Fed Rate Hike - Rationale

Why in news?

\n\n

The Federal Open Market Committee (FOMC) of the U.S. recently voted unanimously to increase the short-term interest rate.

\n\n

What is the recent decision?

\n\n

\n
- The Federal Open Market Committee (FOMC) is the monetary policymaking body of the Federal Reserve System in the U.S.
\n
- It voted unanimously to increase the short-term interest rate by a quarter of a percentage point, taking it from 2.25% to 2.5%.
\n
- This was the fourth increase in 12 months, a sequence that had been projected a year ago.
\n
- The FOMC members also indicated that there would be two more quarter-point increases in 2019.
\n
- The announcement soon met with widespread disapproval.
\n

\n\n

What is the concern?

\n\n

\n
- The FOMC statement gave no explicit reason for the interest-rate hike.
\n
- Economic growth in the U.S. has slowed in the current quarter.
\n
- The Fed’s preferred measure of inflation (the rate of increase of the price of consumer expenditures) had fallen below the official 2% target.

\n
- The Fed has long said that its interest-rate policy is “data dependent”.
\n
- Given this, it is not clear why it went ahead with its previously announced plan to continue tightening monetary conditions.
\n

\n\n

What could the possible reasons be?

\n\n

\n
- **Inflation** - The current level of the real (inflation-adjusted) interest rate is remarkably low.
\n
- The real interest rate was slightly negative before the recent increase and approximately zero even after it.
\n
- A zero real rate might be appropriate in a very depressed economy.
\n
- But it is not so in an economy in which real GDP was growing this year at more than 3% and unemployment rate was exceptionally low.
\n
- Given this condition, an extremely low real interest rate can cause a variety of serious problems -
\n

\n\n

\n
i. businesses respond to the low cost of capital by taking on excessive debt
\n
ii. banks and other lenders reach for yield by lending to low-quality borrowers and imposing fewer conditions on loans
\n
iii. portfolio investors can drive up the price of equities to unsustainable levels
\n
iv. governments are induced to run large deficits because the interest cost of servicing the resulting debt is relatively low
\n

\n\n

\n
- **Future** - FOMC needs a higher interest rate level now, for it to reduce interest rates later, during the next economic downturn.
\n

- The current expansion, one of the longest since World War II, has now lasted 114 months since the upturn began in June 2009.
\n
- There are enough warning signs to indicate that the next recession could begin during the next two years. These include -
\n

\n\n

\n

i. falling equity prices
\n
ii. weakness in the housing sector
\n
iii. downturns in major European countries
\n
iv. the uncertain level of US exports
\n

\n\n

\n

- **Neutral level** - The FOMC might have wanted to return the real rate to the “neutral” level.
\n
- Neutral rate is the level that neither increases nor depresses overall demand, often referred to as r*.
\n
- This r* has declined substantially in recent years which reflects the declining interest rate set by the Fed and other central banks.
\n
- In the past, it was generally assumed that the real value of the neutral rate was equal to about 2%.
\n
- As the current real rate is close to zero, substantial increases are needed to get back to the traditional neutral level.
\n
- These three reasons, and perhaps others, justify the FOMC view that the current interest rate is too low and needs to be raised.
\n

\n\n

\n\n

Source: Business Standard

\n



SHANKAR
IAS PARLIAMENT
Information is Empowering