Economic Analysis of News Article

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1. Rising interest rates signal mild confidence in the economic outlook for USA. When the Federal Reserve raises interest rates, cost of borrowing rises too. This results in increased interest rates by banks for individuals as well as businesses which hampers borrowing trends. The decreased borrowing then results in decreased spending which leads to an overall economic slowdown. However, this measure is usually undertaken by Federal Reserve to curb inflation. The increase in interest rate by the Fed is a sign that it wants to stabilize prices of commodities in the market. This is a classic measure to curb inflation in the market and signal to investors by the Federal Reserve that the overall outlook of the US economy is somewhat positive as more and more people are inclined to deposit money and the Fed is willing to take the risk of slowdown in economy. This shows the strength of the US economy.

Investors are incentivized to place their money in US treasury because they will get better returns on a higher interest rate. This helps in increasing deposits in banks and Federal Reserve which results in increased pool of money that can be loaned out at higher rates for increased yields. Thus, shored up reserves are one of the goals of this policy of increased interest rates by the Federal Reserve.

2. If people hold money, their opportunity cost is the revenue that they can generate if they invested the money in bonds. The bonds yield income that is equal to the interest rate so if interest rates rise, people are inclined to buy bonds and this decreases money supply in the market. An increasing interest rate signals that the government is moving towards contractionary fiscal policies that are designed specifically to curb inflation. However, the cost of curbing inflation is a slowed down economy which tightens money supply.

The increasing interest rate will result in decreased money supply. On a money demand, money supply curve, the money supply curve, MS1 will shift towards the left as it gets decreased. To keep the market equilibrium, money demand curve will also shift towards the left. Thus, the entire equilibrium will shift towards the left that signals a decreasing money supply as well as money demand, slowing down the economy.

3. As a result of increasing interest rate, aggregate money supply will decrease. This phenomenon occurs because a decrease in money supply results in people holding lesser amount of money which will result in lower spending. Hence, aggregate demand will decrease because people have less amount of money to spend.

On an aggregate demand aggregate supply curve with equilibrium at E1, increasing interest rates will result in a shift of aggregate supply curve, AS1 towards the left. Calling this point AS2, the aggregate demand curve, AD1 will shift towards the left as well in order to maintain equilibrium in the market. The new aggregate demand curve AD2 coupled with AS2, will result in a new equilibrium point, E2 which will be towards the left of E1. This signals an overall slowed down economy but with controlled inflation, which is the main goal of Fed’s policy.

4. An increased interest rate increases the cost of borrowing. This forces people and businesses to borrow less money as cost of borrowing is high. The reduced demand for loans leads to less spending as people invest a lower amount of money in the economy. This decreases demand in the market, causing an increased supply of products and services as there are lesser buyers and more sellers. This simple demand-supply relationship causes inflation to fall or at the very least, leads to control in rising inflation, so the risk of hyper-inflation is significantly reduced.

Since, people borrow less for investing, there is less investment in the economy which leads to lower economic output. The lower output results in a lower amount of GDP growth as people tend to finance less and less businesses, resulting in decreased economic growth. Risk taking also suffers as a result of increased interest rate as investors are more wary of increased risk associated with increased interest rates.

Furthermore, unemployment could rise as a result of elevated interest rates. This is due to the fact that less investment in economy coupled with a slower GDP growth, results in decreased job creation. This is inevitably a blow to workers as they have to make do with existing jobs as competition increases in the market. Slower economic growth as a result of increased rates will most likely result in a slightly worse off unemployment rate than before.

5. The Federal Reserve should not continue to increase interest rates as the adverse impacts on economy outweigh the perceived advantages. Although, the existing increase in interest rates turned out to be a necessity as a means to curb rising inflation but this trend should not be repeated indefinitely. The increasing interest rates are only a short-term measure to achieve immediate results in controlling inflation.

The adverse impacts include lower investments, which means a lower economic growth percentage. This inevitably leads to a decrease in creation of employment opportunities that hurts the interests of the middle class people. The growing unemployment as well as the slower economic growth is unsustainable in the long term even if inflation is controlled. The added disadvantage of an increased interest rate is the shrinking money supply that affects the market negatively. Increasing interest rates also tend to increase market volatility which can spiral into a crisis like situation if risky investments such as those in over-the-counter derivatives is left unregulated.

References

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