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The Economist explains

The Fed's plan to hike interest rates

Aug 31st 2015, 23:50 BY R.A.

ALL across America there are nine-year-olds filing into fourth-grade classrooms who have yet to enjoy the thrill of a Federal-Reserve rate increase. The Fed, America's central bank, last raised rates in June of 2006, by 25 basis points to 5.25%. It soon found itself reversing course, as a housing bust gave way to the Great Recession; since December of 2008, the Fed's benchmark interest rate has been set at between 0.0% and 0.25%. Yet that may be about to change. A speech delivered on August 29th by Stanley Fischer (pictured), the vice-chairman of the Federal Reserve, gave no indication that the Fed had been deterred by recent market wobbles from its plan to raise rates this year, and perhaps at the next meeting, on September 16-17th. Why is the Fed about to raise interest rates?

The Federal Reserve is charged with setting monetary policy in order to meet Congressionally set mandates for "maximum employment" and "stable prices". The Fed has long determined that the best way to meet those mandates is to target a rate of inflation of around 2%; in 2011 it officially adopted a 2% annual increase in the price index for personal consumption expenditures (often called PCE inflation) as the target. Fed officials reckon that when the economy is weak, inflation will fall, while when the economy is close to maximum employment, rising wages will push up inflation. Keeping inflation near 2% should therefore

keep the economy growing at a healthy clip. The Fed raises its benchmark interest rate (called the federal funds rate) when the economy is growing too fast; that encourages people to spend less and save more, which slows the economy down and reduces inflationary pressure. When the economy is growing too slowly, it reduces the fed funds rate. Since 2008, when its benchmark rate fell to near zero and could not be cut any more, the Fed has instead sought to encourage investment and spending by other means, like purchases of government bonds designed to reduce long-run interest rates.

Schools brief: How monetary policy changed after the financial crisis

The Fed now believes that the time for those unusual measures is over, and that it is appropriate to begin raising rates. The improved financial heath of households and banks, seven years after the financial crisis, mean that slightly higher rates should not cause too much pain. Its preferred inflation gauge, PCE inflation, is still well below the 2% target; in the year to July it rose just 0.3%, or just 1.2% if volatile food and energy components are excluded. But America's job market has been booming. Employers added nearly 3m workers over the last 12 months, and the unemployment rate, at 5.3%, is close to levels at which Fed officials expect wage increases to accelerate. Fedsters argue that inflation has recently been held down by one-off factors, such as falling oil prices and a rising dollar, the effects of which should soon fade. They also note that low interest rates can encourage risky investments that lay the foundation for future financial havoc, and they worry that if inflation is allowed to shoot above 2% people may lose confidence in the Fed's ability to keep price increases under control, which could lead to still higher and more volatile inflation rates. The Fed is therefore expected to increase rates once or twice before the end of the year: perhaps to 0.25% in September and 0.5% in December.

Yet raising rates is risky. Despite low unemployment, wage growth has so far been modest. That suggests that wage-driven inflation may yet be some way off—and America's labour market may still be some way away from "maximum employment". The Fed has been over-optimistic about inflation before; it found itself repeatedly restarting its asset-purchase programmes after inflation failed to rise to and stay near target when purchases were curtailed. The move toward Fed tightening has also destabilised global markets, squeezing emerging economies, putting downward pressure on commodity prices and pushing up the dollar; rate rises may therefore ensure that the factors which have been dragging down inflation are not in fact one-off events. But what really ought to give the Fed pause is the asymmetry of the risks it faces. If it waits too long to raise rates then inflation could rise to 3% or 4%. But inflation which temporarily rises that high is not a major threat to the American economy, and the Fed has unlimited capacity to raise rates to rein in price increases. If it hikes too soon, however, then very low inflation might quickly become deflation, and the Fed will have little room to cut interest rates before returning to zero—and the uncertain world of unconventional monetary policy. It is understandable that Fed officials want to get back to interest-rate business as usual. If they move too soon, they may not get to enjoy business as usual for very long.

