

Central Banks May Face Race To Hike Interest Rates

By: Jeff Cox
CNBC.com

As the global economy climbs out of the crater left behind by the financial system's collapse, central banks in 2010 could end up in a horse race to see who is first to start tightening the reins on growth.

In the US, the Federal Reserve is not expected to raise rates until summer at the earliest. Yet the Fed already has begun pulling away the punch bowl of quantitative easing, and could have its interest-rate posture influenced should its global counterparts start tightening ahead of schedule.



China has been ahead of the pack, recently announcing a de facto rate increase through tightened capital requirements for banks.

How soon the rest of the world follows suit will be watched closely by investors, who generally don't take well to efforts at slowing growth.



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"The fact is the Fed probably will continue the rhetoric of low interest rates. But at one point or another you cannot have global interest rates spread far apart without causing a problem here in the States," says Peter Cardillo, chief economist at Avalon Partners in New York. "If the global economy does grow at 4 percent, that means that the move by China is going to influence other central banks, mostly likely the ECB [European Central Bank] first."

Monetary policy will be a hot topic at this week's World Economic Forum's annual meeting in Davos, Jan. 27-31, where it is a common thread at many of the forum's dozens of discussions slated through the week.

Like the Fed, the ECB has held fast to its position of low rates until the economy gets surer footing. More clues about the bank's posture will come in February when it releases its annual inflation report.

ECB member Ewald Nowotny has told several news outlets recently that the organization also will be careful about withdrawing its quantitative easing measures.

Other central banks, though, are ready to pull the trigger.

With its standing near the top of emerging market economies, India likely will be the first in line to raise rates, according to a recent analysis from Nomura Securities detailing the expected pace of increases around the world.

"A rebound in private demand, rising inflationary pressures and a surge in capital inflows have set the stage for policy reversal in 2010," Nomura analysts wrote. "But managing the fiscal deficit will remain a challenge."

Nomura expects India to hike repo and reverse repo rates by 125 basis points, or 1.25 percentage points this year. In turn, the country's currency, the rupee, will appreciate.

Global currency strengthening could put pressure on the U.S. to follow suit and prop up the anemic dollar.

"We would probably see Europe pull the trigger, followed by the United States," says Cardillo.

Brazil, another of the so-called nations making up the BRIC—Brazil, Russia, India and China—also could tighten by summer or sooner as it becomes "one of the strongest growth stories" in Latin America this year, Nomura said.

Elsewhere, Nomura expects tightening policies or rate increases to come from Turkey, Mexico, Australia and South Korea.

Hungary announced a quarter of a percentage point hike to 6 percent over national debt concerns.

"Hungary's risk assessment has not improved since December and consequently we have stuck with the 25 bp [basis point] rate cut that we decided for December as well," Governor Andras Simor said in announcing the decision.

As for stock investors, strategist consensus is that even if the Fed starts raising rates this year it shouldn't alone have a major effect on equities prices.

However, rate hikes combined with the pulling back of liquidity programs and a perception that the Fed is cutting the apron strings could send investor confidence lower.

"If domestic rates go up by 200 or 300 basis points this year due to a strengthening economy, and with inflation remaining contained, I don't think that would derail equities' performance," Cardillo said. "But it will cause a correction somewhere along the line, possibly a 10 percent correction maybe in the second quarter of the year."

And the Fed faces another issue relative to the pressure it will get to raise rates.

The flood of long-term debt the Treasury is putting into the system is likely to face a wall somewhere in terms of demand, requiring higher yields to attract buyers. A surge in long-term interest rates could provide wary stock investors with an incentive to look elsewhere.

"All of a sudden you'd have some competition for capital out there," says David Twibell, president of wealth management for Colorado Capital Bank in Denver. "Right now there are very few places where you can earn a return. The equity market is about the only game in town. If Treasury yields even get up to 5 percent or more that might be an appealing rate of return for a lot of people. Investors have ridden the stock market roller coaster down, now they've ridden it back up. They may want to get off here."