The Pros and Cons of Rising Interest Rates

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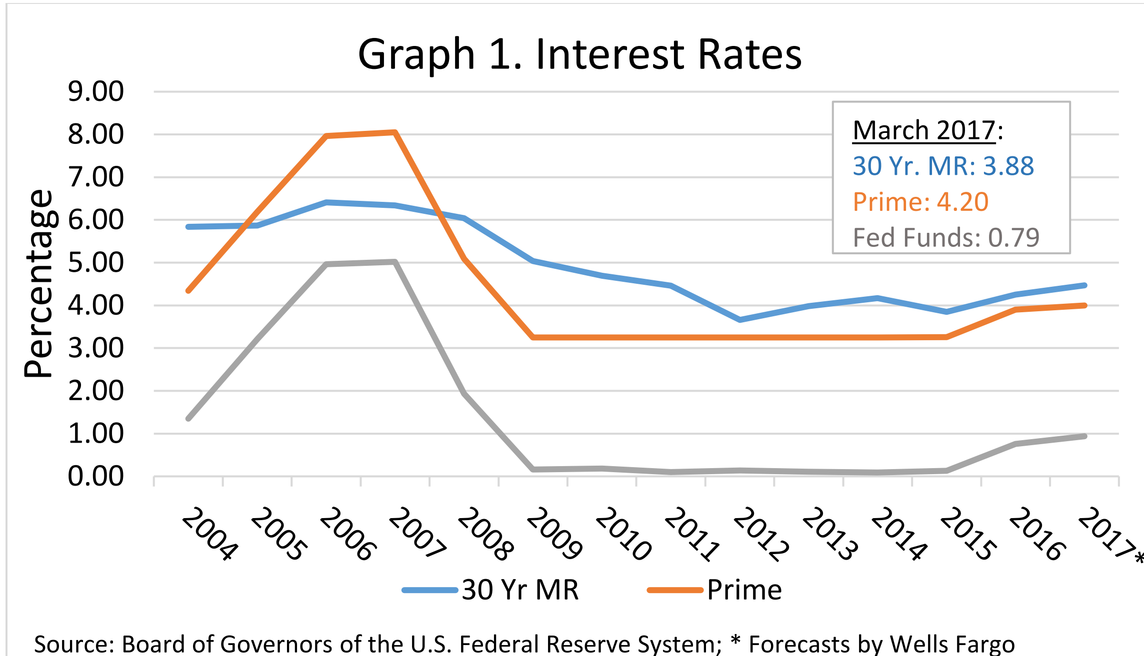
The severity of the last recession caused the Federal Reserve Bank to reduce interest rates rather dramatically as the first graph shows. Rate reductions are a trusted and often-used tool to stimulate the economy, mostly through the mechanism of decreasing borrowing costs for households and businesses. This monetary policy of "quantitative easing" essentially infuses money into the hands of consumers and businesses with the hope that households will spend more on goods and services, and businesses will invest more on capital and labor. As an economy recovers from a downturn, the Fed then carefully watches key indicators such as job growth and inflation. Job growth means businesses are confident enough to hire, but it also means there are more people with income to buy more goods and services. Inflation means there is enough money supply and willing consumers that demand is beginning to outstrip supply and prices are rising. As the labor supply continues to dwindle, wages typically begin to rise as well. What is different this time is that the fed funds rate has stayed low for a long time (since 2008), since it took so long for new jobs and inflation to happen after the "Great Recession." In 2016, the Fed began to see enough job growth and inflation that it began the long and gradual process to restore rates to more "normal" levels.

