Federal Reserve and uncertainties of economic cycle

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On 27 July, for the fifth time in a row, the Federal Reserve of the United States decided to leave interest rates unchanged. This stance goes against the strategy announced at the end of 2015, when the same institution raised rates for the first time in seven years and considered implementing four more hikes of 25 basis points in 2016. This discrepancy between the authority's expectations and what has happened this year mainly reflects its doubts about the recovery of the U.S. economy both short and long term.

In the first instance, even though household spending has remained relatively stable, several factors have cast doubt on the economy's ability to absorb higher interest rates. One of these is the highly volatile financial markets, weak non-residential investment and labor market, the UK's decision to leave the European Union, a stronger dollar and expectations of slower inflation. In light of these factors, most of the FOMC members have preferred to take a more cautious approach and they have pushed back their hike expectations toward the end of the year or even 2017.

In second place, the persistently low productivity growth and uncertainty about the remaining spare capacity, have led to cuts in the forecast for the country's potential growth and the equilibrium of real interest rates, consistent with full employment. This, in turn, has led long-term interest rate expectations to be revised downwards. In other words, the central bank believes monetary policy can normalize at lower interest rates than it did before.

Therefore, the Federal Reserve only expects two hikes by the end of the year and an interest rate that is nearly 50 basis points lower over the longer term. Nevertheless, the FOMC members will continue to review these expectations as economic indicators are released over the next few months. In the event the information shows strengthening economic conditions, mainly in the labor market and inflation, and they confirm that the economy doesn't face any contagion risk due to global weakness, the central bank may stick to its normalization strategy. However, if the economic indicators continue to be volatile or financial uncertainty is perceived as a risk that could derail the recovery, the Fed will choose to keep holding rates and take a more cautious approach. For now, the market's expectations are more in line with the latter scenario.

In line with the previous point, the Federal Reserve must also assess the impact of the political cycle and the possible election outcomes for the next four years. On one hand, the agreements that support economic expansion and the normalization of the labor market, would help ease concerns about the economy's performance and would be consistent with a strategy of monetary policy normalization the Fed is currently following. However, an adverse environment of political deadlock would raise uncertainties, and delay the following hike or even lead to further stimulus measures to prevent further damage to the economy.

However, monetary policy can't do much to offset slower growth in the labor market, slowing productivity, economic weakness in other countries or the United States' role in globalization. In this regard, it is imperative that the political actors reach agreements that make it possible to implement structural reforms capable of revitalizing the economic cycle. In light of what has happened in the last few years, this outcome doesn't look very feasible. However, we cannot rule out the possibility of the electorate sending a strong message next November and that the private sector is willing to lose some of its privileges and absorb part of the cost in exchange for greater benefits over the long term.