Interest-rate Increase Could Trigger Global Recession

With every eye focused on the Board of Governors' meeting of the Federal Reserve System on Thursday, expecting the earth-shaking announcement that it will, or won't, raise interest rates for the first time since January of 2008, few are considering the global implications if it does.

Expectations in the very short run are modest. The debate centers on whether rates should be increased by a tenth of a percent, or a quarter of a percent. In the real world it isn't likely to matter: New car loans will be adjusted upward by a couple of dollars a month and new home loans will increase by perhaps as much as $50 a month, probably less. This is likely to galvanize some fence-sitters into action, drawing future purchases into the present.

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The real impact in the long run, however, is several-fold: The first increase in nearly eight years is a de facto announcement that further increases are to be expected, with the Federal Funds Rate (the only key rate the Fed can control directly) likely to rise to five percent over the next few years. In a zero-percent world, that is a very big deal.

Germany's Deutsche Bank has analyzed all 12 interest rate tightening cycles since 1950 and discovered that, from six to 18 months out, economic growth starts to slow.

The problem is that the U.S. economy is barely recovering from the Great Recession. Employment participation in the economy is at the lowest level in decades, making the unemployment rate of 5.1 percent suspect. New jobs at the rate of 200,000 a month are barely at replacement levels. And with the latest from the Empire State manufacturing index for September coming in at a negative 14.7 when every economist polled expected it at least to be flat, is a harbinger. Orders in the New York region remained deep in negative territory along with shipments, while the future outlook worsened.

The federal government estimates are that the costs of paying interest on its massive debt will likely triple over the next few years, approaching $1 trillion a year. That's nearly a quarter of the government's total revenues.

Interest rate increases will also impact state and local finances, to say nothing of private companies and corporations that have gorged themselves on essentially free money since 2008.

But the real impact of a rising interest rate environment will be felt overseas by emerging market economies that have also stuffed their balance sheets with loans mostly denominated in dollars. The Swiss-based Bank for International Settlements (BIS) has calculated that total debt ratios (debt compared to economic output) are now significantly higher today than they were at the peak of the last credit cycle in 2007, just before the start of the Great Recession. In its own unique esoteric language, the bank expressed its concern: "We are not seeing [just] isolated tremors [in the money markets] but the release of pressure that has gradually accumulated over the years along major fault lines."

This is how a central bank announces that the global economy is in serious trouble.

Examples: the combined public and private debt among developed countries (e.g., Japan, France, Germany, Canada, the UK, and the United States) has jumped by more than a third in less than seven years, while in emerging markets (i.e., Brazil, Russia, India, China, South Korea, Mexico, Indonesia, Turkey, and Saudi Arabia) it has jumped by half. As noted by the BIS, this is a pace of growth of indebtedness that has almost always preceded major financial crises in the past.

Ambrose Evans-Pritchard, the international business editor of London's *Daily Telegraph*, concluded:

> The BIS' "house view" is that the global authorities may have put off the day or reckoning by holding interest rates below their "natural" [read: free market] rates with each successive cycle, but this merely stores up greater imbalances, drawing down prosperity from the future and stretching the elastic further until it snaps back.
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> At some point, you have to take your bitter medicine.

Underlying all of this, however, is the basic mistaken assumption that economies across the globe can be steered, much like a passenger liner or a cruise ship, with modest adjustments made with the help of computers and algorithms run by economists with PhDs from Harvard or Stanford. Confidence that these machinations and manipulations can be depended upon is dreadfully misplaced, according to David Stockman, Ronald Reagan's director of the Office of Management and Budget. When speaking of one of those precious indicators, the Taylor Rule, developed by Stanford University economist professor John Taylor, Stockman wrote:

> Needless to say, this [is] about as anti-free market as you can get. Rather than allowing millions of savers and borrowers to clear the money market at the efficient price, it consigned the task not even to the discretion of the 12 member FOMC [the Fed's Open Market Committee], but to the arrogant, formulaic scribblings of an insufferably conceited academic who, like Janet Yellen, thinks the US economy is a giant bathtub to be plumbed and filled by manipulating the interest rate dials in the Eccles Building.

Instead, the Federal Reserve System, enabled by the BIS and central banks around the globe, has created a tinder box just waiting for a spark to set the conflagration. Thursday's decision, if it starts the next credit-tightening cycle, just might be that spark.

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