Institute for Monetary and Financial Stability

25 Basis Points for the Banks?

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After seven years of low interest rates the Federal Reserve Bank has raised the rate allowing once again for a positive interest yield on US dollars. The Fed raised the target of the interest rate for "federal funds" to 0.25 to 0.5 percent. Federal funds are daily reserves that commercial banks hold at the Fed. A bank that holds too many of them may lend the excess amount to other banks. If necessary, the Fed will intervene using its own loans in order to reach the target for the market interest rate. "Who cares?," some may think.

As a matter of fact, using this tool the Fed exerts considerable influence on the global economy. The first little step increases the expectation of future interest rate increases. Consequently, long-term interest rates in the financial markets increase as well. Saving becomes more attractive. Investments become more expensive. The tight monetary policy is designed to slow down economic activity. It reduces the pressure on companies to raise prices, and causes an inflow of capital. Other currencies, such as the euro, show a downward trend. U.S. demand for international goods increases.

The Fed has repeatedly promised such a decision. In January 2012 it signaled for the first time to banks that the zero interest rate period would be over by the end of 2014. But the decision was consistently postponed. A risky game. Because the influence the Fed exerts through its monetary policy relies on its predictability. If a central bank diverges in its reactions from those of the past it creates uncertainty and volatility in financial markets. A very long period of low interest rates may cause exaggerations in financial markets and erode the business model of banks.

A change in the interest rate in the United States was long overdue. The Fed's mandate focuses on stable prices as well as high employment rates. This aspect was especially emphasized by the Fed during the past two years. But recently unemployment rates have been in the range of 4.7-5.8 percent, considered the "natural" rate of unemployment by the Federal Open Market Committee. A further long-term reduction of unemployment would only be possible by implementing structural, politico-economic measures, and not through monetary policy instruments. The inflation rate has also suggested an interest rate increase for a while. The core rate of inflation, excluding energy and food prices, was between 1.3-1.8 percent, depending on calculations, already during the last meeting and thus close to the Fed's 2% target rate.

If inflation were to suddenly increase and significantly exceed the Fed's target rate, an unexpected and stricter monetary policy could become necessary. Consequently, the Fed's expansive monetary policy causes risks for financial stability. Long-term loans lent to households, enterprises and public institutions by banks at extremely low interest rates steadily increase. If the central bank raises the interest rate, interest rates for short-term deposits increase and the banks are facing losses. Hopefully, the Fed will manage to reduce these risks as it ends its ultra-loose monetary policy. However, there is no guarantee.