

The article I have selected for the topic of monetary policy is, "*How high will the Fed go*". This article deals with the consequences on the economy based on monetary policy. It discusses the recent interest rate increases and the effect that it has on mortgages, home equity loans, car loans, credit cards, the money market, and the certificates of deposit. The question I have chosen to explore, based on the article, is what effect does an interest rate increase have; more specifically, how far-reaching are these effects?

The opportunity cost of holding money is the interest rate forgone on an alternative asset (Bade & Parkin, 2004). So, when the Federal Reserve decides to increase the interest rate, they are increasing the opportunity cost of holding money and therefore encouraging people to put that money into other interest-earning assets. They are attempting to decrease the amount of money. Therefore, in changing the interest rate, the Federal Reserve is changing the quantity of money (Bade & Parkin, 2004, pp 321).

As the article points out, the economy has been growing steadily in recent quarters. In order to keep the economy from a high rate of inflation, the Fed has increased rates along with the increase in economic production. This has several effects on individual citizens.

On the homeowner front, experts are saying that it is still a good time to finance, or re-finance, a home to lock in a lower than usual interest rate. As the Fed increases rates, fixed-rate mortgages will also increase. Furthermore, the home equity lines of credit rates increase in line with the interest rates. Since 2004, the rate for a \$30,000 line

of credit increased from 4.71% to 6.24%; more than one and a half percent in a year.

This is substantial to home owners who borrow against their home equity for large ticket purchases and home improvement and will help curtail spending and consumption.

Credit cards have also seen an increase in interest rates. The article implies that even fixed-rate credit cards are not immune to the rate increase, as companies can change the card to a variable rate card, or can simply raise the fixed rate interest rate with as little as fifteen days notice. Auto loans and financing has also seen an increase in the interest rates due to the monetary policy at the Federal Reserve. These changes are somewhat smaller and do not account for the various incentives companies are offering in order to sell vehicles in a difficult and competitive market.

On the positive side of interest rate increases, people can now enjoy a higher yield, or rate of return, on certificates of deposits and money market accounts. However, the article points out that even money market accounts are not paying a higher rate of return as compared to the inflation rate. The article cites the CPI, which is the consumer price index discussed in chapter seven of our Macroeconomics textbook. It states that the current rate of inflation is 2.8%. On a survey of money market account yields, the author found that most pay fewer than 2%. Conversely, certificates of deposit have seen an increase in yields as the interest rates have risen, and short-term yields are paying around 3.73%, up from 3.6% a year ago, and about a point higher than the inflation rate. Therefore, short term securities, such as CD's are becoming a more attractive alternative to holding money, which will help the Federal Reserve achieve its goal of less money and higher rates of interest.

As it has been shown, interest rate increase have multiple effects across a wide range of areas of the economy. Some people who wish to get a home loan may not be impressed with the Fed's decision to raise rates, while a person with a large amount of money they wish to put into an interest producing asset, other than holding the money, will be happy. This is all done in an ongoing effort to regulate the economy, and keep price level and inflation from causing the economy to render itself out of control.

#### References:

Bade, R. & Parker, M. Foundations of Macroeconomics. 2<sup>nd</sup> edition. Pearson Education, Inc. 2004.

*"How High Will the Fed Go?"* <http://www.moneycentral.msn.com>. Accessed 8-19-2005.