Will the Fed Raise Interest Rates in September?

The Fed appears to be waiting for stronger evidence of economic growth before announcing a timetable for the upcoming interest rate hikes. At the conclusion of its recent two-day meeting on July 29, the Federal Open Market Committee (FOMC) voted to keep the federal funds target rate unchanged.

The Fed upgraded its assessment of current U.S. economic activity, noting that the labor market continued to improve and underutilization of labor resources has diminished, while growth in household spending has been moderate and activity in the housing market showed additional improvement.

Since the meeting, economic data has shown advancement. Household spending has increased and, now that households have solidified their personal finances, consumer spending should continue to expand. The housing market has shown more growth driven by gains in household formation, and light vehicle sales remain robust.

The soft sectors of the U.S. economy are business spending on equipment related to the downshift in energy prices and exports, which are being impacted by the strong dollar and with weaker-than-expected growth in key global economies such as Brazil and China.

In spite of a split-level economy and global financial turbulence, the case is building for beginning the normalization of interest rates. Expect a quarter-point increase at the meetings scheduled Sept. 16-17 and Dec. 15-16. If these two raises happen, the federal funds rate will increase to 0.5 percent from zero, where it has been since December 2008. The Fed last raised interest rates in 2006.

The emergency zero interest rate is no longer required six years after the Great Recession ended. The most-effective immediate policies to generate faster economic growth are tax reform and infrastructure spending, not a continuation of emergencylevel interest rates.

Keeping zero interest rates too long typically results in excessive risk-taking behavior as investors look for higher-yielding investments in an exceptionally low-rate environment. Evidence of this can be seen in the large run-ups in high-yield debt issuance, greater subprime lending activity, particularly in the auto market, and corporate borrowing for buying back stock, dividend increases and for mergers. The longer the Fed waits to increase interest rates from the zero emergency level, the greater the risk that credit sectors become overheated.

A 0.5 percent federal funds rate will still be highly accommodative. It does not mean the end of easy credit by the central bank. Further, the Fed continues to maintain its existing policy of reinvesting principal payments from its holdings of Treasury and mortgage-backed securities, keeping the size of its balance sheet at about $4.5 trillion. The Fed's balance sheet was about $1 trillion in 2008. The increase in the Fed's balance sheet is due to its quantitative easing policy.

The criteria to begin raising the target rate for the federal funds rate are further improvement in the labor market and reasonable confidence that inflation will move back to its 2 percent objective over the medium term.

Further improvement in the labor market can be seen in the following ways:

• The three-month average change in total non-farm jobs exceeds 225,000, and that job growth is accelerating. The July figure is 235,000, up from 226,000 in June.

• The labor force participation rate stabilizes and begins to increase, which shows that discouraged workers are entering the labor market. The July rate is 62.6 percent, the same as in June.

• Average weekly earnings continue to expand; it was $864.65 in July, an increase of 0.5 percent from June.

Reasonable confidence that inflation will move back to its 2 percent objective is measured by increases in the Consumer Price Index for all items, less food and energy, rising by at least 1.7 percent over the past 12 months. It rose by 1.8 percent in June over the past 12 months. Stability in the dollar and energy prices will also help inflation move toward the 2 percent objective.

The July jobs report showed further improvement in the labor market. An improving economy and labor market in August will keep expectations high that at least one rate hike will occur later this year, most likely in September.

Jonathan Silberman is a professor of economics at Oakland University. He writes a monthly column on the economy for the JN. You can contact him at silberma@oakland.edu.