

How Does Raising Interest Rates Lower Inflation?

Between March 2022 and March 2023, the Fed raised the federal funds target rate by 475 basis points or 4.75%. This news was widely covered in the media because it wasn't immediately clear whether the persistent rate hikes were slowing inflation.

If you're reading this article, there's a chance inflation is high right now, and you've been hearing about the Fed raising interest rates. Many people are confused about the Fed's monetary policy and how raising interest rates can affect what you pay at the gas pump or supermarket. In this article, we'll try to clarify the relationship between the two.

Key Takeaways

- When consumer demand exceeds supply, the prices of goods and services increase until the Fed can restore a balance.
- Higher interest rates tend to discourage spending and encourage saving money, which lowers demand to bring supply and demand back in balance.
- The most considerable risk with raising interest rates to lower inflation is that there usually won't be a soft landing, which can push the economy into a recession.

What You've Likely Heard

If you've seen a news segment on the Fed raising interest rates or heard a relative complain about the high cost of borrowing, you may have preconceptions about what raising

interest rates means.

For example, you may think that rate hikes always cause an economic recession. You may also have heard the Fed wants to raise unemployment to stop inflation. Neither of these paint an entirely accurate picture of the situation.

The Fed generally raises interest rates when inflation doesn't naturally resolve itself. While an economic recession is a risk of rate hikes, it's not a certainty. Let's go into further detail to understand the Fed's thought process and how its actions affect inflation.

Monetary Policy

The Federal Reserve is the central banking system of the US and has the dual mandate of maintaining sustainable growth and maximizing employment. The Fed influences these things through monetary policy, the tools available to the Fed with which they control the nation's money supply.

The federal funds target rate is one of the Fed's monetary policy tools.

The fed funds rate indirectly affects the rate at which banks borrow and lend their excess reserves to each other overnight. Because banks have to meet specific reserve requirements related to the amount of money they keep on hand, a higher fed funds rate disincentivizes borrowing.

The fed funds rate impacts more than just banks. Borrowing becomes more expensive for consumers when the Fed raises rates, encouraging people to save money and decreasing demand. When demand falls, it allows prices to stabilize and curbs inflation.

But before we go into more detail, we should also understand what causes high inflation in the first place.

What Causes High Inflation?

There are many possible reasons why inflation could be on the rise in an economy. Generally speaking, inflation can increase when the cost of raw materials or production increases, demand for products surges past the supply level, or the government's fiscal policies cause disruptions. Many other factors could exacerbate inflation, from supply chain issues caused by global conflict to unexpected demand levels, as we saw governments lifting pandemic restrictions.

For a case study of rising inflation and the Fed's response, let's consider the build-up to the 475 bps rate hike from 2022 to 2023.

Initially, inflation was labeled as "transitory" in the spring of 2021 because the Fed believed the unique spike in global demand from loosening pandemic restrictions was causing the price increase. The supply chains couldn't keep up because they had grown accustomed to a "new normal," so when consumer demand shifted, there was a delay as supply chains caught up.

There were also unique global events impacting inflation in 2022. The Russian attack on Ukraine disrupted global supply chains, and many countries introduced sanctions against Russia. The Russian war with Ukraine heavily affected energy prices, as the former held a high market share of European gas.

This huge mismatch in supply and demand led to increased prices, with inflation reaching 8.3% year-over-year in August 2022.

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It may seem counterintuitive to hear the central banks raise

interest rates because everything is becoming more expensive. But we can't stress enough that price stability is the goal of raising rates.

In the event of high inflation (unsustainable economic growth), the central bank has to decrease the money supply to restore the balance of demand and supply. Said another way, demand has to slow down enough for supply to catch up.

When borrowing money costs more due to higher rates, consumers are less likely to carry credit card debt or apply for a loan. An auto loan or mortgage is now more expensive. You may not make that home purchase if borrowing costs you more than it would have a year ago. Consumers may think twice before putting a transaction on a high-interest-rate credit card.

The Fed aims to bring demand down enough to match supply, which should control the increasing prices. The challenge is to get the entire economy down to an acceptable level without leading it into a recession.

Does Raising Interest Rates Always Work for Fighting Inflation?

The obvious question many of us have is whether monetary policy always works. It feels frustrating that the move to fight inflation is to cool off the whole economy. A frequent effect of rising interest rates is higher unemployment, as many companies adjust to reduced revenue and a stop to growth.

The truth is that the Fed only has so many tools that it can use to control inflation. The Fed can raise rates to fight inflation but can't introduce fiscal policies or pass laws.

The government introduces fiscal policies and legislation to support the central banks. Using our 2022-23 case study again, we saw fiscal policy used in August 2022 when President Biden signed the Inflation Reduction Act into law. The government

can also broker deals with other countries to increase supply, thereby alleviating issues with the supply of raw materials.

The Fed is also obviously limited when it comes to influencing global supply chains. Using our case study, the Fed couldn't single-handedly resolve the conflict in Ukraine, which caused massive disruptions in the world's grain, gas, and oil supply.

The danger of the Fed not managing inflation is serious. Stagflation, though rare, is a possibility. Stagflation refers to a uniquely dangerous economic situation in which inflation and unemployment are high, and economic demand has stagnated.

While the Fed will try to bring demand in line with supply, supply chain issues make this restoration difficult. There are no one-size-fits-all solutions for managing supply, as the central bank can't control global conflict.

What Are the Consequences of Interest Rates Increasing?

Many consequences come with raising interest rates; certain people can suffer more than others.

When borrowing money becomes more expensive, getting a mortgage, applying for an auto loan, or getting a business loan to grow a company becomes costlier. Businesses and consumers will spend less, cooling off the economy. Unfortunately, this can also lead to job loss. Every industry impacted by the rate hikes will likely report lower earnings, leading to layoffs and higher unemployment rates.

It's difficult to anticipate the impact of every rate hike on consumer spending. The Fed aims to engineer a soft landing where prices cool down without mass job loss and a full-blown recession.

How Can You Invest Your Money?

When the Fed announces interest rate hikes, the stock market tends to suffer. It becomes challenging to find the best investment when interest rates are high because uncertainty can lead to stock market sell-offs.

Companies that are generally considered recession-proof include utility companies, food and beverage vendors, discount retail stores, and healthcare companies. If high interest rates lead to a recession, discretionary spending usually decreases, but not in the essential sectors of the economy.

Bond Prices and Interest Rates

When the Fed adjusts the fed funds rate, it affects the bond market. Bonds and interest rates have an inverse relationship. Because most bonds come with a fixed rate when interest rates fall, bonds with now comparatively high rates become more attractive to bond investors. This pushes the price of bonds higher. Conversely, if the Fed raises rates, bonds with relatively low rates become less attractive investments, causing their prices to decrease.

You may hear about something called an inverted yield curve. This refers to shorter-term bonds having higher yields than longer-term bonds. This is considered an inversion of what should be true: taking a longer-term bond (a bond with greater risk) should earn you a higher yield.

An inverted yield curve suggests investors are not confident about the economy's future, and experts see it as an indicator of an upcoming recession.

The Bottom Line

News around high inflation tends to be doom and gloom. Rate

hikes can end companies' growth periods, lead to unemployment, and push the economy into recession. At the same time, out-of-control inflation can lead to even more dangerous economic situations.

The Fed will fight against inflation by raising interest rates until supply and demand come back into balance. Don't be surprised to hear about rate hikes in the future, as they're a common reaction to high inflation. You can prepare yourself financially for the worst-case scenario by saving money and diversifying your income.

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