US Interest Rates

Dallas Fed chief 'actively considering' December rate rise

Kaplan says tight US job market weighing on decision despite stubbornly low inflation

Robert Kaplan © Bloomberg

5 HOURS AGO Sam Fleming in Dallas **2 comments**

One of the Federal Reserve's leading doves has said he is "actively considering" backing another increase in short-term interest rates at the central bank's meeting next month, pointing to the risks that an overheating job market will create "imbalances and excesses" in financial markets.

Robert Kaplan, president of the Federal Reserve Bank of Dallas, said that despite stubbornly low inflation in the US, he was increasingly concerned that historically low unemployment rates — which this month hit a 17-year record — required heightened vigilance.

Mr Kaplan, who stressed he remained undecided on rates ahead of the December 12-13 Fed meeting, said central banks needed to move quickly when there were signs companies were facing shortages of workers, which could distort investment decisions and lead to market excesses.

"History has shown that normally when we have a substantial overshoot the Fed ultimately needs to take actions to play catch-up," said Mr Kaplan in an interview. "And there is not a long history of soft landings in those events."

Mr Kaplan has long been one of the most cautious Fed policymakers on moving away from historically low interest rates, arguing that inflation is being held down by long-term factors including globalisation and technological change.

The Fed's rate-setting Federal Open Market Committee, where Mr Kaplan is one of the voters this year, has repeatedly signalled it is prepared to raise rates again in December and three times in 2018, but financial markets have not been convinced, pricing in no more than one increase next year.

Investors remain sceptical about the FOMC's inflation projections, thinking it will take longer than the Fed anticipates for the US economy to return to 2 per cent inflation.

But Mr Kaplan said that despite the subdued inflation outlook, there was a mounting case for moving ahead of any signs of price increases, saying that would enable the central bank to move away from crisis-era emergency measures more gradually.

"The reason for moving sooner rather than later [is] it might increase the likelihood that we are able to move patiently, gradually, and I want to avoid a situation where we get behind the curve and have to move much more rapidly," he said.

The mix of strengthening employment, rocketing financial markets and stagnant inflation has bedevilled central bankers in Washington, London and Frankfurt with all three struggling over how quickly to move away from easy money policies adopted at the height of the financial crisis.

The lack of wage growth in the US, UK and eurozone has been particularly confounding to economists, since a tightening job market would normally be accompanied by a raise in salaries as workers become more scarce.

Mr Kaplan stressed that he was closely watching core inflation amid a persistent failure to hit the Fed's 2 per cent target. But he said he needed to weigh this undershoot to the Fed's inflation goal against overshoots to the central bank's other mandate: maximum sustainable employment.

"If we are not meeting our inflation mandate or I don't see a prospect of it, I am still going to be assessing the size of the overshoot in our full employment objective," he said. "And that could be a justification for me to [vote to] continue to remove accommodation in the months ahead."

Asked if he was willing to consider a rate rise at the Fed's upcoming meeting, Mr Kaplan said: "Yes, I am actively considering appropriate next steps. As I should be."

Mr Kaplan said that strength in the jobs market was not only evident from the 4.1 per cent unemployment rate, but from a broader gauge of labour market slack that included people who were discouraged or working part-time because they could not find a full-time job.

This latter "U-6" rate is now matching its pre-recession lows at 7.9 per cent. If the jobs market overheats it could create broader imbalances both in investment decisions and in the financial markets, he argued. Mr Kaplan stressed he favoured regulatory tools to curb market excesses, but he also cited a range of indicators that merited "high" scrutiny.

Among the areas he is watching: commercial real estate prices, an equity market valuation which is now as large as a share of the economy as it was in 1999 or 2000, high levels of margin debt, and ultra-low volatility. Discussing the last of these, Mr Kaplan said that if the US goes 15 months without a market correction of 3 per cent that would be "highly unusual in historical terms".

It was important to monitor possible financial imbalances because when these get unwound it could create a "very rapid tightening in financial conditions" that could hit growth. "I believe these imbalances are likely manageable, but I am aware that as we overshoot or potentially increase the size of the overshoot of full employment it is wise to monitor imbalances," he said.

Mr Kaplan said the US was still in a period where there were "significant headwinds" to growth — including slow workforce growth and high government debt. One implication is that rates may not need to rise a long way, said Mr Kaplan, who pencilled in a terminal federal funds rate of 2.5 per cent in the Fed's latest forecasting round.

He listed a number of policies that could help galvanise stronger sustainable growth. These included reviews of regulatory burdens, infrastructure spending, education reforms and workforce development. The country also needed to boost its workforce, which meant the US should be loath to lose its "distinctive competence" of attracting and retaining immigrants.

Corporate tax reform, which the Republicans are trying to push through Congress, could be a positive for growth if it encouraged companies to locate and invest in the US, Mr Kaplan said. However, the Republican overhaul will add up to $1.5tn to the deficit over 10 years. Mr Kaplan said that he would be careful about a tax cut financed by an increase in the deficit at a time when the economy is already nearing full employment.

The concern is this could trigger a "short-term bump" in GDP that will then be followed by a decline back to trend growth, at the end of which the US has higher debt to GDP levels than before. "That would make that structural headwind maybe worse," he said.

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