The Good News About No Rate Hike

Keeping the economic training wheels on a little while longer may not be such a bad thing.

By Andrew Soergel – September 17, 2015

Investors, analysts and economy buffs around the world held their breaths Thursday afternoon in anticipation of what could have been America's first interest rate hike since 2006.

But then the Federal Reserve elected to punt. Sluggish inflation, international economic concern and stock market volatility were all cited by the Fed as contributing factors to holding off on a liftoff.

"In light of the developments that we have seen and the impacts on financial markets, we want to take a little bit more time to evaluate the likely impacts on the United States," Fed Chair Janet Yellen said Thursday during a news conference. "I can't give you a recipe for exactly what we're looking to see. But as we say, we want to see continued improvement in the labor market and we would like to bolster our confidence that inflation will move back to 2 percent."

Analysts considered the odds of a rate increase taking place this month as a virtual coin toss heading into Thursday. But Lindsey Piegza, chief economist at Stifel Fixed Income, suggested the high degree of uncertainty may have been a deterrent in and of itself.

"If the decision is so controversial or too close to call, the U.S. economy is clearly not sending strong enough signals," she wrote in a research note Thursday. "To justify the first interest rate increase since 2006, it should be pretty darn clear to Fed officials and market participants alike that the U.S. economy can withstand a rising rate environment."

Yellen said in her news conference that inflation still sits "way below" the Fed's long-term 2 percent objective, also noting that a strong dollar, international economic turmoil and weak energy prices are putting "further downward pressure on inflation in the near term."

Despite the country's sluggish inflation, many expected America's strong labor market – which has managed to generate 1.7 million new jobs so far this year – to ultimately tip the scales in favor of a liftoff, allowing U.S. monetary policy to begin its long road toward normalization.

But not so, said the Fed. And by taking a pass, America's central bank only has two more opportunities to make a move if it wants to begin normalizing monetary policy at some point this year. The only other scheduled meetings of the Federal Open Market Committee in 2015 – at which such a decision would be made – are in October and December. Until then, analysts will have to continue playing the waiting game.

So now what?

"Employers and job seekers can celebrate, because the Fed's decision to hold off on a rate hike gives the U.S. economy a bit more time to hit a stronger stride," Tara Sinclair, chief economist with employment site Indeed, tells U.S. News in an email. "By keeping us at [near-zero rates] a little longer, they are giving businesses more time to spend and incentivize workers to get off the sidelines."

Borrowing money would have become more expensive if the Fed had lifted rates, and some analysts feared such a shift would discourage U.S. firms from investing in new facilities and equipment, conducting merger and acquisition operations and hiring new workers.

Not boosting rates, however, could lead to splurges in capital expenditures and a hiring uptick between now and the Fed's October meeting, opening opportunities to the unemployed or those working hours or jobs they aren't happy with.

Indeed, Yellen on Thursday said she believes there is room for "further improvement in the labor market" before the country reaches interest rate liftoff.

"A higher interest rate normally puts constraints on borrowing. But the first interest rate rise could be seen as a signal of even higher rates in the future. Hence, consumers and businesses may borrow sooner than later, boosting borrowing in the short term," Jai Liu, a research fellow at the American Institute for Economic Research, said in a statement Thursday.

Aspiring homeowners will also likely rejoice, considering mortgages will take off along with interest rates. Americans now have at least another month of near-zero rates to help make homeownership more affordable.

"The federal funds rate, and in turn mortgage rates, remain low and will likely end the year roughly where they started it," Svenja Gudell, chief economist with real estate marketplace Zillow, said in a statement Thursday. "For most markets and buyers around the country, the effects of any eventual interest rate hikes should be pretty small in the near term, but in some unaffordable markets where buyers are already stretching their finances, higher interest payments could more dramatically limit buyers' options."

Overall, a closer inspection of an economic outlook report released Thursday along with the Fed's decision shows members of the FOMC expect the U.S. economy to notably improve in the months ahead through better-than-expected economic growth and declining unemployment.

"The projection on [gross domestic product] in 2015 was revised up, and the projection on unemployment rate went down, indicating the Fed improved its outlook for economic conditions," Liu said.

But while most FOMC members still expect to hike rates at some point this year, according to the committee's so-called "dot-plot" included in the report, the number of participants who support such a policy shift (13) has fallen since June (15). And gross domestic product outlooks for next year and 2017 were both revised down, casting doubt on U.S. growth prospects in the longer term.

"The September statement not only suggests growing fears surrounding the underlying momentum of the U.S. economy, but suggests an increased and growing concern over the international economy," Piegza said.

It's unusual for America's central bank to put so much emphasis on foreign affairs, but the Fed made it clear that fluctuations abroad at least partially contributed to its decision to hold off on a rate hike. International markets are grappling with a Chinese economic slowdown, a good but not great performance in the eurozone and recessions in major emerging markets like Brazil and Russia – all of which cast doubt on whether the U.S. can sustain its growth path without external support.

"I don't see the reason for [a rate hike], frankly," Ray Dalio, chairman of Bridgewater Associates, said Wednesday in an interview with Bloomberg. "We're in a world economy. Tell me a country outside that should be tightening monetary policy. They all should be easing monetary policy."

But some analysts argue that the Fed should be focused more on the U.S. economy than on international developments. Though China's yuan devaluation and stock volatility have contributed to significant losses in commodity values and international trade uncertainty, pro-rate hikers argue that the Chinese economy is largely irrelevant to America's monetary policy.

"By keeping the fed funds rate at the emergency level of near zero, the Yellen Fed is acknowledging that the U.S. is now so closely integrated into the global economy that it can no longer focus on just domestic conditions," **Bernard Baumohl, chief global economist at The Economic Outlook Group,** tells U.S. News in an email. "From our perspective, the probability of a rate increase in December has risen to 65 percent.

"For if not then, does the Fed really want to begin a round of tightening in the middle of a politically charged presidential election year?"

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