Fed dithering will destabilize markets

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As widely anticipated, the Fed on Wednesday decided not to raise its federal funds target rate. As it did so often in 2015, it put off a decision on a rate increase to the next meeting. The decision is unlikely to become easier as 2016 progresses. Investors beware.

The Fed has stated its intention to do a series of interest-rate increases over the next two years. Those statements have already moved markets. In particular, the dollar has strengthened against other currencies. A stronger dollar has ramifications both here and abroad. It makes U.S. exports more expensive on world markets. Purchasers in other countries must exchange more of their own currencies to purchase U.S. goods. That dampens demand, which impacts American producers and their suppliers. The stronger dollar also makes imports cheaper, and to some extent U.S. consumers and businesses will substitute imported goods for domestically produced ones. That slows U.S. economic growth.

The anticipation of a Fed tightening has already had some of the effects of an actual policy tightening. Markets are reacting in advance of further tightening. These market movements are expectations driven.

There are other effects of a stronger dollar.

1. Oil is priced globally in dollars. Dollar strengthening makes oil more expensive in local currencies, and that dampens demand for it. The collapse in oil prices was precipitated by the technological revolution in shale production. The decision of major producers, like Saudi Arabia, to keep pumping pushed prices down further. But the strong dollar has contributed. It is difficult to see oil prices rising significantly in the face of further dollar strengthening that would result from further hikes in interest rates.

2. There has been a great deal of borrowing in dollars in emerging markets by sovereigns and individuals. The servicing of those debts has become more expensive for those collecting taxes or earning income in depreciating local currencies. For the most heavily indebted borrowers, there is risk of default. For sovereign borrowers, default on foreign debt is as much a political decision as an economic one. Sovereign borrowers are more likely to default on debt held by foreigners than that held by their own citizens.

So, if the Fed adheres to its plan, 2016 will see turbulence in global credit markets and continued downward pressure on energy prices. With each postponement of a rate hike, however, the Fed will increase uncertainty in financial markets. Instead of being a stabilizing force in financial markets, Fed dithering will destabilize markets.

The Fed realizes that, by holding interest rates down for so long, it has distorted investment decisions and inflated asset bubbles. It needs to stick to its plan to raise short-term interest rates to more normal levels – to 2 percent or higher. But the adverse reaction in global financial markets to its tentative first step pressures policymakers to hold off and postpone further rate hikes.

Fed officials have repeatedly justified a gradual increase in short-term interest rates by their anticipation of higher inflation rates as the economy strengthened and unemployment rates fell. Falling energy prices make higher inflation much less likely. The public justification for tighter monetary policy is weakening in the face of stubbornly low inflation rates.

The truth is the Fed kept interest rates too low for too long. It kept hoping that real economic growth would pick up. The effects of low interest rates channeled investment into financial speculation rather than real productive activity. Now that the Fed has decided to act, there will be major economic adjustments to be made. We have only begun to see some of these. Whether Fed officials can stay the course will be tested in 2016. It will likely be a turbulent year for investors.

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