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A Fed-Engineered Rise in Consumer Borrowing Costs

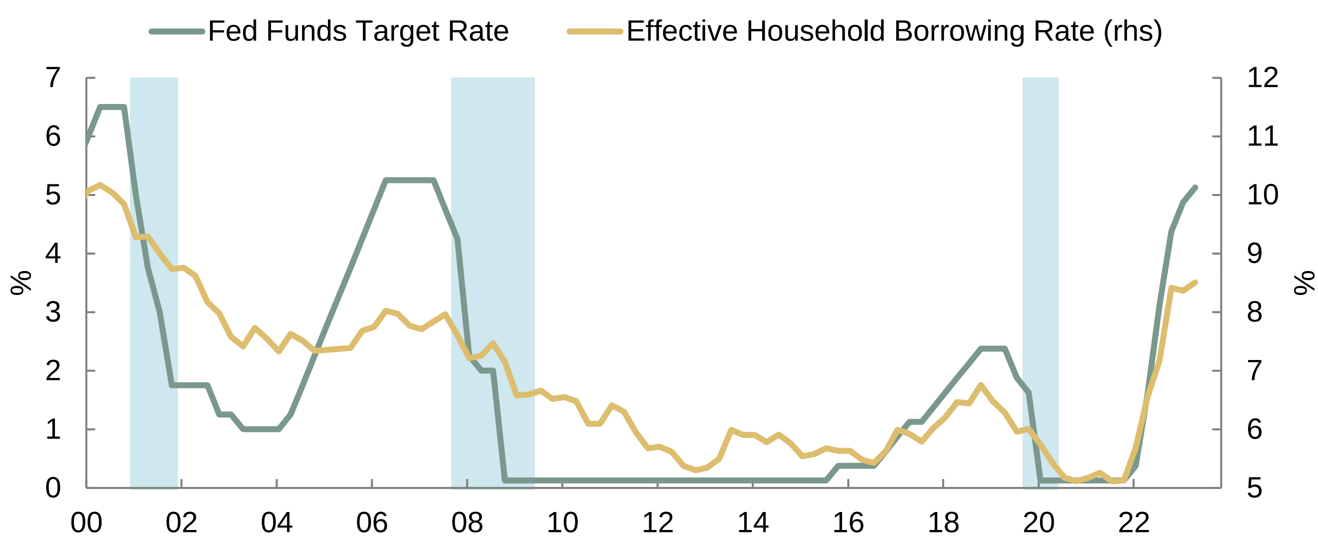
The Fed is on track to lift the funds rate another 25 basis points (bps) to 5.50% next Wednesday, which would be its highest reading since February 2001. In the process, the official overnight borrowing rate, which is already restrictive, will become more restrictive. No doubt, this will be a headwind to private economic activity.

Fed tightening has rapidly lifted consumer financing costs. In the chart below, we show the fed funds rate versus the effective household borrowing rate. The latter is a weighted average interest rate based off the consumer share of borrowing for automobiles, credit cards, mortgages and personal loans. Mortgages have the largest weight at 65%, followed by personal loans at 20%, automobile loans at 8% and credit cards at 7%.

As the chart shows, **in the previous two hiking cycles, consumer borrowing costs did not rise much relative to the amount of Fed tightening**. Perhaps this is why the Fed was able to wait longer than usual before pivoting to interest rate cuts as monetary policy was not particularly restrictive.

For example, when the Fed raised rates 425 bps from June 2004 to June 2006, the effective household borrowing rate rose just 70 bps from 7.3% in June 2004 to a peak of 8.0% in June 2006. These low interest rates were described as a "conundrum" at the time. Then when the Fed raised rates 225 bps from December 2015 to December 2018, effective household borrowing rates increased 109 bps to a peak of 6.76%.

Since monetary policymakers began raising rates in March 2022, the fed funds rate is up a staggering 500 bps. This is the largest 16 month interest rate hike since the early 1980s. In response, **the effective household borrowing rate has advanced 350 bps to 8.5% at present, its highest reading since Q2 2002**. In our view, this will pose a meaningful headwind to consumer spending, particularly for large-ticket durable goods purchases which tend to be financed. Furthermore, the Fed is likely to reinforce its desire to keep the funds rate elevated if not hike again at the September 26th FOMC meeting, if economic and financial conditions warrant.



Sources: FRB, Haver, SMBC Nikko

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