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.
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- 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%.
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- This was the fourth increase in 12 months, a sequence that had been projected a year ago.
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- The FOMC members also indicated that there would be two more quarter-point increases in 2019.
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- 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.
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- Economic growth in the U.S. has slowed in the current quarter.

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- 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”.
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- 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.
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- 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.
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- 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
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ii. banks and other lenders reach for yield by lending to low-quality borrowers and imposing fewer conditions on loans
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iii. portfolio investors can drive up the price of equities to unsustainable levels
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iv. governments are induced to run large deficits because the interest cost of servicing the resulting debt is relatively low
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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.
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- 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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- There are enough warning signs to indicate that the next recession could begin during the next two years. These include -
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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

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