

Aftermath of Fed Rate Hike

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The dawn is now in the world. At last, the Fed has raised the interest rate to prod the economy and to pacify the President! Milton Friedman, the pioneering monetarist and a Nobel Laureate from the University of Chicago once told that if you print money, it is a policy. If you do not print money, it is also a policy. To make an analogy, so if you raise the interest rate it is a policy and if you do not raise the interest rate, it is also a policy. The most important podium to look for in this policy revision is the context; the environment and the economic fundamentals on which you change your decision or strict to static situation. It is not a relevant issue or question whether Janet Yellen who was appointed by Barack Obama and whose next tenure is in the regime of Donald Trump should flip on the movement of wind or should her decision be based on the sound working principle of the Federal Open Market Committee [FOMC] on interest rate change. There are many historical anecdotes on the issue of policy changes that slide to favor a party or group on the event of an election campaign but the world seldom see changes on any of this fundamental issues in the developed world. Even in many countries of the developing world, even the changes are molded through a fair and impartial institutional set up; the integrity of that institution was never put on trial. You may also consider the static state of Alan Greenspan on lowering the interest rate when the economy was in recession in late eighties despite the repeated request of the President H. W. Bush who appointed Alan Greenspan but he disappointed the President in his second term in office.

Any querulous reader could foresee the rate hike embedded in the Fed Chairperson's assertion since the end of 2016 that the days of threshold zero interest rate was reaching an end. A few fundamentals such as growth in labor markets and the creeping inflation in the vicinity of 2 percent target may transpire hope but the environment is still shrouded in the future policy perspective by the new President. Moreover, it is important to monitor the events in Europe and the political consultations in the Netherlands, France and Italy after the Brexit. The interest rate hike should not derail the healthy labor market. It should be compatible with inflation rate target and soothes the economy from overheating. The most important is to protect the independence of the Fed and to free the economy from overheating.

The immediate effect on interest rate hike will be on the increased cost of the consumers and business. That may have a dampening effect in the short run on consumer confidence important to propel growth. An increase in prime rate will have its effect on increased credit card rate, a versatile instrument to settle transactions in the western world and also in the credit-deposit rate; there will be an increase in the propensity to save. Higher interest rate also result in additional borrowing cost specially for sovereign debt; a tentative estimate by the Congressional Budget Office tells that the U.S. government may end up paying \$2.9 trillion more over the next decade due to increases in the interest rate, than it would have if the rates had stayed near zero. There may be also perceptible difference on the auto loan rates and mortgage rates but the resultant rate is a function of inflation, the nominal rates move with expected inflation. Consumer may move

to arrangement where the loan agreement is on the basis of a fixed rate rather than variable interest rate. Even a modest hike in interest rate in long term mortgage cost heavily the borrower; for example on a 20-year loan at 4 percent, home buyers is supposed to pay at least 50 percent in interest payments over the duration of the project.

Besides company's fundamentals, the interest rate is one of the determinants of the price of the securities. At a lower interest rate; the price of securities shoots up since the return on securities is reasonably higher than the interest rate. When interest rate is high, profitability may drop and as a result the price of securities may also drop. It is obvious that savers have now other options to invest their money. Stock market tends to decline or experience uncertainty and the impact on the commodity market depends on market environment. The price of oil indeed reacted positively with strong demand commensurate with strong economy but surprisingly increase in gold prices contradicts the common conviction of the inverse relation between strong dollar and the price of gold.

An increase in interest rate pari-passu increase the demand for dollar because there will be more investment in dollar denominated assets. As a result dollar appreciates or become stronger. So companies that do bulk of business abroad see their sales decline in real terms. However, products produced in United States gets an edge over the competitor because of strong dollar; though it depends how the exporter adjusts their real price in the face of strong dollar.

The American economy has many offshoots and strings. The decision on any crucial macroeconomic variable in the domestic front has ramifications and implications all over the world. It is not the question of rate hike in South Africa or New Zealand that may have such a wider impact. Even the ripple effect in the United States may result in chaos in the world economy. China has already raised the rate by 10 basis points and we have to weigh the impact if Bank of England or the European Central Bank follow suit.

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