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The world is not ready for the next recession (June 2015)

US Federal Reserve "dot-plots"

Federal Reserve Open Market Committee predictions

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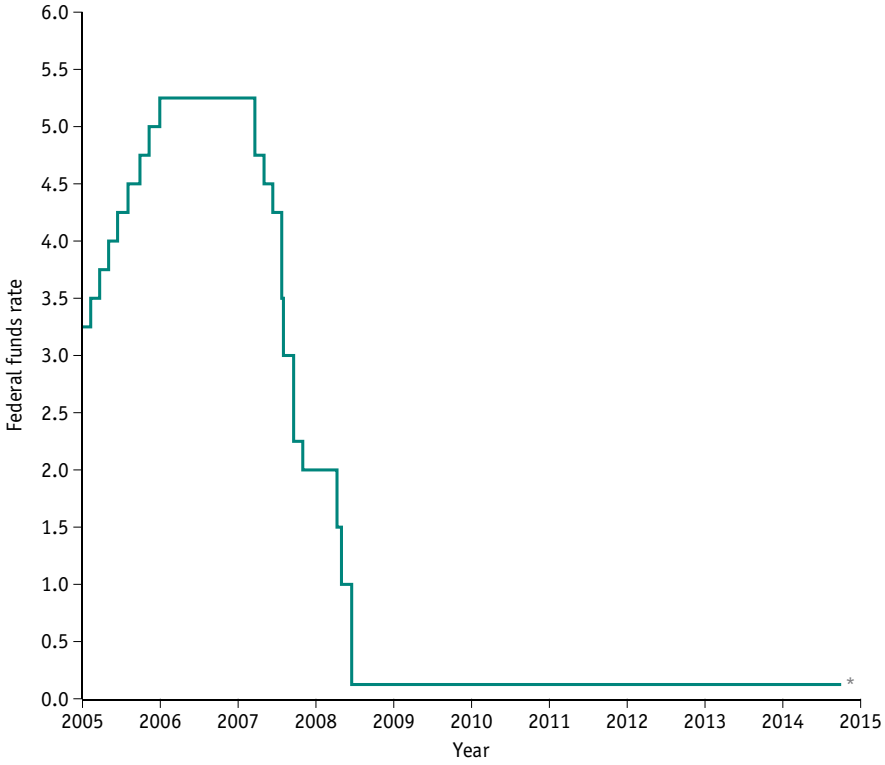
Eight times a year, the Federal Reserve's Open Market Committee (FOMC) meets to consider its policy and amend the federal-funds rate—an interest rate which it adjusts to influence banks' appetite for lending. The FOMC pushes the rate up to slow down a fast-growing economy and lets the rate fall to perk up a slumping economy. In December 2008, they lowered the federal-funds rate between 0% and 0.25%. They have not changed it since.

Federal funds rate, 2005–present



Sources: US Federal Reserve; Federal Reserve Bank of New York *Range of 0% to 0.25%

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A Simple Human Sep 2nd, 13:23

It is time T.E. makes every effort to write an article, where the TRUTH, is paramount, rather giving a flowery edge to it, just like former Fed. Chairman: Allan Greenspan & the rest who followed him, to justify all its (Fed.') actions just to benefit The Street and its henchmen.

Your predictions that Fed. may "increase the rate to 0.2% by Sept. & 0.5% by Dec.", is quite wrong, if you imply that it could be year 2015; but for year 2018, it may be; provided so many things happening around, if you have the time to look around, are taken into consideration.

Best of luck for your future predictions, about Fed's rate increases, in the near future.

Recommend 1 Report Permalink Reply

hedgie Sep 2nd, 03:53

Focus on the peak debt with ZIRP. You are can only chisel through for lost decades to reduce for the real economy to be restored to fitness.

Fed and other CBs are still experimenting and stifling free markets to do the cleansing. Egos will not rest in just being referees instead of players.

These egos are now flirting with interest rate increase in the deformed markets with collapsed price discoveries. Let them go as increasingly they are impotent in managing global fund flows in a G Zero World with other emerging formidable economies who have high predatory instincts.

For 7 to 8 years these fossilized minds have not proved to be credible with their QEs to restore stable growth. A small interest rate increase can be the catalyst of a bonfire to the deformed markets that is not detached from the real economy.

So TE is arguing its case from improving data (Job numbers, inflation, etc). These numbers have first to be scrubbed from their flawed methodologies. More importantly, you need to expose that they are the smokes from a system fueled by debts. Amazing that TE has descended to be an Echo.

Recommend 1 Report Permalink Reply

bampbs Sep 1st, 22:04

Anyone foolish enough to apply standard recession criteria to the exit from a depression still doesn't get it. Until inflation is the result of increasing wages, the economy is still sick. The 2% fetish is absurd. It ought to be double that. Doesn't anyone learn?

