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Chances of regret high as US policymakers face familiar dilemma

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INSIGHT

Twice in the past 30 years the US Federal Reserve has faced the prospect of prematurely abandoning tightening during market turmoil. Today, global currency devaluations, market volatility and plunging commodity prices have trapped the Fed in a similar policy dilemma.

In 1987, the central bank aborted rate rises and reversed course after a stock market crash. Again, in 1998, after the failure of Long-Term Capital Management, a highly leveraged hedge fund, the Fed abandoned its planned rate increases to stabilise markets and avoid a global crisis. In both cases, the unintended result of delaying was inflated asset prices, which ultimately destabilised the economy and led to severe financial consequences and recession.

In 1986, inflation slowed as oil prices collapsed, raising serious concerns about US economic expansion following the worst postwar recession up to that time. Policymakers were slow to raise rates, allowing for a surge in equity prices in early 1987 as energy prices rebounded.

After falling behind the curve, aggressive Fed actions to address inflation inadvertently pricked the stock market's speculative bubble. In October 1987, US equities plummeted more than 30 per cent. The Fed quickly reversed course and reduced rates.

By mid-1988, markets stabilised and the Fed again raised rates to head off inflation. By this time, more than four years of accommodative monetary policy had led to a commercial real estate boom with a glut of new properties. As the economy tumbled toward recession in 1990, a sharp decline in property values caused defaults and the failure of financial institutions. The government-sponsored Resolution Trust Corporation was set up in response to resolve troubled banking assets.

After the ensuing recession and another period of accommodation, the Fed again raised rates in the mid-1990s. During this time, many Asian nations had pegged their currencies to the US dollar. By 1997, the pressure to maintain these pegs amid rising US rates became too much for some. Thailand was first to break its peg, allowing the baht to collapse and increasing pressure on neighbouring economies in a dramatic round of competitive devaluation.

By 1998, contagion from emerging markets reached the US, pressuring domestic markets. A collection of 14 major financial institutions convened by the Fed intervened to stem the collapse of the LTCM hedge fund that threatened the solvency of the global financial system.

Once again, the Fed aborted plans to raise rates, allowing equity prices to skyrocket. When the Fed finally tightened, stocks began a long, deep slide. Numerous companies that flourished amid the speculative wave failed.

Today, policymakers are caught in this familiar dilemma. Labour markets are moving toward full employment, and declining energy prices and a stronger dollar have resulted in languishing inflation. Still, questions remain about the viability of sustained economic expansion in the US and around the world, and volatility is rising.

At the same time, currency devaluation, particularly in Japan and the eurozone, is putting pressure on countries to devalue to improve export competitiveness. Those countries slow to devalue, like China, are feeling economic pressure at home, driving down asset prices and increasing deflationary pressures, escalating the risk of financial contagion abroad.

The Fed is hard pressed to justify a rate increase based on its self-prescribed metrics, which include rising inflation and an improved employment situation with clearly rising wages. At best, policymakers can argue that the prospects for wage growth and inflation are improving, but clear evidence is lacking.

A pre-emptive rate increase seems risky and opens the Fed to potential criticism given the fragility in financial markets and the prospect that rising US rates could exacerbate foreign economic turbulence. But while prices and wages remain tame, the risk of another asset bubble is increasing. If policy remains highly accommodative, the likelihood grows that asset classes including commercial real estate, equities or certain categories of bonds could become dangerously overvalued.

Regardless of the path the Fed chooses, after seven years of accommodation and now facing volatile global markets, the likelihood of regret is high.

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