Fed raises interest rate for first time in 3 years

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The US Federal Reserve has lifted its base interest rate by 0.25 percentage points to take it to 4 percent in the first such decision since 2023.

In making its unanimous decision, the Fed's policymaking body really had little choice. In the weeks leading up to it, financial markets had been demanding an increase and insisting that Fed chair Kevin Warsh back up his words about the determination to bring down inflation with action.

Financial markets had priced in a 90 percent probability of a rate increase amid warnings of instability if the Fed had decided to again stand pat as it did at its July meeting.

In his prepared remarks, and in answers to questions at his press conference, Warsh pointed to the "geopolitical landscape of shocks and uncertainty" and cited "geopolitics" as one of the reasons for inflation, without directly mentioning the war on Iran, no doubt with the aim of avoiding any hint of criticism of US President Trump.

"The plain fact is that inflation is too high and has been for too long," he said. "This summer's inflation readings do not tell me that underlying trends have meaningfully improved." One reason is that the ongoing war is impacting prices throughout the economy.

He said that in the period since the last Fed meeting in July, the prices of many "key inputs have risen."

This was referred to by one questioner, who asked how Warsh thought "these smaller rate hikes will be effective" when they could not "necessarily address the energy supply side of inflationary pressures."

Warsh acknowledged that the decision would not affect any individual prices, whether it be oil or foodstuffs. The decision was aimed at ensuring that changes in relative prices "don't broaden out, don't have second and third order effects on the economy." In other words, the effect of the increased rate would be to dampen demand in the broader economy and thereby bring some downward pressure on the overall price level.

Warsh repeated earlier remarks that he would be "hard pressed" to describe broad financial conditions as restrictive. "This view was widely shared by the committee, so we removed a dose of accommodation."

The Fed's decision, which goes against the demands of Trump that interest rates be lowered, brought a predictable response from that quarter.

In a post on social media in response to the decision, Trump said: "Interest rates in the United States should be 1 percent, or less, because we are the Best Credit in the world—BY FAR."

In his all-cap style, he continued: "Lower the interest rates for the United States of America, and fast."

Trump had previously called former Fed chair Jerome Powell a "moron" and "stubborn mule" for not lowering rates, but did not call out his latest appointee, Warsh, by name. His position has been that Warsh wants rates to come down but has been hamstrung by a "political" Federal Open Market Committee, the Fed's interest-rate setting body.

In fact, the decision of the committee to back the rise was not due to "politics" but was the expression of demands in the financial markets. And there could be more. Trades in the market after the decision indicated a 90 percent chance the Fed will raise its rate at least one more time by the end of the year.

In the so-called "dot plot," where Fed officials set out their projections—an exercise in which Warsh did not take part—a dozen Fed officials forecast an additional quarter point rise by the year's end, while another four expected there would be two such increases. Only two indicated they expected rates to remain stationary.

This issue was raised by a questioner at his press conference who pointed out that "when the Fed starts raising rates, it generally follows with a sequence of hikes" and asked whether there was anything different in the assessment of present economic conditions to suggest that the typical pattern would not apply.

Warsh refused to be drawn on the issue, saying he was not "in the forward guidance business" and was not going to "prejudge any future decisions we make."

An important question was raised on the reasons for the rise in long-term bond yields in the past few months.

The yield on the 10-year Treasury bond, which, as Warsh pointed out, is the "risk-free asset upon which every price of virtually every asset in the world is related to," has risen above 5 percent and stayed there for the first time since 2007, and the yield on the 30-year bond is continuing to rise.

Warsh gave what he said were "three leading explanations." These were the economic strength of the US economy, competition for capital (particularly by so-called "hyperscalers," who are increasingly issuing debt to finance their AI buildouts), and "geopolitics" in "hot spots around the world" which are driving up long-term yields.

In doing so, he carefully avoided the proverbial elephant in the room. This is the rise in US government debt to more than $40 trillion and the increasing interest bill running at around $1 trillion a year, threatening to become the largest item in the government's budget.

This is being accompanied by concerns that US government debt is not "risk free" but could give rise to market turbulence, not least because of the increased involvement of hedge funds in the $32 trillion Treasury market, where their speculative activities are being financed by large amounts of debt.

Under these conditions, the response of the two key economic arms of the capitalist state—the Treasury and the Fed—is becoming increasingly chaotic as they pursue cross purposes.

Treasury Secretary Scott Bessent has insisted his aim is to reduce the yield on long-term bonds. Earlier this month, he unveiled a program to increase Treasury buybacks of these bonds from $2 billion to $6 billion per operation.

The intervention fell flat as yields continued to rise.

But at the short end of the market, the Fed is seeking to raise interest rates, and this has an impact on the debt market. Following the Fed decision, the yield on the two-year Treasury note increased by 0.07 percentage points to 4.74 percent. It has risen by half a percentage point since the Fed's meeting in July.

One of the aims of Bessent's intervention is to shift investors in government debt to the shorter end of the market, where yields are lower, to lessen the interest bill for the US government. But these debts must be rolled over in a shorter period, and involve borrowings in a market where rates are rising and look set to continue to rise, on the expectation that the Fed is not done with increases in its base rate.