

### Fed Rate Hike - Rationale

## Why in news?

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

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#### What is the recent decision?

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- The Federal Open Market Committee (FOMC) is the monetary policymaking body of the Federal Reserve System in the U.S.
- 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%.
- This was the fourth increase in 12 months, a sequence that had been projected a year ago.
- The FOMC members also indicated that there would be two more quarterpoint increases in 2019.
- The announcement soon met with widespread disapproval.

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#### What is the concern?

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

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

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# What could the possible reasons be?

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• **Inflation** - The current level of the real (inflation-adjusted) interest rate is remarkably low.

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• The real interest rate was slightly negative before the recent increase and approximately zero even after it.

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- A zero real rate might be appropriate in a very depressed economy.
- 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.
- Given this condition, an extremely low real interest rate can cause a variety of serious problems -

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

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• Future - FOMC needs a higher interest rate level now, for it to reduce interest rates later, during the next economic downturn.  $\$  • The current expansion, one of the longest since World War II, has now lasted 114 months since the upturn began in June 2009.

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 $\bullet$  There are enough warning signs to indicate that the next recession could begin during the next two years. These include -  $\ensuremath{^{\backslash n}}$ 

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i. falling equity prices

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ii. weakness in the housing sector

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iii. downturns in major European countries

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iv. the uncertain level of US exports

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• **Neutral level** - The FOMC might have wanted to return the real rate to the "neutral" level.

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 Neutral rate is the level that neither increases nor depresses overall demand, often referred to as r\*.

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• This r\* has declined substantially in recent years which reflects the declining interest rate set by the Fed and other central banks.

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• In the past, it was generally assumed that the real value of the neutral rate was equal to about 2%.

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• As the current real rate is close to zero, substantial increases are needed to get back to the traditional neutral level.

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• These three reasons, and perhaps others, justify the FOMC view that the current interest rate is too low and needs to be raised.

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**Source: Business Standard** 

