# Fed policy: it's conditional

*Remarkably few economic decisions depend directly on the interest rate set by the US Federal Reserve (the Fed). Yet with this tool, the central bank is able to exert vast power over the US economy and to steer it towards the Fed's dual mandate of full employment and 2% inflation. The key to understanding how this is possible is found in the role of "financial conditions".*

Financial conditions cover the entire constellation of asset prices, as well as non-price financial indicators such as bank lending criteria. Together these variables affect things like how easy it is for firms and individuals to access credit; the competitiveness of exporters and importers; mortgage rates; and household wealth. As a result, financial conditions help determine the saving and investment plans of households and businesses and therefore drive the level of economic activity.

The level of financial conditions can typically be captured by just five variables: short term interest rates, long term interest rates, credit spreads (the extra premium charged to riskier borrowers), the foreign exchange value of the currency, and equity market prices. Most financial condition "indices" represent some combination of these variables for an individual country, reduced to a single number. The weight attached to each variable within the index will depend on the structure of the economy in that country, which determines the relative importance of that variable in driving economic activity.

For example, US companies rely less on banks and more on credit markets for access to finance than those in the Eurozone or the UK, so market-based credit spreads are more important to US financial conditions. The equity market is also a more important source of wealth in the US. In addition, since 30-year fixed rate mortgages are used to finance house purchases, long term interest rates may play a particularly important role in US financial conditions.

The Fed only has direct control over the short term interest rate. Nevertheless, it is able to use its control over this rate to influence other financial conditions. For example, when the Fed wants to ease financial conditions to boost economic activity, it will cut short term rates. This will typically also reduce long term rates, weaken the dollar, reduce credit spreads and push up equity prices, all of which will magnify the easing in financial conditions brought about by the original cut. Conversely, when the Fed wants to tighten financial conditions to reduce the risk of the economy overheating, it will raise short rates. This will typically also lead to higher long term rates and higher credit spreads, a stronger dollar, and weaker equity prices. Former Fed Chairman Ben Bernanke labelled this effect the "financial accelerator", and used it to explain why economic activity tends to be so sensitive to changes in interest rates.

The difficulty for the Fed in setting monetary policy is that the relationship between short term interest rates and broader financial conditions may not be stable over time. Indeed, financial conditions may even move in the opposite direction to the one implied by the change in short term rates. This could be due to a shift in 'animal spirits', i.e. a hard-to-explain sudden change in sentiment about the future; or a change in overseas financial conditions that is transmitted in domestic markets; or a shift in investor demand for safe assets regardless of monetary policy; or investors deciding the change in current policy stance is much more important as a signal about the future policy stance.

So it can be incredibly difficult for policy makers to predict the impact of their policy stance on broader financial conditions. As a result, policy errors can occur, where the level of financial conditions is inappropriate given the state of the economy.

One good example is the so-called 'conundrum' in the run-up to the global financial crisis. In June 2004 the Fed started a tightening cycle that saw it hike by 25 basis points in each of 17 consecutive meetings, taking the shorter term interest rate from 1% to 5.25%. However, during this time long term interest rates fell and financial conditions as a whole eased, contrary to what the Fed intended. This was partly due to a shift in the savings preferences of emerging market countries, which were using their current account surpluses to buy US government bonds. This demand kept long term US interest rates relatively low, eased financial conditions and may have fuelled the housing market bubble.

Turing to the present, there is a risk that we are witnessing the beginning of another conundrum-like episode, with the Fed failing to achieve the tightening of financial conditions it is looking for. With unemployment having fallen significantly and wage growth creeping higher, the central bank is now very close to achieving its dual mandate goals. While political outcomes are especially hard to predict at the moment, fiscal policy looks set to be eased in the future, which could help to push growth above potential. In this environment, there is a possibility of the economy overheating and inflation picking up above the Fed's target. The Fed therefore wants to tighten financial conditions, raising short-term interest rates twice in the past four months. However, the expected relationship between short rates and financial conditions seems to have broken down again: financial conditions have actually eased over this period through a 4% increase in equity prices and tighter credit spreads, perhaps helped by rising animal spirits following Trump's election victory.

Back in June 2015, New York Fed President William Dudley raised the possibility of this situation and described how the Fed would respond:

" …if financial conditions were not to tighten at all or only very little, then—assuming the economic outlook hadn't changed significantly—we would likely have to move more quickly."

So it is important to stress that, from the Fed's perspective, the benign response of financial markets to its rate rises is not unambiguously good news. The central bank is tightening policy because it wants tighter financial conditions. If it is struggling to achieve tighter financial conditions, it may need to hike short rates faster than the market currently expects. This is something investors would do well to remember as they celebrate buoyant asset prices.

**Luke Bartholomew**
**Investment Strategist – Aberdeen Solutions**

**The value of investments and the income from them can go down as well as up and you may get back less than the amount invested.**

**Contact details**
Should you require any further information, please visit **aberdeen-asset.com** for details of your local Aberdeen representative.

**Important information**
The above marketing document is strictly for information purposes only and should not be considered as an offer, investment recommendation, or solicitation, to deal in any of the investments or funds mentioned herein and does not constitute investment research as defined under EU Directive 2003/125/EC. Aberdeen Asset Managers Limited (Aberdeen) does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials.

Any research or analysis used in the preparation of this document has been procured by Aberdeen for its own use and may have been acted on for its own purpose. The results thus obtained are made available only coincidentally and the information is not guaranteed as to its accuracy. Some of the information in this document may contain projections or other forward looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make their own assessment of the relevance, accuracy and adequacy of the information contained in this document and make such independent investigations, as they may consider necessary or appropriate for the purpose of such assessment. Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither Aberdeen nor any of its employees, associated group companies or agents have given any consideration to nor have they or any of them made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document. Aberdeen reserves the right to make changes and corrections to any information in this document at any time, without notice.

For additional fund information, investors may request the prospectus from Aberdeen, distributors or download from the website. Please study product's features, conditions, and relevant risks before making investment decision.

Issued by Aberdeen Asset Managers Limited which is authorised and regulated by the Financial Conduct Authority in the United Kingdom.

ID: GB-070417-28948-1