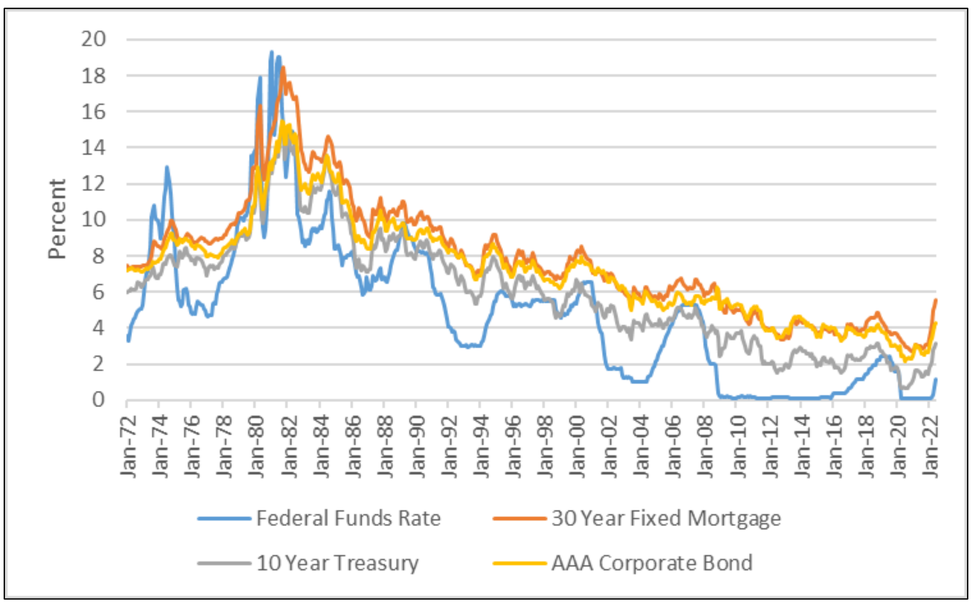
Rising Interest Rates: Economic and Policy Implications

August 4, 2022

Interest rates have risen significantly since the beginning of 2022 (see **Figure 1**). This is partly because of tighter monetary policy—the Federal Reserve (Fed) has increased its federal funds rate (the short-term interbank lending rate) target range from 0%-0.25% in March to 2.25%-2.5% in July 2022 in an attempt to reduce inflation, as required by its statutory mandate. But long-term rates have increased even more than the federal funds rate in 2022 and started rising before March. And the rise in long-term interest rates in 2022 has been global, although less pronounced than in the United States.

Figure 1. Selected Interest Rates

January 1972 to June 2022



Source: FRED.

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Causes and Considerations

Each loan or bond has a unique, market-determined interest rate based on its specific risk profile, but macroeconomic forces also cause all interest rates to follow similar trends. Three macro trends causing rates to rise in 2022 are monetary tightening, the economic recovery, and inflation.

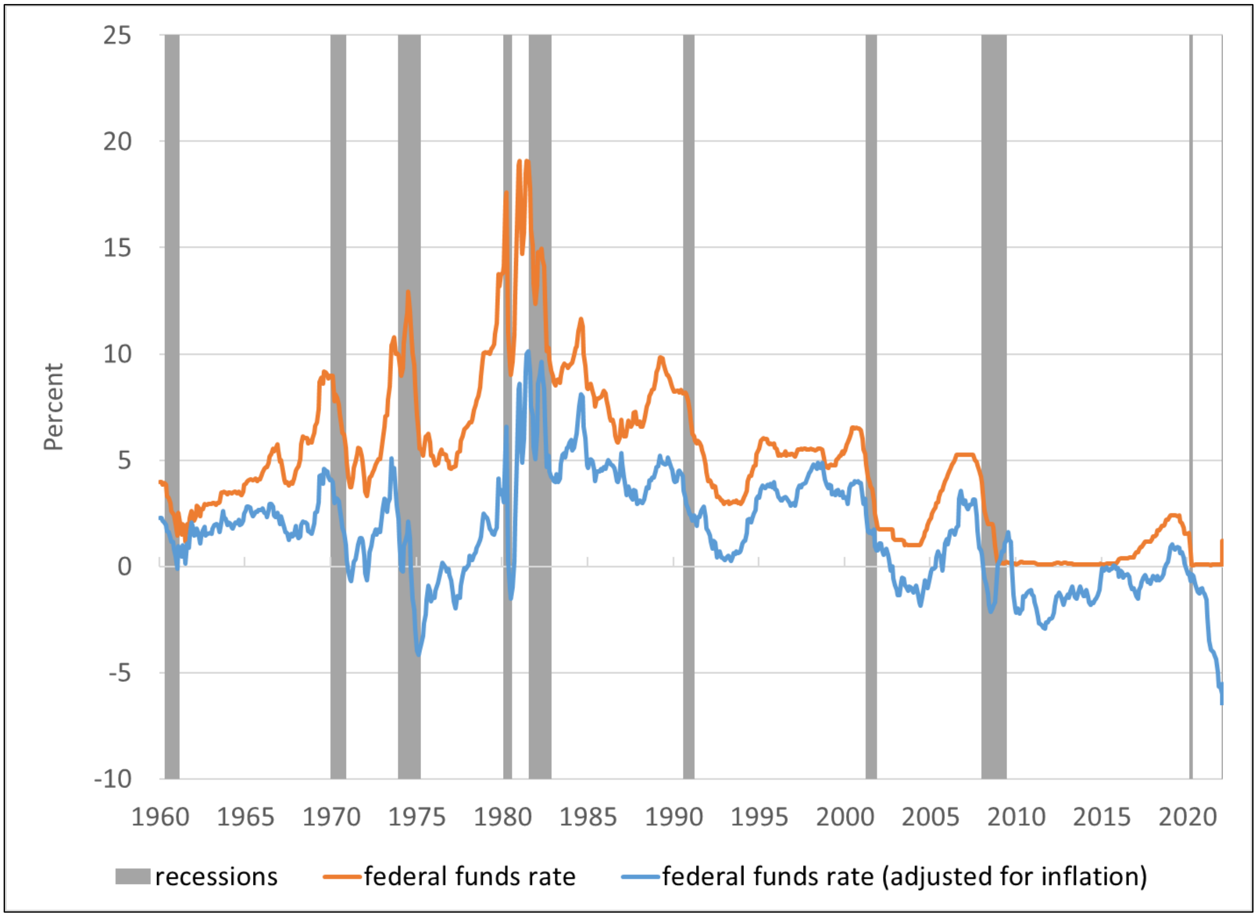
First, the Fed has raised interest rates and reduced its holdings of Treasury securities and mortgage-backed securities. Although the $47.5 billion per month securities holdings reduction is too small to have much of a direct impact on rates, markets have nevertheless responded to these actions by revising their projections for future interest rates upward, and long-term rates have risen this year because current long-term rates are based on expectations of future rates.

