Fed risks roiling global markets

Populist successes point to domestic turmoil

by Desmond Lachman in Washington

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Normalising interest rates after several years of ultra-easy monetary policy was never going to be easy for the US Federal Reserve. The grim global political environment raises the difficulty level even further.

Interest rates around the world have dropped to levels that presuppose that risky borrowers will not face any major political or economic setbacks in the near future. This leaves the Fed with the narrowest of paths to tread. It needs to raise interest rates to curtail inflation. However, it needs to do so without causing disruptive credit repricing that could disturb financial markets.

Developments in Italy, the euro area's third largest economy and the world's third largest sovereign bond market, with more than $2.5tn in outstanding debt, illustrate the trial facing the world's major central banks. Ample global liquidity and bond buying by the European Central Bank has allowed the Italian government to borrow at 2% despite the country's high public debt, unstable banking system and sclerotic economy. Strikingly, this is below the corresponding 3% rate at which the US government borrows.

A storm appears to be gathering in Italy just when the Fed might be forced to raise interest rates at a faster pace than intended and as the ECB is planning the conclusion of its bond buying programme. More than half of voters in the March general election supported populist anti-euro parties. This makes it all too likely that the next Italian government will be headed by either the eurosceptic Five Star Movement or the League. Neither of these parties are known for their support of budget discipline or economic reform.

Italy seems to be only the first of several systemically important countries that might face political setbacks in 2018. The left-leaning populist Andrés Manuel López Obrador is heavily favoured to win the Mexican presidential election in July. This could complicate negotiations with the US over the North American Free Trade Agreement and unsettle Mexico's investment climate.

Brazil, Latin America's largest economy, is similarly likely to suffer economic fallout following its general election in October. The country's public finances are unsustainable, as evidenced by a budget deficit of close to 9% of GDP, and the Petrobras scandal has irreparably discredited the establishment political parties. Brazil will probably find itself saddled with a populist president who will be ill-equipped and unwilling to address its serious public finance issues.

All of this leaves Fed Chair Jay Powell with an unenviable task. He must find a way to raise interest rates to prevent President Donald Trump's expansive budget policy from causing the US economy to overheat. Yet he must do so without unsettling major troubled countries abroad, which could roil overstretched global financial markets. It is a daunting challenge for the most experienced of policy-makers, let alone the nascent chair of the world's most important central bank.

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