

Four reasons why the FED should hike rates in September

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The FED's last three monetary tightening cycles

1994 – 1995: During that period, the FED's main policy rate has risen by 300 basis points up to 6%.

1999 – 2000: The FED's main policy rate has risen from 4.75% to 6.50%.

2004 – 2006: In June 2004, the FED starts a monetary tightening that will bring its key rate from 1% to 5.25%. During the month following the first hike, the dollar index climbed 2.29% and gold lost 3.35%.

A large number of investors dream of a QE4 or at least of a first rate hike postponed to 2016 by the FED. That would be a headlong rush. Two arguments have been raised in support of a status quo:

- **the American economy is not strong enough to raise rates.** Nobody can deny that the American economy has not returned to what it was before 2007. Wage pressures, the participation rate of the labour force down 440 basis points compared to what it was before the crisis and a weaker economic growth than during the last recovery phases, when the US were able to post a 4% if not 5% GDP growth are the main indicators confirming the idea of a slower and more fragile economy. As shown by a weaker GDP potential growth (2% for the years 2015-2025, compared to 3% in 2000-2007), the US are entering into a form of economic stagnation. This is not only the consequences of the production capabilities destroyed as an effect of the 2007 economic crisis. This is a worldwide phenomenon. It reflects the population ageing, the slowdown in productivity as well as structural changes reshaping the economy ("uberization" of the labour market, robotization of industries, innovation everywhere but no breakthrough innovation,...). The monetary policy is able to cope with this situation. It has reached its limits and it's time for budgetary policy to take over;

- **a monetary tightening involves a risk of a new downturn in emerging countries.** This should be inevitable. All of the four tightenings within the last four decades have ended in a turmoil for emerging markets. Since the 2007 crisis, emerging countries' debt in dollars has increased sharply, on longer and longer maturities. In 2014, they were indebted 100 billion dollars over the next 10 years. A FED's status quo is unlucky to encourage a deleveraging that has not begun yet. The end to this debt cycle will certainly not occur without bankruptcies and another financial crisis. Among most vulnerable countries are those which didn't succeed in reducing their oil dependency in the last decade when oil prices increased strongly during the period. Following Kazakhstan giving up the pegging of its currency against dollar to devalue it by 20%, many countries could be forced to do the same in Africa, in Asia Minor or in the Arabian Peninsula, which would lead to even more volatility on the forex. Anyway, the failure of some countries (South Africa, Brazil, China, Turkey,...) should not hide the success or potential of others (at first, Colombia, India, Peru, Philippines or even Poland). Countries that carried out the required

structural reforms these last few years are more likely to adapt to a FED rate hike which will probably be very progressive, unlike the former cycle that began in 2004.

However, the probability of a rate hike in September is stronger than generally believed. There is no perfect timing to tighten monetary policy but several arguments confirm that the FED is able to begin this month if wanted. Here are the four we can see:

- **stricto sensu, the FED is on its way to achieve its dual mandate.** With a 5.1% unemployment rate, the American economy is very near from full employment. It enters its seventh year of expansion. The current period of growth is already 16 months longer than the average period of growth since 1945. Likewise, as for inflation, the FED has nearly achieved its goal as inflation excluding oil and energy lies at 1.8%, close to the 2% target. Taking into account the evolution of the barrel, inflation is down significantly, but this near-deflation situation is an external factor on which the central bank has little influence and can not be the only driver of the American monetary policy strategy ;

- **the FED is clearly aware of the risk of creating speculative bubbles.** Even if preventing speculative bubbles is not officially part of the FED dual mandate, this legitimate preoccupation is strengthened by the financialization of the economy. The economic literature dating from the beginning of the previous century already underlined the necessity for central bankers to include the price of the financial assets and real estate to get a more comprehensive view on actual inflation. Recent speculative bubbles on stocks or real estate in several industrialized countries confirm this necessity. In the United States, the excesses that lead to the 2007 crisis seem to appear again. Many stock prices are disconnected from the companies' balance sheets and first-time buyers can once again take out a loan worth 97% of the price of the property they purchase. Coming back to a more orthodox monetary policy implies obvious dangers but the first benefit would be to give back a "real" value to money;

- **credit conditions will remain durably flexible.** Even if a coordination of monetary policies between the main central banks is just an illusion, such cooperation exists to a certain extent. It can be witnessed in the SNB's decision to give up its three-year-old cap on the value of the Swiss franc last January, just a few days before the official announcement of the ECB's QE. In the event of the FED raising its rates in September, the global monetary printing will go on. The monetary tightening in America will be very gradual. In addition, the ECB shouldn't hike its rates before the end of 2016, at least, and the Bank of Japan is involved in a similar process which is not intended to end soon;

- **the FED's credibility depends on it.** A rate hike in September has been in the consensus for months and it led to a repositioning of the portfolios in favour of dollar denominated assets since last Spring. Any backward step from the FED could weaken its credibility, its forward guidance strategy, toughly introduced in 2008, and support the idea that market upheavals drive its decisions. Since the Swiss franc case occurred early 2015 central bankers' credibility has been notably affected. A postponed rate hike might blur the American central bank's message. In the case the FED should decide a status quo this month, perhaps because of China's situation, it is hard to see how the rate hike could wait until the end of the year. The FED would quickly be short of valid arguments to justify this change in its strategy.