Recommend 4 Report Permalink Reply

jouris in reply to bampbs Sep 1st, 23:38

Maybe they are looking, as economists, to test the theory that the Fed raising rates prematurely in 1937 was responsible for prolonging the Great Depression. The cases would look to be parallel enough to make this a great test of the theory.

Of course, if the theory is correct, it would be a bit hard on the population. But hey, you can't put a price on knowledge.

Recommend 0 Report Permalink Reply

hedgefundguy in reply to bampbs Sep 2nd, 10:54

Anyone foolish enough to apply standard recession criteria to the exit from a depression still doesn't get it.

Agree.

Until inflation is the result of increasing wages, the economy is still sick.

That's going to be an awfully long time.

"Over the past 42 years, the real hourly wage rate has increased by only 17 percent and 46 percent for our first and second wage series, respectively, while per capita GDP grew much more, almost doubling."

"Lagging Long-Term Wage Growth"
https://research.stlouisfed.org/publications/economic-synopses/2015/06/2...

NSFTL
Regards

Recommend 0 Report Permalink Reply

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adriantan Sep 1st, 21:09

The Fed should raise rates juz to show China that there is only one Hegemon even if its leader is a wimp. What better time than when Xi visits New Rome to remind him that China has to keep on paying tribute to the Fed.

Recommend 3 Report Permalink Reply

marco666 Sep 1st, 17:07

"They also note that low interest rates can encourage risky investments that lay the foundation for future financial havoc" .. low interest rates has destroyed the free market system. Those with huge capital pools have very different risk factors from those with limited capital. Those with large amounts of capital have found holding cash to be more risky than high profit risk investments. Then when you are bailed out by central banks when your greeced junk bond goes south, you really can't lose. Ordinary working folks are not only punished by low interest rates, they are told that their labor and capital are worthless.
When the central banks finaly raise interest rates to freemarket levels (5.5-10%) you will see many

high risk rollers get what they deserve (bankruptcy on debt they can't afford) and it will give a chance to real entrepeneurs to get back into the market and to move forward.
Low interest rates have done nothing but create world wide economic disaster. No country,except perhaps the USA has benefited from low interest rates. But that is debatable because the USA benefits from international financial chaos. It is evidence that central banks are not independent but tied to big business and big banks.

Recommend 5 Report Permalink Reply

Skip27 in reply to marco666 Sep 1st, 20:10

You miss the point. No one has a right to high risk-free returns. If you have sufficient savings, then you should not keep them in a bank account. That is insane, and extremely unproductive to the economy as a whole.

Stupid people will cry and get their 1% CD's, but normal people will invest in real estate, equities and higher yielding fixed income products. These place capital in more beneficial areas (housing, industry, investment in the future,...).

Low interest rates are good. Yes, there was a golden period in US history for savers where one could obtain large yields risk-free, but this was an anomaly. For most of human history people invested in dividend-paying stocks or purchased annuities from insurance companies (still a choice).

Also, when you say "free market levels," I think you mean distortionary levels. The free market is what it is. That means mush lower than what you write in the 1950's, and much higher in the 1970's.

Now, if you want a more "managed" economy, then move to the Middle East or Africa. You can get your higher interest rates there. Here in the US we have a rational, patriotic Fed that does what is best for the US people, not what is best for whining old men who are too scared or stupid to properly invest their savings.

Recommend 3 Report Permalink Reply

guest-njsooll in reply to Skip27 Sep 2nd, 00:43

What a silly response. If you don't understand the reality that the (FED) (IMF) and all world wide central banks abide by the rules (are owned) and regulations of bank of international settlements a Swiss bank (also the entity responsible for the reality that 64 people in the world have more money than 3 and a half billion) you are in for a rude awakening I believe very soon. The reality is there is no such thing as a free market its all side show and public relations. Not one serious market mover actually thinks the Fed will raise rates this year, but they trick people time in again to staying in stocks while the big money quietly exits JUST LIKE WHAT"S BEEN HAPPENING THIS SUMMER!!!!! To skip 27 and and the three people who recommended his post you are either corporate trolls or very misguided individuals.
#1partyorwelliancentralbankelitistcontrolledsystem #FOOLS #Everythingisarichmanstrick

Recommend 0 Report Permalink Reply

Expand 1 more reply

MrR.Fox Sep 1st, 15:32

Fed Funds below 4.0% do nothing to help the real economy - but they are catnip for the financial engineers on The Street.

