Why three rate hikes in 2017 may be too many—And not enough

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The Federal Reserve is widely expected to increase the short-term interest rates it controls by 25 basis points. There have been a string of statements to that effect by Fed Governors and Presidents. And now Fed Vice Chairman Fischer and Chair Janet Yellen have added their voices to the chorus.

Most notable has been the change of heart by Governor Lael Brainard. She was a prominent dove prior to the election. Now she has turned hawk, in what may be one of the greatest conversions since that of St. Paul on the road to Damascus.

If the Fed does not raise rates at the March FOMC meeting, it will surprise financial markets. And it would damage the Fed's remaining credibility. So, we can assume a March rate hike is baked in. The interesting question is how many increases in the Fed's administered interest rates will there be this year. Fed officials are signaling two more, for a total of three in 2017. For reasons I will explain, two more rate increases may not be enough and yet may be too many.

Fed officials reason in terms of the so-called dual mandate of keeping inflation at 2 percent and achieving "full employment." Inflation, which has long been running below 2 percent, is now approaching that rate. And Fed officials have decided that an unemployment rate of 4.8 percent signals the economy is at or close to full employment. For purposes of this piece, I will accept both judgments. So, the dual mandate certainly calls for one rate hike, and might justify two or three.

I believe there is another, underlying justification for at least three rate increases. That is a desire to get back to "normal" interest rates and "normal" monetary policy. "Normal" is a term of art, but certainly does not sanction interest rates in the zero-to-one-percent range. So the next rate increase is only a first step to normality.

I would also argue that a Fed balance sheet of $4.0+ trillion is not normal. But shrinking the balance sheet remains too big a dose of normality for now for most Fed officials. Nonetheless, a return to normal interest rates justifies three increases in the Fed's short-term interest rates.

There are other, largely unstated reasons for beginning a program of rate increases that very well might not be limited to three. First, Fed officials know that financial firms generally are being squeezed by ultra-low interest rates.

The margins between what they pay for funds and what they can earn deploying funds (e.g., making loans) have been squeezed. Bank stock prices have rallied not just on the prospects of financial deregulation in the Trump administration, but also in anticipation of interest-rate increases.

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No segment of financial services has been hurt more by the Fed's extraordinary monetary policy of low interest rates than the money-market mutual fund industry. At rates near zero, money-market mutual funds are not a viable business model. Either the Fed raises rates steadily this year, or that industry is at risk.

Second, I venture that at least some Fed officials must be worried that they have created asset bubbles by the long period of very low interest rates. And they would surely be correct. Here, they are between a rock and a hard place. The history of asset bubbles is that, once inflated, they are not easily deflated gradually. They tend to burst, as evidenced in the last financial crisis.

We never know which financial firms have over-extended themselves until the bubbles burst. I predict an extended period of rate hikes will end with a financial upheaval of some type. I am not predicting another 2007-08, but there will be some degree of financial distress. I am not arguing against further rate increases, but reporting the likely consequences. Indeed, three hikes may not be enough to deal with financial froth the Fed has created.

There is at least one factor arguing against three rate increases in 2017: the dollar. President Trump has already tweeted disapprovingly about the strong dollar. If the dollar appreciates further, his Twitter account will likely light up. That is a political risk to the Fed, which officials must calculate.

There is also the economic risk to the economy of too strong a dollar (which plays into the political risk). A strong dollar can curb exports and stimulate imports. That would add to the trade deficit, which so occupies this Administration. That is yet another risk for Fed officials to weigh.

There is another major risk of a rise in the dollar. A very large amount of global debts are denominated in dollars. Countries, especially emerging markets, firms, and individuals have borrowed cheaply in dollars. To repay that dollar debt, governments, businesses and individuals must earn income or collect taxes in local currencies. As the dollar strengthens, the real burden of those debts rises in terms of local currencies. Borrowers will need to devote more of their income to servicing the dollar debts.

Inevitably, at some point, defaults will be triggered. Banks and other financial firms holding the debt will be impaired as losses mount. Correspondent banks, including U.S. banks, which have lent to the foreign banks, will be at risk. This dollar-trade risk could ignite another global financial crisis. It would certainly limit the Fed's scope for further rate hikes.

To recapitulate, there are strong domestic reasons for the Fed to initiate a program of increasing interest rates. Some of these domestic factors justify one, two, three or even more rate increases in 2017. There are also, however, strong international factors mitigating against further rate increases.

The Fed's fundamental problem is that the dollar is global money and the Fed is running a global monetary policy. But Fed officials, except in crisis times, stubbornly adhere to the fiction that they are conducting a purely domestic monetary policy. That stubborn fiction is what helps produce global financial crises.

There is no "right" policy to address so many policy goals. The Fed has painted itself into a policy corner. It cannot extricate itself without causing financial instability somewhere in the world. My best guess is there will be a rate increase in March and likely another one later in the year. A third hike might become problematic as a stronger dollar works its effects globally.

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