

The Significant Consequence of Fed's Monetary Policy: Saving, Investment and Exchange Rate

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Abstract: This article provides a comprehensive overview of interest rate hikes, focusing on the reasons behind such decisions, the magnitude and frequency of rate adjustments, and the policy objectives driving central banks' actions. Interest rate hikes are implemented to control inflation, manage economic overheating, and stabilize currency and capital flows. The magnitude and frequency of rate adjustments are determined by the central bank's assessment of economic conditions, with larger adjustments made for significant impacts and smaller adjustments for fine-tuning purposes. Policy objectives include price stability and sustainable economic growth. This analysis sheds light on the background and rationale behind interest rate hikes, highlighting their importance in shaping monetary policy and influencing economic conditions. This paper discovers that higher interest rates incentivize individuals to save more, leading to increased returns on savings. However, it also highlights the shift towards fixed-income securities and its potential impact on the stock market, as investors seek stable returns.

Keywords: interest rate hikes, monetary policy, inflation control

1. Introduction

Central banks, like the Federal Reserve in the United States, have a significant impact on monetary policy and economic conditions through interest rate increases. These decisions are made based on a variety of factors, including economic indicators, inflationary pressures, and policy objectives. Understanding the background of interest rate hikes requires an examination of the reasons behind such decisions, the magnitude and frequency of rate adjustments, and the policy objectives driving these actions.

Interest rate hikes are often carried out in response to particular economic circumstances or difficulties. The central bank may increase interest rates for the following reasons: (1) Inflation control: When the economy undergoes continuous growth and faces increasing inflationary pressures, the central bank may opt to raise interest rates. This measure helps regulate consumer spending, borrowing, and investment, thereby curbing inflationary tendencies; (2) Manage economic overheating: In times of robust economic expansion, characterized by high levels of economic activity, low unemployment, and excessive credit growth, interest rate hikes can help prevent the economy from overheating, avoiding imbalances and potential asset bubbles; (3) Stabilize currency and capital flows: In cases where a country's currency is depreciating rapidly or capital outflows pose risks to

financial stability, raising interest rates can make domestic assets more attractive to foreign investors, stabilizing the currency and attracting capital inflows.

The magnitude and frequency of interest rate hikes are determined by the central bank based on its assessment of the economic situation. Larger adjustments are made when the central bank seeks to have a more significant impact on borrowing costs, consumption, and investment. Smaller adjustments may be employed when the central bank aims to fine-tune policy or gradually address emerging risks.

The frequency of rate adjustments can vary widely, depending on the economic conditions and policy objectives. Central banks may choose to increase rates in a series of incremental steps over time to gauge the impact on the economy and avoid abrupt disruptions. Alternatively, in times of rapid economic changes or inflationary pressures, more frequent rate hikes may be necessary to maintain control over the macroeconomic environment.

Interest rate hikes are driven by specific policy objectives set by the central bank. These objectives can include: (1) Central banks aim to achieve and maintain price stability while keeping inflation within a desired range. Interest rate hikes are often employed as a tool to manage inflation and anchor inflation expectations; (2) Sustainable economic growth: Central banks seek to promote sustainable economic growth by ensuring a stable and balanced macroeconomic environment. Interest rate hikes can be used to prevent excessive credit expansion, speculative bubbles, and potential financial instability, fostering a more sustainable growth trajectory.

This article primarily focuses on analyzing the impacts of interest rate hikes by the Federal Reserve on different aspects of the economy. It emphasizes the rise in lending costs, resulting in increased expenses for borrowers, both individuals and businesses, which consequently leads to a reduction in consumer spending. Furthermore, the article delves into the consequences of elevated interest rates on consumer and corporate demand, as well as the potential implications for savings and investment returns. Additionally, it discusses how interest rate hikes are used to control inflationary pressures and their dampening effect on economic growth. Furthermore, the article examines the influence of interest rates on exchange rates and international trade, including changes in exchange rates and trade competitiveness. By understanding these effects, policymakers, businesses, and individuals can make informed decisions in response to interest rate changes, contributing to a more stable and sustainable economic environment.

Structure of the Article:

The remaining parts of this essay are organized as follows: Part 2 introduces the borrowing costs and consumption behavior following rate hikes. Section 3 delves into the topic of saving and investing. Section 4 explores the relationship between interest rate hikes, inflation, and economic growth. Section 5 investigates the influence of interest rate hikes on exchange rates and international trade. Finally, Section 6 concludes the paper by summarizing the key findings and emphasizing the multifaceted nature of the impact of interest rate hikes on the economy.