All the balance sheet wealth that was created by the move from 'normal' to ZIRP has to be given back when the movement back toward normal BEGINS. That's going to hurt a lot of balance sheets - but not The Street's.

The wise guys have unloaded all their trashiest long-dated stuff on to the Fed, at the highest prices ever paid for such things. It won't be The Street that has to eat the losses on those items as rates rise - it'll be taxpayer-muppets who do.

There's a reason The Street pays Benny $500k-a-pop to stop in for lunch. Nice work if you can get it - or buy it with muppets'-money like Benny did. One kosher palm washes the other - greases it too.

Recommend 2 Report Permalink Reply

hedgefundguy in reply to MrR.Fox Sep 1st, 16:03

It won't be The Street that has to eat the losses on those items as rates rise - it'll be taxpayer-muppets who do.

.

Nope.

The Fed is an independent institution and has no ties to taxpayer money.

.

If the price of "their trashiest long-dated stuff" falls, then another Asset must rise, or Liabilities and/or Capital must take a hit.

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2014 Fed Balance Sheet - Page 6

http://www.federalreserve.gov/monetarypolicy/files/BSTcombinedfinstmt201...

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NSFTL

Regards

Recommend 4 Report Permalink Reply

guest-njsooll in reply to hedgefundguy Sep 2nd, 00:50

HAHAHAHA. What happend in 08? Tax payers gave hundreds of billions of dollars to these gangsters because they said they were to big to fail in 08. Fundamentally things have gotten much worse in the markets, more high risk bets than before the first part of the financial crisis in 08. There's better ways to make money than speak propaganda for the same european bankers who funded Hitler.

Recommend 0 Report Permalink Reply

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guest-njssmnm Sep 1st, 14:36

Dear Editor: I have for a long time wondered about macre-economics, particularily the "magic numbers", e.g. 2% inflation, and the mantras "maximum employment" and "stable prices". The article provides an explanation: Central bankers have observed that weak economy leads to low inflation, while an economy close to maximum employment, will push up inflation due the increased wages. Thus the magic inflation number of 2% should be strived for. However, one might wonder about the causality, despite the observed correlation.The employment level is presumably the cause and inflation a consequence. It seems unlikely that increased interest rates would generate "maximum employment"

Recommend 3 Report Permalink Reply

MrR.Fox in reply to guest-njssmnm Sep 1st, 15:21

... but no more unlikely than that higher inflation will generate 'maximum employment' either. Brazil enjoys high inflation and it hasn't helped their employment situation at all, to say the least.

Recommend 3 Report Permalink Reply

guest-omomnij in reply to guest-njssmnm Sep 1st, 15:23

I think overall, the mantra of limiting yourself to "maximum employment" and expecting wage rates to rise can be a bit too much of unconventional wisdom. You'd have to factor in the underemployment rate, real GDP per capita across monthly periods (which they cite as being modest), income distribution spreads across social classes, etc. The only problem is the dilemma now becomes internationally focused just as much as it is domestic with the fed; international borrowing in US dollars and paying off debts, imports of US goods, etc.

Recommend 2 Report Permalink Reply

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WT Economist Sep 1st, 13:49

What does this say about the world economy that there is a panic about the potential for a 1.0% Fed rate a year from now?

Recommend 3 Report Permalink Reply

MrR.Fox in reply to WT Economist Sep 1st, 14:06

It says that there's a lot of money to be lost in the mark-down of assets that has to happen as rates rise.

Recommend 4 Report Permalink Reply

hedgefundguy in reply to MrR.Fox Sep 1st, 14:30

That's only for bond traders.

If you bought a 2 year note on the exchange yesterday, you would earn 0.75% for 2 years. http://www.whig.com/story/29926178/us-treasury-bond-market-at-a-glance

If inflation is under 0.75% for the next 2 years, you make out regardless if the Fed rate rises to 1% next year.

Similar to one buying 2 year CD at 0.75% from their local bank.

NSFTL
Regards

Recommend 3 Report Permalink Reply

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wnderer Sep 1st, 12:34

"The Fed raises its benchmark interest rate (called the federal funds rate) when the economy is growing too fast; that encourages people to spend less and save more, which slows the economy down and reduces inflationary pressure."

