Optimal Timing: The Federal Reserve’s Difficult Decision

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“As the economy has steadily gained strength, the Federal Reserve has been gradually returning interest rates closer to levels that are normal in a healthy economy. We took another step on that path today with a quarter-point increase in short-term interest rates.” It was hardly a surprise when Jerome Powell, the chair of the Federal Reserve bank (Fed), took another step on increasing the interest rate. However, what followed this press conference were numerous controversies fueled by ambiguity of the effect of the Federal Reserve’s decision.  Despite the fact that the Federal Reserve is independent of any source of political power, President Donald Trump was the one who spearheaded the opposition of the Fed’s decision, claiming that the “Fed has gone crazy.” As stock prices dramatically dropped on October 11th, 2018, the dispute and concerns regarding the increasing interest rate grew. Yet, with the current American economic level, the increase in the interest rate is largely accepted by most economists as not a choice, but rather a necessity. The question, however, is the timing. Was it irresponsible to increase the interest rate when the country is having a trade war and economic confusion?

The American economy has been doing exceptionally well as of late, but this performance may be unsustainable. Factories have been operating above potential at about 104.5 percent[[1]](#footnote-1) while the unemployment rate has been at 3.7 percent which is below the natural rate of unemployment.[[2]](#footnote-2) When the economy is overheating while the Fed keeps the interest rate very low, it means that the Fed is putting its foot on the accelerator of a car already going too fast, which can lead the economy into risk of crisis. Working environment can deteriorate with an unnatural rate of production. The Fed’s decision to raise the interest rate can solve this problem by mitigating some of the risk caused by companies running over its capacity and can in the long-run increase people’s welfare.

In a short-term, however, for corporations that were benefiting from Trump’s tax cut, an increase in the interest rate was not good news. As the interest rate for bonds went up, the relative yield from these bonds became more profitable compared to stocks, with stocks prices have a higher variability compared to bonds. This, along with America’s imminent trade war with China, was one of the main reasons why stock prices crashed on October 11th.[[3]](#footnote-3) Additionally, an increase in the interest rate would raise the cost of lending for firms, leading to fewer opportunities for investment. Even if firms are able to maintain their original investment amount, the profit of each firm will decrease as consumers will also have to bear the burden of the high-interest rate to consume causing a decrease in consumption and an increase in savings. Even though the Fed believes that the “system today is stronger,” it is certain that the increase in the interest rate would cancel out some of the short-term boost of Trump’s corporate tax cut.

An increase in the interest rate affects banks the most, as it brings heavy effect on the shape of the yield curve, one of the most important indicators in banking. Today the Federal Funds rate for one year is about 2.25 percent while the ten-year long-term interest rate is about 3.25 percent, forming an optimal upward sloping yield curve which provides banks with a one percent difference to create profit. If the Federal Reserve aims to raise the interest rate to three percent over time and if the ten-year interest rate stays constant, the yield curve would become a “flat yield curve” which would not be beneficial for banks to invest in carry trade to earn profits. The fact that the European Central Bank is giving an end to the Quantitative Easing, of the Central Bank printing out money to purchase bonds, at the end of 2018 might possibly increase the long-term interest rate, shifting up the current upward sloping yield curve. To conclude what is going to happen on the long-term interest rate and on the shape of the yield curve is premature. However, it is inevitable that the alteration of the interest rate is putting banks into an ambiguous future risk.

This begs the question, why did the Fed raise the interest rate despite all the effects on consumers, firms, and banks? Is solving the problem of an overheating economy worth all the risk that individuals have to take? Until now, the American economy has been constructed with high consumption and investment with low savings rates due to the low-interest rate; the real interest rate was lower than the growth rate while the average return on capital was higher than the growth rate, and this was one of the factors that fostered the growth of the American economy. However, if the increase in investment and consumption keeps on growing exponentially with lower savings, there are two possible imbalances that the economy can run into. First, when consumption grows rapidly as individuals use not only their own income but also loans from the bank due to low-interest rates, if the investment rate does not grow at the same pace, the rate of demand can exceed the rate of supply leading to an inflation rate of more than two percent. On the other hand, there could be a moment when the growth of consumption halts and begins to drop rapidly. This is because the capital that individuals can consume is limited due to inadequate income. When there is excess supply with low demand, firms would start to lose profits and as the economy recedes, those firms’ stock prices would also fall, leading to risk of bankruptcies. All of these effects on corporations would not only lead to a decrease in the growth rate but also a massive decrease in employment rate and increase in default risk, causing the potential of another recession to rise.

The Federal Reserve Bank’s monetary policy can be a metaphor of a flu shot. Even though at the moment of the injection, it brings pain and some side effects, in the long-term it prevents much more severe issues from arising. Yes, the interest rate can cause some problems in the short-term such as decreases in corporation’s profits or risks to bank management, especially in this timing with the trade war between China and America. However, in the situation where Trump’s tax cut is boosting the corporate earnings and European Banks slowing down quantitative easing, an increase in the interest rate will not hurt the economy but rather the negative effect will cancel out with the timing, reducing the possibility of a potential threat. Napoleon Hill always said, “Don’t wait. The time will never be just right.” America has been procrastinating since the recovery from the recession and right now is the time to call a halt in that habit.

Congressional budget office, 2018 10 year economic projections and potential GDP, 2018, <https://www.cbo.gov/about/products/budget-economic-data>

Bureau of Labor Statistics, Unemployment rate, [call number: LNS14000000], 2018, <https://data.bls.gov>

Mary Hall, “How do interest rates affect the stock market.” *Investopedia*, 2018, Retrieved from <https://www.investopedia.com>

1. CBO [↑](#footnote-ref-1)
2. BLS [↑](#footnote-ref-2)
3. Hall, “Interest rates” [↑](#footnote-ref-3)