FINANCIAL TIMES

The time for tightening by the US Federal Reserve could be nigh

By Philipp Hildebrand

Any changes in wage growth will force the central bank to act, writes Philipp Hildebrand

The brutal American winter has brought disappointing economic data along with the wind and snow, from weaker than expected fourth-quarter growth to disappointing employment numbers. It is clear that some of the slowdown is weather-related but it is difficult to say just how much. If the lag in growth persists, it could indicate more underlying softness in the US economic recovery.

In that scenario, the stuttering recovery could put pressure on monetary policy makers to do even more to try to stimulate growth – either through a pause in the tapering of asset purchases at Wednesday's Federal Open Market Committee meeting or through signals that the FOMC intends to keep interest rates low for even longer than currently expected.

But there are increasing signs that pressure on the Federal Reserve could come in the opposite direction; that, in fact, the US economy is closer to its potential level than previously thought. If so, the time to begin tightening monetary policy might come sooner than currently projected.

The debate on US monetary policy centres on the crucial question of how much slack remains in the US economy, and how much monetary policy can and should do to lure back some of the 13m Americans who have left the labour force since 2007.

Although the Fed set a threshold of a 6.5 per cent unemployment rate as the point at which it would consider raising rates, nobody now expects an immediate rate rise once that threshold is reached. This is in part because much of the fall in the participation rate has been thought to be cyclical, the result of a weak economy, and therefore something to be addressed by countercyclical monetary policy.

However, an increasingly vocal group of observers, including within the Fed, posits that more of the fall in the participation rate appears to have been structural than cyclical, and it was even predictable – the result of factors such as an ageing workforce and the effect of technology on jobs.

If that view is correct, the Fed's responsibility to boost employment is much reduced. And the time for a gradual normalisation of US policy – a crucial moment for the global economy and for asset prices across markets – will come sooner than market participants have been assuming.

How will we know which view is right? Important clues will come from a wider range of labour market measures – hours worked and re-engagement rates of the short and longer-term unemployed – as well as headline employment numbers.

But, above all else, this debate sharpens the focus on the variable that has traditionally been the biggest of all warning signals for central bankers: wage growth.

If the labour market is indeed beginning to tighten, then wage growth will surely respond. And traditional playbooks for central bankers tell us that some withdrawal of monetary policy accommodation should begin long before wage growth is back to rates usually consistent with inflation at target levels.

Some signs are there already. During the 10 years before the financial crisis, rising productivity helped propel US hourly earnings up almost 3.5 per cent a year, on average. By late 2012, earnings growth had fallen to 1.3 per cent, the lowest rate for at least half a century.

Earnings growth has now recovered significantly from that point – rising to 2.5 per cent, according to data released this month. For some perspective: following the last recession, wage growth returned to that level by the end of 2004 – by which point the Fed funds rate had already been increased four times (and recall that many now criticise the Fed for raising rates too slowly then, not too quickly).

Of course, every tightening cycle is different. By the second half of 2004, the annualised rate of US nominal gross domestic product growth – the sum of real growth and inflation – was above 6 per cent. At the moment nominal growth is barely above 4 per cent, and the US central bank is wary of tightening too early and stifling the nascent recovery.

But if Fed policy makers wish to manage the recovery in an orthodox way, steering GDP back to potential without overshooting and bringing inflation back to 2 per cent without climbing higher, then tightening might at least need to begin before the second half of 2015, the timing currently reflected in market prices.

There is another, less familiar, way to manage policy and the recovery – so-called “optimal control”. In speeches in 2012 as just an FOMC member, Janet Yellen, now the Fed chairwoman, set out such an approach to policy in which the recovery was stimulated by a clear commitment to keep policy looser for longer than more standard policy rules would suggest. As one aspect of such a policy, inflation might be expected to rise a little above 2 per cent for a period, as the economy approaches full employment.

We do not yet know whether Ms Yellen still judges such a policy to be desirable; or, if she does, whether she will be able to convince fellow policy makers of its merits.

Regardless, markets will begin to reassess – and test – which central bank will be first to pull the trigger on a policy change. The thinking had been that the return of growth and budding inflation in the UK made Mark Carney, Bank of England governor, a potential first mover.

Ms Yellen before Mr Carney?

The writer is vice-chairman of BlackRock and former chairman of the governing board of the Swiss National Bank