This doesn't work. The Fed's interest rates don't encourage people AKA 'consumers' at all. By lowering interest rates, the Fed has encouraged corporations to save more and spend less. This has led to the rise in asset prices. By raising interest rates the Feds will encourage businesses to try to

make money by paying workers to do work and create value instead of grabbing at the money the Fed has been printing. When money starts flowing into workers/consumers hands we will start seeing inflation. The Fed has no tools to directly remove money from consumers hands. In order to combat inflation, the Fed will raise interest rates to take money away from businesses, who will layoff workers and drive the economy back into recession.

I agree that lower interest rates and QE were necessary to bring stability to the markets but once the markets stabilized the inflation criteria was nonsense. To combat inflation Congress needs to modify the tax code to encourage workers to save more and borrow less as wages rise. The federal funds rate won't do it.

Recommend 4 Report Permalink Reply

hedgefundguy in reply to wnderer Sep 1st, 14:38

"The Fed raises its benchmark interest rate (called the federal funds rate) when the economy is growing too fast; that encourages people to spend less and save more, which slows the economy down and reduces inflationary pressure."

Our blogger is still in the 1970's.

Our blogger forgets that people will buy with their 16% interest credit card.

the Fed has encouraged corporations to save more and spend less.

Actually, to roll over existing debt to a lower interest rate (interest payment) which leads to more profits.

It also encourages borrowing cheaply for stock buybacks.

When money starts flowing into workers/consumers hands we will start seeing inflation.

No, as stated above, people use credit cards today.

Inflation of wages will occur when businesses have to fight over available workers (currently working or not).

NSFTL
Regards

Recommend 3 Report Permalink Reply

FlyingBlind in reply to wnderer Sep 1st, 16:11

I find I agree. Rising rates do not encourage saving; they simply cause prices to rise which eats up limited wages.

Recommend 3 Report Permalink Reply

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hedgefundguy Sep 1st, 11:35

FWIW,

At yesterday's Treasury auction:

The 3 month went at 0.095%
http://www.treasurydirect.gov/instit/annceresult/press/preanre/2015/R_20...

The 6 month went at 0.270%
(Highest since 8/17/2009.)

http://www.treasurydirect.gov/instit/annceresult/press/preanre/2015/R_20...

NSFTL

Regards

Recommend 3 Report Permalink Reply

Communal Award Sep 1st, 11:26

Since dollar is pegged to OPEC, Fed should PRINT and distribute dollars for rest of the world;

Recommend 3 Report Permalink Reply

P6McJ4xDi7 Sep 1st, 11:11

I nominate the opening sentence as one of the most interesting leads I have ever heard to a financial news story- "ALL across America there are nine-year-olds filing into fourth-grade classrooms who have yet to enjoy the thrill of a Federal-Reserve rate increase." Bravo

Recommend 13 Report Permalink Reply

MrR.Fox Sep 1st, 06:21

To put this piece in proper perspective, you have to look at who wrote it.

For ideological reasons the author doesn't care to 'get it', but Fed-types do - ZIRP is an extremely distortionate activity; it inspires all sorts of financial gamesmanship that create future risk and present detriment to the economy, while offering little or nothing to benefit the real economy.

The people making the decisions know that every day that ZIRP persists more and more landmines are sown into the landscape of the economy.

It's an example of the classic political dilemma - persist in the path of least short-term political resistance at the expense of ever more future distress, or do the unpleasant thing sooner and get it over with before it becomes even more entrenched and painful to shed? No wonder Janet's in hiding - no doubt trying to think of a good explanation for why she and others ever got us into this fix in the first place.

The author implicitly purports to believe that the difficult choice isn't before us. I don't believe he's sincere in that.

Recommend 11 Report Permalink Reply

blue chicken in reply to MrR.Fox Sep 1st, 09:42

"They also note that low interest rates can encourage risky investments that lay the foundation for future financial havoc,..."
TE did mention something about future risk.

Recommend 3 Report Permalink Reply

MrR.Fox in reply to blue chicken Sep 1st, 09:50

He mentions it in passing in the body of the text - and in the final paragraph where he argues against a rate hike, he cites inflation as the only down-side to continued ZIRP.