2. Borrowing Costs and Consumption

2.1. Increased Cost of Lending

The adjustment of interest rates by the Federal Reserve has a profound impact on the prevailing interest rate environment. This, in turn, prompts banks to raise the interest rates on loans, making borrowing more costly for individuals and businesses alike [1]. The heightened borrowing costs can dissuade individuals from availing loans for significant purchases such as housing and automobiles, resulting in a contraction of consumer spending [2].

According to a study, an increase in interest rates leads to a decrease in consumer borrowing and spending, particularly for durable goods. This is consistent with the notion that higher borrowing

costs can discourage individuals from taking out loans for major purchases, as the cost of financing increases [3].

2.2. Impact on Consumer and Corporate Demand:

Higher interest rates exert a dampening effect on both consumer and corporate demand. With the increased cost of borrowing, consumers may opt to postpone or reduce their expenditures on high-value items, leading to a deceleration in consumer spending [4]. Similarly, businesses may become disinclined to undertake investments aimed at expanding their production capacity or launching new projects due to the escalated borrowing expenses [5].

Empirical research by Barsky, House, and Kimball (2016) supports the notion that higher interest rates reduce consumer spending. Their study finds that an increase in interest rates leads to a significant decline in consumer durable expenditures. This is consistent with the idea that higher borrowing costs can discourage consumers from making major purchases [1].

3. Saving and Investing

3.1. Increased Returns on Savings

Elevated interest rates serve as an incentive for individuals to save more, as they can yield higher returns on their savings [3]. As savings accumulate, individuals may curtail their discretionary spending, choosing instead to save for future expenditures or establish a financial safety net [3].

Studies by providing evidence of the positive relationship between interest rates and household saving behavior. These studies suggest that higher interest rates increase the reward for saving, prompting individuals to save a larger proportion of their income.

3.2. Impact on Investment Returns

Rising interest rates have repercussions on the investment landscape. As interest rates increase, fixed-income securities such as bonds become more attractive due to their higher yields. This can prompt some investors to reallocate their investment portfolios away from riskier assets, such as stocks, and towards fixed-income securities [6].

According to research, higher interest rates can lead to a decline in stock market returns. This is consistent with the notion that as investors shift their investments from stocks to bonds, there is downward pressure on stock prices [6]. Moreover, higher interest rates are associated with lower future returns on stocks, supporting the idea that changes in interest rates affect investment returns [7].

4. Inflation and Economic Growth

4.1. Control of Inflationary Pressures

One of the primary objectives of the Federal Reserve in raising interest rates is to control inflationary pressures in the economy [8]. As interest rates rise, the cost of borrowing increases, resulting in a potential decline in borrowing and spending for both individuals and businesses. This decrease in overall demand can contribute to the moderation of inflationary pressures.

Research highlights the importance of interest rate adjustments in curbing inflation. The study suggests that central banks use interest rate policy to manage inflation expectations and anchor them at desired levels. By raising interest rates, central banks can influence market interest rates, which, in turn, affect borrowing costs and consumer spending, thus moderating inflationary pressures [6].

4.2. Dampening Effect on Economic Growth

With the escalation of interest rates, borrowing costs rise for businesses and individuals alike. Consequently, companies may curtail their investment plans, leading to a slowdown in capital expenditure [6]. Reduced borrowing and spending can also constrain consumer demand, potentially impeding economic growth [7].

Higher interest rates can negatively affect economic growth, as indicated by the authors' findings. They observe that increased interest rates are associated with reduced investment and consumption, ultimately leading to a contraction in output and employment. This suggests that changes in interest rates have significant implications for overall economic activity [8].

5. Exchange Rates and International Trade

5.1. Changes in Exchange Rates

Increased interest rates in a country can affect exchange rates and impact international trade. When a country's interest rates rise, it attracts foreign investors in search of higher investment returns. This heightened demand for the domestic currency can result in its appreciation compared to other currencies [9].

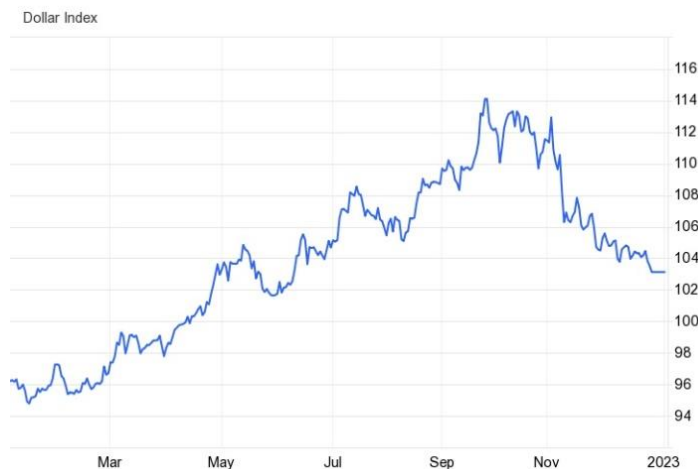


Figure. 1:USD index in 2022.

