

The End of the 2007-08 Crisis?

If the general consensus is right, by the time this article is published, the US Federal Reserve would have increased its short term interest rate from a band of 0 to 0.25%, to 0.25 to 0.5%. This of course assumes that the Federal Reserve Board ignores US Congressman Brad Sherman's belief that God does not want a rate rise now, but in spring 2016. (No, he was not joking.) One reason for doubting Sherman's belief is that the Almighty created the world in six days while the Federal Reserve has been pondering over the issue for the last two years. More seriously, this would be the first rate rise since 2006 and, assuming it takes place, would signal the official end of the 2007-08 crisis in the mortgage market in the US.

Weighty economists from the International Monetary Fund, World Bank, and the Bank for International Settlements have been cautioning for the last few months about the impact the rate rise could have on emerging economies, through both capital flight and a fall of the currencies leading to defaults by corporates having unhedged dollar loans. Our own central bank announced last week that it is fully prepared for any volatility that may arise in financial markets as a result of the rate rise. To be sure, at the time of writing, a rate rise is yet to take place and many weighty commentators are expressing caution -- in central bank-speak. Lawrence Summers, the former US Treasury Secretary, recently wrote in an article that he is *"far from confident that there is substantial scope for tightening in the US"* (Financial Times, December 7, 2015). It is also difficult to say whether the rate rise would be the first of many (as happened in 1994 for example) or could even be reversed sooner rather than later -- if inflation does not rise to 2%. As James Bullard, President of the St Louis Federal Reserve, said the previous Monday, *"We are concerned about all the variables ...The main one is particularly the inflation variable. We have to see if that actually starts to materialise."* One reason for the pessimism about a rise in the inflation rate is commodity prices which are continuing to soften.

This apart, the quotation also suggests how the fashions and tools of conducting monetary policy have changed over the last few decades. Initially the belief was that

money supply determined inflation; from this starting point, policy makers moved to short term interest rates and “forward guidance” as the principal tools to influence inflation expectations and these, in turn, were supposed to influence inflation itself to change in the desired direction. Simultaneously, it has become customary to emphasise that future actions will be data-dependent. In fact, empirical evidence suggests that stock and bond price volatilities have doubled since forward guidance became fashionable. To give one example of the latter, in 2012 the Federal Reserve forecast a growth rate of 3.4% for the current year; it has since been gradually reduced to 2.1% (data from a column by A. Gray Shilling on Bloomberg).

One big imponderable is the impact the rate rise, assuming it takes place, would have on the shape of the yield curve. In principle, if market participants believe that the rise is the first of many, the yield curve would steepen; on the other hand, if the belief is that rates may remain reasonably stable, the impact on the shape of the yield curve would be limited. And, the flatness/steepness of the yield curve is crucial to bond prices – and, hence to the net asset values of bond funds. A few high yield bond funds are already in trouble in the US market. Other funds are facing redemption demands from sovereign wealth funds of oil exporters, hit by the sharp fall in oil prices. Arguably, the probability of a run on bond funds is higher than a crisis in emerging economies in general – i.e. other than those like Russia, Brazil, South Africa, who are commodity exporters.

Recently, mutual funds successfully lobbied to avoid being labelled as systemically important financial intermediaries, which would have led to tighter regulatory prescriptions. They may well be forced to seek help from monetary authorities if a run develops and liquidity in the bond market evaporates. But this would be in keeping with the general stance of too many financial intermediaries: “don’t interfere when we are making money, but please rescue us in the event of any problems.”

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