The Fed has to raise rates in December

Gerald O'Driscoll, Jr.

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As widely anticipated, the FOMC voted not to raise rates in November. The changes in the language of today's statement were slight. There was a somewhat more bullish characterization of the medium-term inflation picture, with a suggestion that the inflation rate would hit the 2-percent target. The Fed now finds itself where it was last year, one meeting left in the year in which to raise interest rates as it has all but promised.

I believe the FOMC will raise rates next month for much the same reason it did in December of last year. Its credibility is on the line. Too many rate hikes were forecast, suggested and anticipated, not to raise rates. The Fed has breathing room between the election and Inauguration Day. I also believe that a majority of the committee has come to the conclusion that it is time to raise rates. Monetary policy has done all that it can at this point. Hence, the calls by some Fed officials for another round of fiscal policy.

Fed officials are limited in the justifications they can offer for raising rates. Basically, they must point to one of the central bank's mandates: employment or inflation. Neither of these has really been able to justify a rate hike heretofore; hence, the dithering all year. The current recovery has been long, but historically weak.

That is true whether one looks at output growth or employment growth. The unemployment rate may be hovering around the magical 5-percent figure. As most observers understand, however, that figure is misleading. Much of the decline has resulted from people exiting the labor force. It is not an indicator of labor market strength. Likewise, GDP growth has been anemic for most of the recovery. The 3rd quarter figure of 2.9 percent growth looks good only compared to recent experience, but not by historical standards.

So why the continued commitment to raising rates? For some FOMC members, the stated reasons are not the real reasons. There are legitimate concerns about the effects of very low interest rates on financial institutions, including banks, pension funds, and money-market mutual funds. Very low rates make it difficult for firms to maintain profitability, or even their business models in the long run. Call this argument for raising rates "financial stability." It is difficult, however, for Fed officials to call openly for higher rates to bail out the financial services industry.

There are also international considerations. Much of the world, including the European Union and Japan, are operating with negative interest rates. The folly of this has become apparent to their central bankers. If very low, positive rates are a problem for an economy, negative interest rates are even more so. Designed to stimulate spending, negative rates have instead fostered more saving. That is perfectly rational. People save for retirement, and must save even more if returns are negative. Investment has not been stimulated. Pension obligations cannot be met. And so on.

For the EU to get its rates even back to zero, however, U.S. rates must move even higher into positive territory. Again, this consideration is not one Fed officials can openly address. Higher interest rates will mean a stronger dollar, weaker U.S. exports and even slower U.S. economic growth.

If we tally up all these considerations, they suggest a rate increase in December and then another long pause. There will be financial blowback from the increase. And then the Fed will face the demands of a new Administration. Both major candidates are committed to spending initiatives, with infrastructure spending a common idea. Deficits will only go higher no matter the victor. That puts further pressure on the Fed not to dramatically increase the government's borrowing costs.

Speaking of the election, I must add a caveat to my forecast. Commentators are raising the specter of a political crisis after the election. I am certainly not predicting it, but I cannot dismiss political tail risk. With a major political event, all bets and all forecasts are off.

Commentary by Gerald P. O'Driscoll, Jr., a senior fellow at the Cato Institute. Formerly, he was vice president at Citigroup, and, before that, vice president at the Federal Reserve Bank of Dallas.