US Macroeconomics

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The Fed is Focusing on the Wrong Measure of Financial Conditions

Market participants and monetary policymakers are placing too much weight on the recent easing of financial conditions. In particular, the collective rally in stock prices, decline in long-term interest rates, tightening in credit spreads, and softer dollar are making the Fed think it needs to hike the funds rate even higher from an already restrictive level. This would be a major policy mistake.

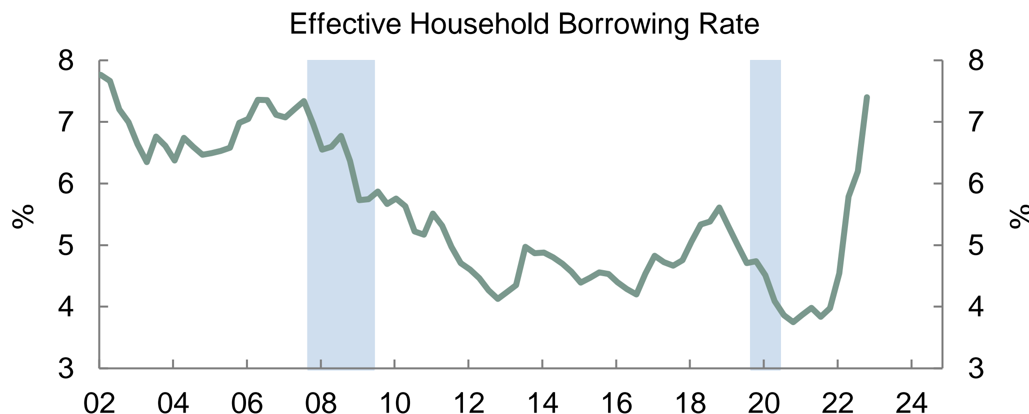
Abundant and affordable credit is a prerequisite for healthy consumer spending and a robust economy since the former accounts for 70% of total economic activity. Households get mortgages to fund home purchases, borrow from commercial banks to buy motor vehicles, and use credit cards to manage intra-month spending needs. Some consumers also have student debt. Credit provides the lubrication necessary for the smooth running of the economy.

Consequently, if the cost of credit becomes excessively expensive as it is now, households will eventually rein in their expenditures, and real GDP growth will decline. This is evident in the chart below, which shows a weighted-average effective household borrowing rate. The weights are based on each borrowing component's respective share of total consumer debt.

Through Q4 2022, the effective household borrowing rate was 7.4%. This is the highest since Q2 2002 (7.7%). Moreover, the surge in borrowing costs is without recent precedent. For example, households were paying an effective rate under 4% before the Fed began raising rates. Thus, the cumulative increase in rates is a stunning 342 basis points from Q4 2021.

With respect to "traditional" financial conditions, mortgage rates have fallen back below 7% but are still double where they were last year. To be sure, if 10-year treasury notes rally, mortgage rates will fall further. However, credit card and auto loan rates are sticky as they tend to move only with changes in the fed funds rate. Therefore, **effective household borrowing costs are likely to remain elevated until the Fed reverses course**.

The bottom line is that monetary policymakers and analysts alike are looking at the wrong metric. **Broad financial conditions have eased, but this is not particularly relevant to US consumers**. Rather, they are paying record high rates to purchase homes, autos, and fund everyday expenses. The Fed should relent and relent soon.



Source: Federal Reserve, Freddie Mac, Haver, SMBC Nikko

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