Future interest rates

The Federal Reserve has a tough task ahead. It hopes to bring the inflation rate down to 2 percent per year. Unfortunately, the inflation rate is currently 8.3 percent. That's 6.3 percentage points too high. In order to reduce the inflation rate, the Federal Reserve has begun reducing the money supply. The Fed took this action because with less money in the economy, people will have less money available to bid up the prices of scarce items. This will result in a slower pace of price increases. The Federal Reserve hopes to reduce the rate of price increases by enough to reach its 2 percent inflation target.

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You will probably never see statistics reporting how much money is in the economy or how much money the Federal Reserve took out of the economy. But, you will certainly see a statistic that indirectly measures how much money is in the economy. This statistic is the interest rate. As you know, there are several interest rates: one for mortgage loans, one for your credit card balances, one that captures how much you earn by keeping money in the bank, and so on. One of the most closely watched interest rates is the federal funds rate. This is the interest rate banks charge each other for overnight loans.

So many people watch the federal funds interest rate because the Federal Reserve uses it as a tool to manipulate the money supply. The Federal Reserve does not really determine how much money it wants in the economy. Instead, the Federal Reserve selects a target interest rate for the federal funds rate. Here is how the target works: If the target federal funds rate was 3.25 percent and the actual federal funds interest rate was 2.75 percent, the Federal Reserve would take money out of the economy. With less money available, the banks with money to lend would be able to get away with charging higher interest rates. Other banks wouldn't have enough money available to offer lower interest rates, so the nationwide interest rate would increase. When the actual federal funds interest rate increases enough to match the target rate, the Federal Reserve will stop taking money out of the economy

On Wednesday, the Federal Reserve raised the target federal funds rate to between 3 percent and 3.25 percent. By increasing the target rate, the Federal Reserve signaled that it planned to take more money out of the economy. Most economists believe that the Federal Reserve isn't done increasing its target rate. Some economists have called for a 4.5 percent target rate. The Federal Reserve Bank of Atlanta publishes three different prescribed target rates, the lowest one is 5.3 percent. In order to get to any of these target rates, the Federal Reserve still has to raise its target rate by quite a bit.

A significant increase in the federal funds target rate will result in a large amount of money being removed from the economy. One implication of the lower money supply is that many interest rates will increase. Just as banks will be able to get away with charging higher interest rates for overnight loans to other banks (the actual federal funds rate), banks will also be able to get away with charging higher interest rates for other types of loans: car, house, and credit card loans.

Given our current high inflation rate, the Federal Reserve's stated desire to bring inflation down, and the likely increase in the target federal funds interest rate, the money supply in our economy will probably shrink significantly, leading to many higher interest rates. Borrowing money will soon become more expensive than it is now. At least now, you won't be surprised.