Second, interest rates tend to be cyclical because demand for credit is cyclical—when economic activity and incomes rise, households and businesses want to borrow more, pushing up interest rates. As the economy has recovered from the recession, credit demand has risen.

Third, higher inflation tends to push up interest rates because investors require higher interest to compensate for inflation reducing their purchasing power upon repayment. Inflation has risen to about 7%-9% (depending on the measurement used) in the past 12 months from around 1%-2% in the years before that. Economists distinguish between nominal interest rates, which are not adjusted for inflation, and real rates, which are. Over time, economic theory predicts that nominal rates will increase by at least as much as inflation, but so far, nominal rates have not risen as much. Thus, real rates are still very low compared to earlier decades even though nominal rates have been rising. For example, the federal funds rate is still negative in real terms (see **Figure 2**)—meaning the interest paid on federal funds is not great enough to compensate for inflation. In contrast, the last time inflation was as high as now, the federal funds rate rose to as high as 19% (around 10% in real terms) before inflation fell.

Figure 2. Federal Fund Rate

1960-2022



Source: CRS calculations.

Risk-free interest rates fell to unusually low levels because of the recession caused by the COVID-19 pandemic and, before that, the 2007-2009 financial crisis because demand for credit was very low. Interest rates were also low because of long-term trends related to demographics, productivity, and saving, as well as the three decades of low inflation until 2021.

If the economy continues to be influenced by those long-term trends, then interest rates are unlikely to rise to 20th-century levels again. But since the low interest rate environment occurred under continuously low inflation, high inflation could cause a trend break that pushes real rates higher, at least for a time. And even if real rates remain low, so long as inflation is high, nominal rates are likely to be higher.

Economic Implications

Higher interest rates put downward pressure on interest-sensitive spending on capital investment, consumer durables, and residential investment—all three declined in the second quarter. Higher interest rates (relative to U.S. trading partners) also attract foreign capital inflows into the country, which raises the value of the dollar, which reduces spending on exports and import-competing goods. The real dollar index has risen 5% since December 2021. Together, these factors reduce total spending, causing economic activity to slow. Recent recession fears have revolved around whether the Fed will trigger a "hard landing" by raising rates too much.

However, the contractionary effects of recent interest rate increases should not be overstated. Economic activity is mainly affected by real interest rates, not nominal rates. Monetary policy is still stimulating activity when real rates are negative. This suggests that nominal interest rates may have to rise significantly more for inflation to fall. Fed leadership projects that nominal rates will rise to a range of 3.1%-3.9% by the end of 2022. Rates might have to be increased more than planned to successfully reduce inflation, since, in that range, real rates would still be negative even if inflation fell to 4.8%-6.2%, as leadership projects.

Financial Implications

All else equal, higher interest rates reduce the value of asset prices, including stocks, bonds, and houses. Low interest rates are seen as a key factor in the financial boom that followed the COVID-19 outbreak. That boom has now reversed—in the first half of 2022, the U.S. stock market fell by 20% and bonds fell by over 10%. So far, overall house prices have not fallen, as prices change far more slowly in housing markets than in financial markets. Higher rates and higher prices have led to a sharp fall in housing affordability, however, which, along with declining sales, could presage a housing downturn.

Lower asset prices reduce household wealth and impose losses on the holdings of financial firms. In addition, companies that have fallen in value could have trouble raising funding in the future.

Budgetary Implications

Low interest rates have allowed the publicly held debt to reach its highest peacetime share of output while keeping net interest payments on the debt relatively low. If nominal interest rates remain higher, eventually, as the existing debt is rolled over at prevailing interest rates, net interest will become much higher. According to the Congressional Budget Office, even small increases in interest rates significantly increase projected deficits over 10 years. That might crowd out other government spending politically and reduce fiscal capacity to respond to future recessions.

Author Information

Marc Labonte
Specialist in Macroeconomic Policy

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