, even as the Fed moves in the opposite direction.

The policy of virtually limitless monetary stimulus has failed to restore economic growth to anything close to the pace of previous recoveries from recessions, and instead fueled increasing trade conflicts and social tensions. The banks, particularly in Europe, remain financially unstable, with hundreds of billions of worthless assets on their books. The International Monetary Fund has warned of record debt levels that threaten to trigger a new and even more disastrous financial crisis.

World trade is growing more slowly, and productive investment and productivity are down in most major industrialized countries, including the US.

Recent developments—the British Brexit vote, the election of Trump, the referendum defeat and resignation of Italian Prime Minister Matteo Renzi—reflect a growth of economic nationalism and the breakup of the post-World War II economic order.

Despite the Fed's pledge on Wednesday to keep interest rates well below previous norms, there were indications that, in the face of Trump's inflationary policies, it could move quickly in the opposite direction. The FOMC statement pointedly referred to "solid" job gains and rising wages, declaring that "Market-based measures of inflation compensation have moved up considerably…"

In a press conference following the FOMC meeting, Fed Chair Janet Yellen showed little enthusiasm for Trump's talk of a $1 trillion infrastructure program. Asked about her views on fiscal stimulus, she said that "the degree of slack [in the labor market] has diminished," and "fiscal policy is not obviously needed to provide stimulus to get us back to full employment." She also warned of a rise in the ratio of US debt to gross domestic product.

A number of financial analysts pointed to the signs of concern at the Fed over the prospect of a sharp rise in inflation. Luke Bartholomew, investment manager at Abderdeen Asset Management, told the *Financial Times*: "If there is a large fiscal stimulus then this will almost certainly create inflation pressure that the Fed will have to fight by raising rates."

Steven Ricchiuto, chief US economist at Mizuho, told the *Wall Street Journal*, "The tone of the statement was also a bit hawkish, with the emphasis on the tightening labor market and inflation being highlighted."

The *Journal* quoted Ian Shepherdson, chief economist at Pantheon Macroeconomics, speaking of the increased pace of monetary tightening. "We're slightly surprised to see it," he said, "but it is a welcome development, in our view. We remain very worried that the Fed and markets do not fully appreciate the extent of upside inflation risk for next year via the labor market, where wage growth is on the verge of a rapid acceleration."

In other words, interest rates must be raised to undercut a possible push by workers for higher wages.