Why The Fed May Not Be Able To Credibly Raise Rates

At the Humphrey Hawkins last night, the Fed Chair, Janet Yellen signaled flexibility on interest rates neither committing to be patient nor being more hawkish in the face of stronger labour market data.

The Fed has signaled that it is ready to raise rates this year as the US economy has shown strength and the labour market has finally caught up with output growth. However, inflation at 0.8% is far from the 2% target and recent labour market strength is unlikely to boost inflation for some time to come. The strength of the USD is another concern as it could hurt exports, yet the US is a fairly domestically focused economy with exports at 13.5% of GDP (2013 numbers but the ratio is quite stationary) according to the World Bank. One reason for raising rates is that under normal conditions, 0.25% is simply too low and the Fed has to reset its policy tool as well as signal some confidence in the US economy. Even 0.50% is not a high number and neither is 0.75%. Beyond that the Fed actually has no interest in raising rates since apart from the low inflation the debt service costs for the US treasury would rise (by roughly 30+ billion USD per 0.25% increase), as would corporate funding costs.

Let's say for the sake of argument that the US Fed wanted to raise rates. It would need to do a couple of things. One, it would have to announce its intention and pick a number. Call it a 0.25% hike to take the Fed Funds Target Rate to 0.50%. The current effective Fed Funds rate is 0.12%, it is not 0.25%. In fact the effective rate has traded below the target rate since September 2008 when liquidity injections, bailouts and QE were applied. A positive gap between target and

effective rates is a sign of the extent of excess reserves in the banking system. From 1985 to 2008 the gap averaged -3 basis points. From 2008 to the present, it has averaged +13 basis points. Incidentally this is a sign of the ineffectiveness of QE on the real economy. If the Fed wants to hike rates, it will first have to close the gap. It will need to reduce excess reserves in the banking system and has 2 instruments to do this. Term deposits and reverse repos. Term deposit take up has been slow with a take up of 188 billion USD on Feb 5, followed by a 107 billion Feb 12, and 107 billion on Feb 19.

Gone are the days when there was a Fed Funds Target Rate, today we have a target band of 0-0.25%. It might be embarrassing if the Fed announced a rate hike, and found the effective rate trading below the old target.