Photo credit: Original.

Taking the example of consecutive interest rate hikes in 2022, the value of the US dollar is likely to exhibit varying trends (please see Fig. 1). The series of rate hikes by the Federal Reserve indicates the tightening of monetary policy, which can impact the currency's exchange rate. Factors such as higher interest rates attracting foreign investors seeking better returns may contribute to the appreciation of the US dollar. Conversely, increased investment costs resulting from consecutive rate hikes could reduce foreign investors' interest in US assets, potentially exerting downward pressure on the dollar's value. Moreover, fluctuations in the US dollar's exchange rate can also have implications for international trade, as an appreciation may raise export prices and potentially decrease foreign demand for US goods, while a depreciation may enhance export competitiveness. However, it's important to consider that the exchange rate of the US dollar is influenced by a multitude of factors beyond consecutive rate hikes, including economic indicators, geopolitical conditions, and

market sentiments. Therefore, while consecutive rate hikes may impact the dollar's exchange rate, other factors should also be considered in assessing its overall fluctuations.

A stronger domestic currency can have mixed effects on international trade. On one hand, it can make a country's exports relatively more expensive, potentially reducing demand from foreign buyers. This can pose challenges for export-oriented industries, such as manufacturing and agriculture, as they face increased price competition in international markets [10].

On the other hand, a stronger currency can make imports relatively cheaper. This can benefit domestic consumers, as they can purchase imported goods at lower prices. Cheaper imports can also provide businesses with access to more affordable inputs and raw materials, potentially improving their competitiveness and efficiency [5].

5.2. Trade Competitiveness

The influence of higher interest rates on exchange rates can affect a country's trade competitiveness. When interest rates rise, resulting in a stronger domestic currency, it can have adverse effects on a country's export competitiveness. The elevated prices of exported goods in foreign markets may reduce their appeal to international buyers, potentially leading to a decrease in export volumes [5].

The decline in export volumes can have broader implications for industries and employment. Export-oriented industries may face challenges, as they must navigate a more competitive pricing environment. This can result in reduced production, job losses, and potential negative impacts on economic growth [8].

Additionally, a stronger domestic currency can contribute to an expanding trade deficit. With relatively cheaper imports, domestic consumers may switch their preferences towards imported goods. This shift can result in a rise in import volumes, potentially outpacing the growth in export volumes. A larger trade deficit can impact a country's current account balance and overall economic stability [7].

It is worth noting that the influence of exchange rate fluctuations on international trade is influenced by several factors, such as the composition of a country's exports and imports, the degree of trade openness, and the prevailing global economic conditions. Governments and policymakers may employ strategies such as export promotion, trade agreements, or exchange rate management to mitigate the potential negative effects of exchange rate fluctuations on trade competitiveness [11].

6. Conclusion

In conclusion, the impact of Federal Reserve interest rate hikes on the economy is complex and multifaceted. The adjustment of interest rates affects borrowing costs, consumer spending, saving behavior, investment decisions, inflationary pressures, economic growth, exchange rates, and international trade dynamics. These interrelated factors collectively shape the macroeconomic landscape and bear both positive and negative implications for various economic stakeholders.

The increased cost of lending resulting from higher interest rates can discourage borrowing for major purchases, leading to a contraction in consumer spending. However, higher interest rates can incentivize saving and lead to higher returns on savings, potentially contributing to financial stability. The impact on investment returns can result in a shift of funds towards fixed-income securities, affecting stock market dynamics. The Federal Reserve's interest rate adjustments aim to control inflation and maintain price stability while also influencing economic growth. Changes in exchange rates due to interest rate differentials can have mixed effects on international trade, affecting a country's export competitiveness and trade balance.

Understanding the complex relationship between interest rates and various economic factors is crucial for policymakers, businesses, and individuals in navigating the ever-changing economic

landscape. Further research and analysis are necessary to fully comprehend the long-term implications of interest rate adjustments on the economy and to develop effective policy measures to foster sustainable economic growth and stability.

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