Are Rising Interest Rates Bad?

By: Andrew Brod

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Abstract:
Sellers of durable goods from automobiles to home furnishings have been nervously watching the Federal Reserve for some time now. Since the middle of 2004, the central bank has raised the federal funds rate 16 times, from 1 percent up to the 5 percent rate set in May of this year. (The federal funds rate is an overnight bank lending rate that effectively determines the market interest rates charged to businesses and consumers.)

Article:
As of this writing, it's unknown what the Fed will do at its next rate-setting meeting in late June, and that uncertainty has roiled financial markets. Many analysts expect further interest-rate hikes as the Fed tries to nip inflation in the bud, but some believe the Fed will take a breather after two years of increases. Analysts have pointed to both ups and downs in stock markets as evidence of how investors are attempting to forecast the Fed's moves.

A good deal of the uncertainty is due to the new kid on the Fed block. Fed chairman Alan Greenspan retired earlier this year, and his replacement, Ben Bernanke, has by most accounts had a rough first few months at the helm. Greenspan had his flaws, such as a habit of inserting himself into public debates not directly related to monetary policy. But investors and analysts knew what to expect of Greenspan in uncertain times. Bernanke is still something of an unknown commodity.

And so analysts can only speculate about the decision Bernanke's Fed will make. Most of the speculation has to do with inflation. Wholesale prices have risen a bit faster than some economists expected, and raising interest rates is the Fed's best lever to prevent the economy from over-heating. Will Bernanke prove to be as strong an "inflation hawk" as Greenspan was? Or will he tolerate a little more inflation in order to keep the economy growing as fast as it did in 2004 and 2005?

Of course interest rates are hugely important to Wall Street and to investors. But are they as important an indicator for the home-furnishings industry? To be sure, the cost of money matters to anyone who buys on credit. But interest rates are just one of a number of factors that govern furniture purchases. Moreover, the American economy has been in a curious phase in recent years, with healthy income growth but also weak employment growth. The macroeconomic picture is neither strikingly positive nor disturbingly negative, and as a result interest-rate changes haven't always had the expected effects.

A few years ago, when falling interest rates sparked the housing boom, furniture orders were weak. There appeared to be a disconnect in the long-standing relationship between home and furniture purchases, as many "house-poor" families used low interest rates to buy nice homes but didn't always follow through by filling them with new furniture. More recently, as interest rates have risen, the picture has actually gotten a bit brighter in home furnishings. According to BDO Seidman, new orders of residential furniture rose in both 2004 and 2005. In the first quarter of 2006, orders are up about 5 percent over the first quarter of last year. There seems to be no one-size-fits-all rule for how interest rates affect the home-furnishings industry.

It's important to keep in mind why interest rates are rising. They're rising in large part because certain U.S. economic policies, coupled with the new realities of a global economy, have kept them low, perhaps artificially low. Our large budget deficits have meant large issues of government securities. The bigger the deficit, the more T-bills must be issued to allow the government to pay its bills.

In the past, such extensive government borrowing crowded out private borrowing and put upward pressure on interest rates. But now that process has been interrupted due to global factors. As no one in the home-furnishings industry needs to be reminded, the U.S. is much more exposed to external economic forces than it used to be. One such force is the industrialization of China and some of its Asian neighbors, which are pursuing export-led growth and undervaluing their currencies by making huge purchases of T-bills. (Buying dollar-denominated securities boosts the demand for the dollar in currency markets and thereby suppresses the value of the renminbi, yen, etc.)

However, as China begins to rationalize its currency policy (at the urging of U.S. officials) and as other countries start to hold euros as well as dollars as foreign-exchange reserves, we're starting to see some upward pressure on prices and interest rates here. Global commodity inflation is adding to the effect. It isn't just the price of oil that's trended upward in recent years. The same price trends are present for commodities such as gold, steel, and lumber. As commodity inflation starts to drive up consumer prices, interest-rate hikes are a reasonable tool to prevent the first serious inflation in the U.S. in 25 years.

The upward correction isn't without hazards. Rising rates will make the huge debt load that many consumers are carrying even heavier. The more money consumers must allocate to service their debts, the less will be available for relatively discretionary purchases like furniture. But for the most part, it's the other warning signals in the economy that should trouble us more than increases in the interest rate. Employment has grown only slowly since the 2001 recession, but even that growth appears to have paused (though the unemployment rate is still fairly low). Higher fuel prices are beginning to filter through the economy. And consumer confidence has recently turned more negative.

Few people—other than those who have the bulk of their savings in money-market accounts—want to see rising interest rates. But the increases may be necessary for the broader health of the economy. In the long run, a healthy economy is always good for home-furnishings retailers.