Fake Rates or Real Rates: How will the Fed's base rate rise?

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The Fed's base rate has been touted to rise for a while now. But, with the latest policy decision expected in the next 24 hours, the question is not only "will it go up?" but "how?" Today I'll look at what the Fed's choices are and tomorrow I'll analyse their decision.

The Federal Reserve's Open Market Committee (FOMC) will today conclude its latest meeting. The Fed uses these meetings to decide its policy going forward on interest rates, money supply and other attempts at controlling the US economy.

In December 2008, in an attempt to help the economy recover from the global financial crisis, the Fed lowered its base interest rate – the rate at which the Fed lends to banks – from 1% to 0.25%.[1] It has remained there ever since, with the objective of making borrowing for businesses and individuals cheaper and thus stimulating consumption.

Since the beginning of the year, commentators have suggested a raise will come[2] – something which is a stepping stone to avoid the vicious circle of Japanese-style debt deflation, where the economy shrinks and becomes reliant on central bank support (for further information on this, see my colleague at IDEA Economics, Prof Steve Keen's 2015 Outlook[3]).

Then after June's FOMC meeting, Fed Chair Janet Yellen said that the Fed rate would be increased sometime this year.[4] This led 82% of the sixty economists regularly surveyed by the *Wall Street Journal* to believe that the hike will be announced after today's meeting.

My own view has changed slightly over the last few months. Minutes from FOMC meetings[5] initially led me to believe that the committee may raise some interest rates – but none of the rates which matter, in terms of increasing private borrowing/bank funding costs this year.

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[1] Federal Reserve

[2] http://www.ft.com/intl/cms/s/0/e49444e4-3203-11e5-8873-775ba7c2ea3d.html#axzz3llkvZWoP

[3] http://www.ideaeconomics.org/

[4] http://money.cnn.com/2015/06/17/news/economy/federal-reserve-interest-rate-janet-yellen/

[5] http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

In March, the Fed started hinting that an increase was in the offing.[6] This led some commentators to suggest it would come in June; though by May Janet Yellen had ruled that out but hinted it would be sometime this year.[7]

At that time it was clear to me that the Fed had talked itself into such a corner over raising rates that, if it didn't want to lose credibility with the markets, it would have to do something even if it didn't want a rate increase. Thus, it looked like the central bank would fake it. They could do that by pushing up a dummy rate like the IOER rate; or through a base-rate increase undermined by other means, such as continued expansion of the Fed's balance sheet and/or flattening the yield curve on treasury bonds. The latter tactic is where the Fed offers lower rates on long-term t-bonds, thus reducing the gap between the yields on short-term and long-term, making any change to the base rate less effective.

> ***IOER rate***
> The *Interest on Excessive Reserves rate* is paid to banks on the money they deposit in the Federal Reserve.
>
> Increasing this rate could give the impression of raising rates, while not actually touching the Fed base rate.

Then in late June, the beginning of the Chinese stock market meltdown[8] gave Mrs Yellen et al. the perfect excuse not to raise rates at all – fake or otherwise.

Now we've reached the September FOMC meetings, there has been so much talk about fake rises that the Fed's decision will be heavily scrutinised. Consequently it may balk from making such a move. In fact it's become apparent to me that the Fed will do one of three things: do nothing but talk tough; do something but talk it down; or increase the Fed fund by 0.25% and declare that they rate won't change again for a while.

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[6] http://www.businessinsider.com/federal-reserve-window-to-raise-rates-2015-4

[7] http://www.wsj.com/articles/yellen-says-fed-on-track-to-raise-rates-this-year-1432314091

[8] http://www.mbmg-investment.com/in-the-media/inthemedia/59

3. An investment is not a deposit, it carries investment risk. Investors are encouraged to make an investment only when investing in such an asset corresponds with their own objectives and only after they have acknowledge all risks and have been informed that the return may be more or less than the initial sum.