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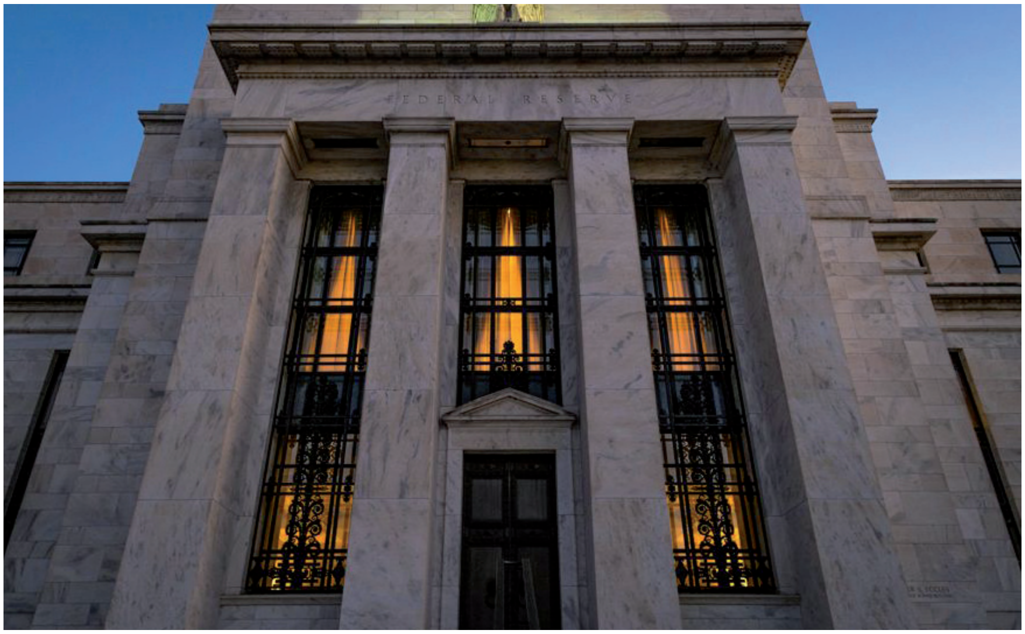
KHEZRI: What the Federal Reserve should do



FILE - This Sept. 18, 2013 file photo shows the Federal Reserve headquarters in Washington. Minutes of the Fed's discussion at its July 29-30, 2014 meeting show that some officials thought the economy was improving enough that the Fed would need "to call for a relatively prompt move" toward reducing the support it has been providing. Otherwise, they felt the Fed risked overshooting its targets for unemployment and inflation. (AP Photo/J. David Ake, File)

By Bijan Khezri - - Wednesday, September 16, 2015

The Federal Reserve will increase its base rate by 25 basis points at this Thursday's rate-setting meeting. Financial markets, if not immediately, but certainly shortly thereafter will rise as the damaging cloud of volatility-breeding uncertainty resulting from a lack of direction will have evaporated. All depends on the Fed's firm action with clear future market guidance.

During the past months, media commentators and economists have intensely debated the pros and cons of tightening U.S. monetary policy. Whether the US economy and, apparently more importantly, U.S. interest rate-sensitive emerging market economies can bear the consequences of tightening U.S. credit markets and an appreciating U.S. dollar will not and cannot be the Fed's sole decision driver.

What is at stake is the Federal Reserve's leadership as a sponsor of market certainty. No doubt, as a proprietor of a global reserve currency the Fed's responsibility goes beyond the borders of the United States. But the global economy has been increasingly locked into a 'complacency trap': cheap money that initially and certainly prevented a 1929-type meltdown in the aftermath of the 2008 financial crisis is now potentially breeding future imbalances - beyond central bankers' control. We are living in a comfort zone that shelters business leaders and politicians alike from facing the hard reality of the cost of complacency.

On the business front: cheap money continues fueling an overheated M&A market, likely to reach a historical all-time high in 2015. "Directionless chief executives suddenly look purposeful", in the words of Financial Times columnist Patrick Jenkins, with deal-activity potentially clouding the focus on fundamentals.

Indeed, cheap money diverts CEOs from building competitive companies from within as they respond to market disruption and diminishing returns by scaling through mergers and acquisitions.

Private equity market valuations have once again reached increasingly unjustifiably high levels, which inevitably catapult financial engineers, fueled by cheap money, to the forefront. Value-centric business builders are crowded out. IPO activity has reached record levels during the past twelve months, though, temporarily disrupted by instances of market volatility. Corporate bond issuance has reached record levels in 2015. “In the first half of 2015, the issuing of net debt securities by borrowers in rich countries rose to its fastest pace since before the crisis” according to data published this week by the Bank for International Settlements (BIS), the central bank of central banks.

Investment returns cannot but slide downwards against this background. In summary, the real economy is turning increasingly short-term as the investment outlook becomes more uncertain and pools of cheap money are to be tapped before they dry up. Corporates will eventually be forced into restructurings with dire consequences for the economy at large.

On the government front: cheap money has sheltered politicians from adopting structural reforms. This is equally true for both sides of the Atlantic. The European Central Bank’s quantitative easing – which is likely to be the ‘new normal’ for at least a decade – is the flipside of European governments’ inability to fundamentally reform public policy and increase the overall share of the private economy.

“It is unrealistic and dangerous to expect that monetary policy can cure all the global economy’s ills”, the BIS highlights before this week’s Fed meeting. And it is at this juncture where the Fed is challenged to take leadership without jeopardizing the recovery of the U.S. and global economy. The world is in need of a soft reminder that current U.S. interest rate levels imply a crisis level. Today, there is no crisis. And if we continue as is, the crisis-calls for crisis-level interest rate levels will become a self-fulfilling necessity.

Lawrence Summers, former Treasury Secretary and a strong advocate against tightening U.S. monetary policy, lately defends his position on the basis of tactical considerations: “Monetary policy should seek to avoid major surprises. Right now the fed funds futures market is assigning only a 28 per cent chance to a September tightening. In the last 20 years, the Fed has never tightened without guiding the futures market to at least a 70 per cent chance of a tightening. So a move now, given how expectations have been managed would be an extraordinary shock at a highly uncertain time.”

There are strong grounds to argue that the measure of potential mispricing of expectations as reflected in futures markets is but the measure of the ‘complacency trap’.

The Fed needs to tighten and provide clear future guidance. If it does not, the market will be trapped in prolonged uncertainty and increased level of volatility until October, the next rate-setting opportunity. Add on top of this the historical year-end October volatility and we are set for wait-and-see period, at best. The economic costs are significant. But more importantly, the credibility of the Fed as a guidepost for economic direction is at stake. Fundamentally, it is a governance issue.

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