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Abstract
The Fed is.using "preventive medicine" to keep the nation from suffering later.

Lon Erickson '97 is a sophomore majoring in business administration. He wrote the following paper about the recent increases in the interest rate for his Macroeconomics class with Dr. Seeborg. Lon is quarterback of the IWU football team and is a member of the Tau Kappa Epsilon fraternity.

An Understanding of the Fed's Interest Rate Increase

by Lon Erickson

Since February of 1994, the Federal Reserve System has increased the short-term interest rate seven times including the November 8, 1994 increase of 0.75 percentage points. Everyone knows that the Fed increased the rate out of fear that the strong economic growth will cause inflation; however, not everyone believes that the Fed's actions are necessary. Many feel that the Fed is trying to fight a "nonexistent evil" (Lucinda Harper, 1994). Their position was supported when the Labor Department announced that consumer prices had risen only 0.1% in October which actually decreased from September's 0.2% increase (Lucinda Harper, 1994). Supporters point to inflationary pressures such as "wage pressures and labor shortages" in areas of the country as justification for the Fed's actions (Lucinda Harper, 1994). Others believe the inflation numbers for October indicate that the Fed's policies have been successful and should still be pursued. Whether one supports or opposes the Fed's interest rate increase, it has had undeniable effects on all aspects of the economy. And therefore, it becomes necessary to understand how the interest rate is changed and how inflation is controlled through the use of monetary policy.

When the Fed increases the interest rate, it increases the rate at which it makes loans to other banks(discount rate) and subsequently, the rate at which banks make overnight loan to each other(federal funds rate). It does not directly affect the interest rate the average consumer receives when he or she takes out a loan. The increases in the discount and federal funds rates induce member banks to increase their short-term loan rates. Actually, the money supply is decreased by the Fed's actions and banks increase their interest rate to ration the remaining loanable funds. These are the increases seen by the consumer. An example of this is how "First Chicago Corp. was the first big bank to react to the Fed's announcement by boosting its prime lending rate by the same 3/4 percentage point, to 8 ½%. Other banks followed quickly" (David Wessel, 1994). In light of this analysis, it could be imagined that banks would not change their short-term interest rates when the Fed raised the discount and federal funds rates. However, this is highly unlikely since banks are in the loan business to make money. If they failed to increase their rates with the Fed's increase, they would potentially lose a great deal of money.

Understanding how the interest rate is changed is important, and now the question becomes what good (or harm) does it bring? That question can be answered by looking at the current state of the economy in terms of the aggregate demand/aggregate supply model. The optimum state of the economy is long-run equilibrium where aggregate demand and short-run aggregate supply both equal long-run aggregate supply. This means the economy is running at the natural level of output and unemployment. Currently, the economy could be operating beyond the natural level. That is, output is greater and unemployment is lower than the natural level. Or, the economy could be at the natural level and the Fed is trying to keep the economy stable using monetary policy now because of time lags involved (the effects of time lags are discussed later). However, to make the explanation clearer, we will consider the first scenario where the economy is beyond the natural level which has occurred because of an increase in AD. Now unfortunately, this period of prosperity is usually accompanied by higher inflation. The inflation numbers for October suggest that this is not a problem; however, the Fed is not taking any chances. By increasing the interest rate, the Fed hopes to decrease AD and move the economy back towards long-run equilibrium which would put downward pressure on prices. The higher interest rate decreases AD by reducing investment activities and consumer spending. Many people fear the Fed's objective of the rate increase, but Frederic S. Mishkin, chief economist for the Federal Reserve Bank of New York insures that "the Fed doesn't want consumers to stop spending entirely; it wants to slow the pace of the expansion...You don't want too much of a good thing" (Georgette Jansen, 1994).

The number of interest rate increases in 1994 leads one to ask why subsequent increases are necessary if the aggregate demand/supply model accurately depicts the economy and how it responds to change. Shouldn't one rate increase be sufficient to move the economy back to or maintain its natural level? The answer is not always. The reason being that monetary policy is not an exact science. The Fed may not be able to hit the target on the first try. Or, since time lags exist between the time when policy is enacted

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and when it takes effect, the economy could change in a manner that makes policy ineffective, or even harmful. And so through the many increases, Marilyn Schaja, a money-market economist for Donaldson, Lufkin, & Jenrette Securities Corp., says, "The Fed may indeed be ahead of the curve in its fight against inflation", but (agrees with other analysts that) "by the time pricing pressures show up at the consumer level, it is often too late for the Fed to put the brakes on growth without forcing the economy into recession" (Lucinda Harper, 1994). The Fed is using "preventive medicine" to keep the nation from suffering later. Another reason for the many increases is that monetary policy is not working entirely. The economy grew "at a healthy 3.4% annual rate in the third quarter" (Lucinda Harper, 1994).

This can be explained by autonomous (unaffected by the interest rate) increases in consumer spending and business investment as well as "a surprising gain in federal government outlays" (Lucinda Harper, 1994). Optimism about the future of the economy and perhaps "animal spirits" are pressing people to spend money (Mankiw, 1994). Either explanation is sufficient to demonstrate why many interest rate increases have occurred.

Understanding how the interest rate increase affects the economy is important because it can help individuals monitor their financial well-being. Not only from a job security and future income perspective, but also, changes in monetary policy can signal appropriate times to apply for a loan in order to acquire that big ticket item such as a house or car. With the February increase raising interest rates to such a high level, the general public may think it is a bad time for such an action. This could be true for an item to be purchased without time constraints; however, if the item is something that needs to be purchased in the next few months, now would be a good time to buy. The reason being that when the Fed recently increased the interest rate it failed to hint that it expects the increase to be the last for a while as it had with earlier increases.

Further increases seem almost a certainty because as according to James Griffin, "...it's not enough to slow the juggernaut of a global boom...They'll probably have to keep doing it" (David Wessel, 1994). Waiting to purchase the item would only increase the price the individual would have to pay for the loan.

Finally, whether one supports or opposes the Fed's actions, it cannot be denied that the Fed has been successful thus far. It has slowed the pace of the economic growth yet it has not stopped it completely. In addition, the Fed has kept inflation under control. Unfortunately, until the Fed slows the economy to a growth rate with which it is comfortable and inflationary pressures subside, future action from the Fed can be expected.

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