

D: PERSPECTIVE

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Consumers, businesses facing more expensive borrowing

Translate

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From mortgages to auto loans to credit cards, borrowing is set to get even pricier.

But the Federal Reserve's decision on Wednesday to hike its baseline interest rate also highlighted an increasingly confounding dilemma: It can raise the price of money across the economy, but it can't determine which sectors are most affected.

That means the rate increase may further slow the weaker parts of the economy, such as housing, while barely affecting the strongest, namely the relentless investment in artificial intelligence.

In its statement summarizing its unanimous vote, the Fed's policymaking committee said it was raising its benchmark rate by a quarter percentage point so that it now stands at a new target range of 3.75% to 4%. It described inflation as still "elevated" and noted that other economic indicators remain strong, from productivity to investment, to domestic spending.

As a scholar of public finance, I believe the Fed probably had little choice but to raise rates given its commitment to maintain inflation-fighting credibility. Markets had already expected the hike, and if the Fed had failed to deliver, it might have pushed longer-term interest rates even higher amid concerns it was becoming less wedded to that target.

But the Fed's action also underscores that the U.S. increasingly looks like an economy moving at two very different speeds. Investment in AI – whether through data centers, computing capacity or related infrastructure – has been booming, while it's crowding out other kinds of investment.

Meanwhile, the housing market is getting crushed by high mortgage rates and diminishing affordability, while consumers are carrying ever more expensive credit card and auto debt.

Many small and traditional businesses are also in a bind as they face substantially higher financing costs than they did several years ago. Those costs reflect the rising yields on longer-term U.S. government debt, which have been going up for months on a mix of factors: Longer-term inflation concerns due to soaring U.S. government debt, geopolitical risks driving up energy costs, and ongoing financing demand for AI.

On Sept. 14, the yield on the 10-year Treasury crossed 5% for the first time since 2023.

An elusive inflation target

When the Fed hikes short-term interest rates, it slows down economic activity by making borrowing more expensive and saving more attractive.

That mechanism works particularly well when consumers are deciding whether to finance a house, purchase a car or take on additional debt. It also discourages businesses from making investments when the expected return is only modestly above their financing costs. As demand slows, businesses have less room to raise prices, easing inflationary pressures.

In this case, the Fed justified its move by citing “elevated” inflation and noting that it “will support a timelier return” to its goal of an annual inflation target of 2%. It also suggested the economy would be able to absorb the tightening and described economic activity as “expanding at a solid pace.”

The decision aligns with Fed Chairman Kevin Warsh’s comments that restoring price stability is central to the Fed’s credibility. In a key speech in August, he underscored his commitment to bringing annualized inflation back down to 2%, an objective he called a “firm, fixed target” – a turnaround from his more ambiguous comments in July.

But in recent months, the economic data has shown that the 2% annual target remains elusive. Consumer prices rose 0.4% in August and 3.4% over the past year. Meanwhile, the war with Iran has pushed oil prices back above US\$100 a barrel, adding a new source of inflation pressure through gasoline, diesel, transportation and production costs.

At the same time, the labor market isn’t faltering. The economy added 162,000 jobs in August, while the unemployment rate remained at 4.1%. The one notable concern is the persistence of long-term joblessness despite the strong headline numbers. More than one-quarter of unemployed Americans have now been out of work for at least six months.

Taken together, those numbers suggested there was room for the Fed to hike rates, given that the economy isn’t sliding into recession. So investors overwhelmingly expected the Fed’s rate increase.

An uneven economic hit

However, tighter monetary policy carries a risk: It falls disproportionately on sectors that are already struggling and highly sensitive to interest rates, while having less effect on one of the economy’s strongest sources of demand – the booming AI investment cycle.

Housing provides the clearest example. Persistently high mortgage rates are reinforcing the “lock-in” effect for current homeowners. Millions of homeowners financed their houses when mortgage rates were 3% or 4%, so they’re staying put, with little incentive to sell their home and purchase another at much higher rates.

Mortgage rates are mostly influenced by longer-term factors, including Treasury yields, inflation expectations and market expectations about the future path of interest rates. But the Fed’s decision still matters. Markets increasingly expect today’s hike to be followed by additional increases, signaling that it views inflation as a more persistent risk and putting upward pressure on longer-term interest rates.

That expectation will keep mortgage rates high – probably resulting in fewer home sales, less mobility and continued headwinds for prospective buyers. It’s also likely to make renting relatively more attractive for potential homebuyers who are priced out of buying.

Higher-for-longer rates also change how consumers save.

When interest rates were near zero, they earned almost nothing on safe assets. Today, Treasury securities, money market funds and other relatively safe assets offer meaningful returns. Higher rates therefore tend to shift incentives throughout the economy away from borrowing and spending and toward saving.

With consumers stretched by inflation and increasingly dipping into their savings, however, this effect may be less pronounced.

The AI sugar high

When it comes to the AI investment boom, it’s a different picture. Warsh noted in August that more than half of recent capital-spending growth could be attributed to the AI buildout.

The companies that are spending billions of dollars on computing infrastructure are doing so because they expect potentially enormous returns from AI. If those expected returns on investment are exceptionally high, a modest increase in borrowing costs may do little to alter their investment decisions. That stands in sharp contrast to a prospective homebuyer getting sticker shock from mortgage rates nearing 7%.

The federal government, for its part, faces a slower adjustment. A Fed rate hike doesn't immediately increase the interest rate on all outstanding federal debt. Most Treasury notes and bonds carry fixed rates until they mature. But as the Treasury issues new debt and refinances maturing securities, today's higher rates gradually become tomorrow's higher federal interest expense. That rise in interest costs is a main reason some economists are sounding alarms about the national debt, which recently topped \$40 trillion.

In effect, the U.S. economy is facing a reality in which both short- and long-term rates stay higher for longer. The federal government, households and businesses are all adjusting to a borrowing environment that looks substantially different from the one that prevailed for much of the previous decade.

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