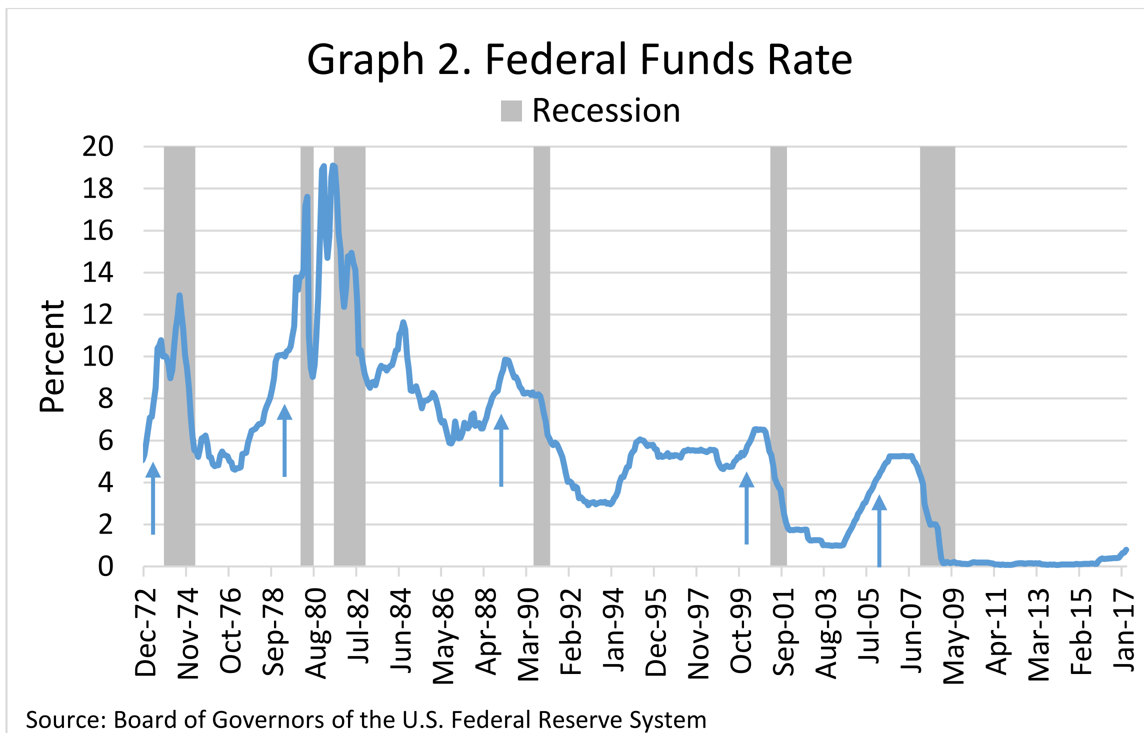
It may not seem that job growth and modest inflation is a bad thing, but there are several reasons why raising interest rates and having an equilibrium money supply is important. If the Fed increases the fed funds rate, which is the short-term interest rate banks charge each other for overnight loans, it instigates certain outcomes. First, the tightening of the money supply implicit in raising interest rates means that there is less money circulating in the economy, and inflationary pressures should subside. Second, higher interest rates can attract more investment to the U.S. as yields will be higher particularly for short-term investments. Third, as interest rates return to "normal" levels, the Fed will have a time-proven mechanism to stimulate the economy in future downturns. Most experts agree that the Fed will have a total of three increases in 2017 and three more in 2018. This may sound too aggressive, but the endpoint will probably be around 3.0% by the end of 2019, and that is not high by historic standards. That endpoint depends, however, on how the economy responds to each incremental increase.

On the flip side, there are also cons associated with raising interest rates. For one, the higher rates raise the costs of borrowing for households and businesses alike. In essence, this cools the economy because consumers and business owners slow their spending patterns. The main question will be whether consumers and businesses will adjust to the higher rates and continue to buy and invest at a healthy, but moderate, pace. Another probable negative impact is that the reduced supply of money boosts the dollar. The U.S. dollar has been strong relative to other currencies for quite some time, which has hurt our exporting industries. In the early part of 2017, our trade deficit has begun to narrow so the timing of the modest rate increases could negatively impact these recent gains. Again, it all depends upon how much the dollar appreciates relative to other currencies. An additional challenge is that higher interest rates mean that the U.S. has to pay more to service our own debt.

If you feel like you are in a confusing economics class, you are not alone. Even the Fed doesn't know which will prevail: the pros or the cons. What is rather certain and supported by the data is the simple fact that interest rate hikes happen late in an economic cycle. Graph 2 shows that rate hikes precede recessions as

shown by the blue arrows before each shaded grey area (a recession). Correlation is not causation, but this does tell us where we are now. The prolonged and aggressive quantitative easing of this last recovery may buck the trends we've seen in the past, but it is good to keep this historical relationship in mind as we move into the longest (albeit not strongest) expansion in 150 years.





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