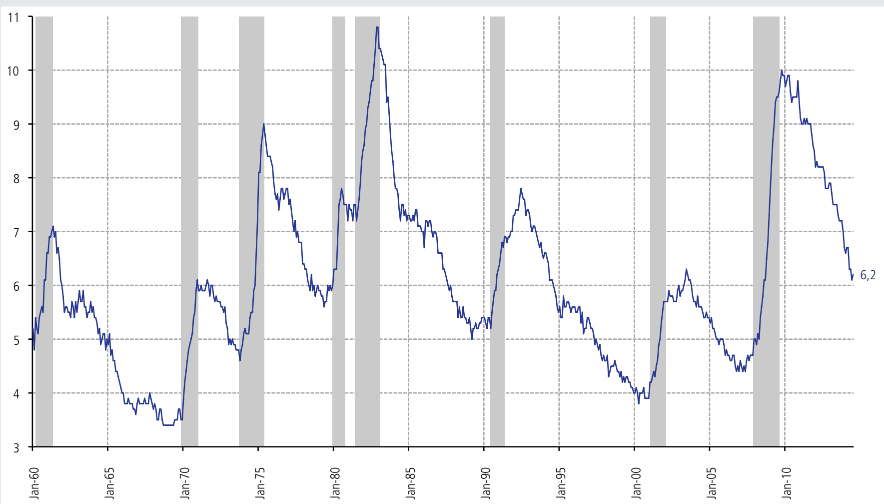
September | 2014

Monthly Economic Outlook

US economic recovery points to first fed funds rate hike in 2015

After six years of exceptional accommodation by the Federal Reserve, with the fed funds rate close to zero and the completion of three rounds of unconventional stimulus measures in the form of quantitative easing (QE1, QE2 and QE3), US economic indicators continue to point to the normalization of monetary policy with a gradual rise in the fed funds rate starting in mid-2015. This accommodation enabled GDP to grow 2.2% per year on average between 2010 and 2014, after contracting 2.8% in 2009. At the same time the labor market has added more than 9.3 million jobs since 2010, offsetting the destruction of 8.7 million jobs by the crisis that culminated in the collapse of Lehman Brothers. As a result, the unemployment rate has fallen to 6.2%, from 10% at end-2009.

USA: Unemployment Rate



Note: Shaded areas indicate periods of US economic recession. Source: BLS e NBER.

The unemployment rate is clearly continuing to trend down as the economic recovery proceeds. GDP fell 2.1% in annualized terms in the first quarter of 2014, but this was a temporary upset due to short-term factors and growth resumed vigorously in the second quarter, rebounding to 4.2% on an annualized basis. Leading indicators point to annualized growth of more than 3% in the third quarter. This robust expansion of GDP is also reflected in retail sales, up 3.7% in recent months, and industrial production, up 4.3% in the last 12 months. Thanks to the economic recovery and concomitant job creation, in the months ahead the unemployment rate is set to reach 5%-6%, which the Fed defines as the long-run equilibrium level of unemployment.

Most members of the Federal Open Market Committee (FOMC) believe the unemployment rate will soon begin to approach long-term equilibrium as the fed funds rate also approaches its long-run equilibrium level, which is in the range of 3.75%. Otherwise, given the typical monetary policy transmission lag, too long a delay before rates rise from the current near-zero level could lead to increasing inflationary pressure, as well as the risks associated with the formation of asset bubbles due to the excessively prolonged maintenance of negative real rates.

On the other hand, while economic indicators are pointing to the start of interest-rate normalization in 2015, we continue to anticipate that this monetary tightening cycle will be implemented with caution. The economy displays significant vulnerabilities: in the labor market, affected by an unusually long period of high unemployment; in the housing market, the initial focus of the ongoing global crisis; in the need to shrink the Fed's balance sheet, which has expanded fivefold in recent years; and in public finance, given the need for more fiscal tightening to balance the budget. In this context, tightening too fast could be counter-productive, adversely affecting a number of sensitive variables and undermining the economic recovery. Another reason for the Fed to be cautious about raising rates is the fragility of the other developed economies, especially Europe, which is flirting with the risk of stagnation and deflation. In line with what appears to be the majority opinion on the FOMC, we project rate hikes of 100 basis points per year starting in mid-2015. This would be the most cautious pace of tightening in the history of US monetary policy.

Interest Rates in the Central Countries
Evolution since 1985

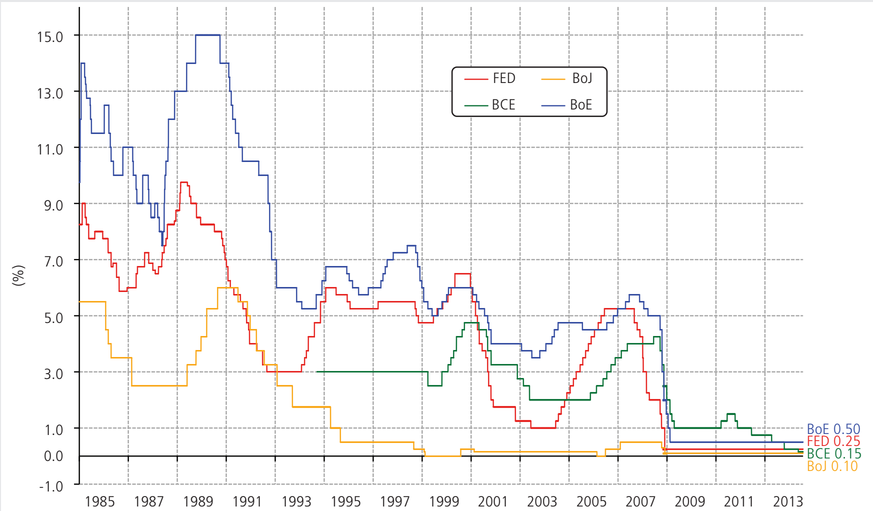


Chart: VAM