Recommend 3 Report Permalink Reply

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guest-omjsmsn Sep 1st, 03:24

The Mormons have it right. Get hold of some farmland and farm animals and horse drawn carriages. Switch of the electric power and go back to basics. Then you do not need to worry about negative interest rates...or the Economist.

Recommend 6 Report Permalink Reply

gossypol in reply to guest-omjsmsn Sep 1st, 03:58

Think that's the Amish you have in mind.

Recommend 17 Report Permalink Reply

GlobeWanderer in reply to guest-omjsmsn Sep 1st, 12:02

I think you mean the Amish.

Recommend 2 Report Permalink Reply

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simpleinvestor Sep 1st, 02:55

The Fed was able to end a lot of unconventional monetary policy last year, and the economy survived (yes, with some bumps and bruises due to some people anticipating decades of easing with arguments like those above).

The next unconventional monetary policy to back away from would be keeping interest rates at 0%. That's not just a stimulus, it's an extreme emergency measure.

Through most of the 60s, 70s, 80s, and 90s the Fed was able to fight recessions with interest rates that never went below 2.5%. A small raise still means that it will be encouraging further inflation and growth. As far as I know there is no talk of a 5% or 7% interest rate in North America next year.

Recommend 2 Report Permalink Reply

guest-njsieel Sep 1st, 02:09

With an abysmally low labor force participation rate ,significant wage inflation seems very unlikely. We may have to resort to Helicopter Ben tactics soon rather than any sort of tightening. Getting the US debt to nominal GDP ratio down would also be a helpful side effect if inlation somehow managed to temporarily rear it's head.

Recommend 4 Report Permalink Reply

Skip27 in reply to guest-njsieel Sep 1st, 21:13

Yes. I think we have not come even remotely close to printing enough money. Japan's experience scares me. I would rather the Fed buy as much outstanding government debt as possible, and keep going until real inflation and its commensurate interest rates appear.

Recommend 2 Report Permalink Reply

jbunniii Sep 1st, 01:18

The U.S. has much the same problem as the Euro Zone: a single interest rate has widely varying effects on different regions. The same low interest rates that keep the rust belt from sinking even further into recession are reinflating the same asset bubbles that caused so much trouble last decade: house prices in the usual frothy regions (especially California this time around) and the stock market, which is still near all-time highs despite the slight pullback of the past few weeks.

Recommend 9 Report Permalink Reply

hedgefundguy in reply to jbunniii Sep 1st, 11:11

Please don't blame the Midwest for Californian's stupidity.

Just look at how they spend large sums of money and the lives of firemen to protect the rich and others that live in wildfire zones.

And this occurs EVERY year.
-

"Originally, each Reserve Bank set its discount rate to reflect the banking and credit conditions in its own District. Over the years, the transition from regional credit markets to a national credit market has gradually produced a national discount rate. As a result, the Federal Reserve maintains a uniform structure of discount rates across all Reserve Banks."

https://www.richmondfed.org/faqs/interest_rates
-
Search for:
Cleveland Reserve Bank set its discount rate

Then look for the book: A History of the Federal Reserve, Volume 1: 1913-1951

You can read about it occurring in 1921, on pages 109-112.

NSFTL
Regards

Recommend 4 Report Permalink Reply

FlyingBlind in reply to hedgefundguy Sep 1st, 16:21

I think you may be mistaken if you think all the homes the firemen in CA are protecting are for the rich. California is a large state, with a very diverse population. The homes burning aren't in Marin county, they're in the modest communities that happen to be tinder dry from years of drought.

Recommend 1 Report Permalink Reply

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jomiku Sep 1st, 00:05

I think the Fed also is thinking of 2 other things:

1. The need to be taken seriously as the determinant of rates. This happens by raising rates, which some of them may see as the opposite of appearing weak before all the economic troubles.

2. Confidence. I think they want to send a signal that the economy is strong, that it doesn't need to be seen as always on the edge of disaster and the only way they can do that is by acting as though things are normal.

Recommend 6 Report Permalink Reply

hedgefundguy in reply to jomiku Sep 1st, 11:51

Plus it allows them to reload.

Assuming they haven't thrown the gun, eh Waldorf?

NSFTL
Regards

Recommend 3 Report Permalink Reply

Skip27 in reply to hedgefundguy Sep 1st, 21:19

Good point

Recommend 0 Report Permalink Reply