Think Strategically: "Inflation and interest rates: Two sides of the monetary policy coin"

September 18, 2023

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The Demand-pull Inflation Explained

We have been facing demand-pull Inflation since August 2021, when Inflation rose to 4.16% or 108% higher than the Federal Reserve Bank's target inflation rate of 2%. During that very same month at the annual Jackson Hole Fed Conference, Fed Chairman Jerome Powell stated, "The Fed will remain cautious in any eventual decision to raise interest rates as it tries to nurse the economy to full employment, saying he wants to avoid chasing "transitory" Inflation and potentially discouraging job growth in the process," the statement proved to be totally wrong and Inflation continued to double until it reached its Zenith in June 2022 at 9.06%. While the Fed began to increase rates in March 2022, it proved too late to prevent Inflation from spiraling out of control. A year after starting the most aggressive Interest rate campaign since the Paul Volcker era, Inflation had fallen to 4.98% or 45.03% when compared to the highest level of 9.06%, it was still 149% above the Fed's target of 2%.

Taking the discussion to the latest inflation number released on September 13, 2023, Inflation rose again to 3.67%, pushed by energy prices, which took the Inflation reading 83.5% above the Fed's target rate of 2%. We intend for you to understand how Inflation and interest rates are two sides of one coin, and we begin this journey going back to the 1970's.

1970s - The Prelude

The 1970s marked the beginning of a challenging period for the U.S. economy. Inflation started to rise due to a combination of factors, including increased government spending on the Vietnam War and the oil shocks of 1973 and 1979. As prices surged, the Federal Reserve faced a dilemma. Initially, they kept interest rates relatively low to promote economic growth. However, this accommodative stance exacerbated inflationary pressures.

Early 1980s - Paul Volcker's Tightening

In response to soaring Inflation, Paul Volcker, the Federal Reserve Chairman, took drastic measures in the early 1980s. The Fed shifted to a contractionary monetary policy, dramatically raising interest rates. The Federal Funds Rate reached its peak at around 20% in 1981. This move was intended to combat Inflation by making borrowing more expensive, curbing spending, and reducing the money supply.

What was the impact on the U.S. Economy:

1. **Taming Inflation:** The primary objective of the high-interest-rate policy was to bring down Inflation, and it succeeded. Inflation rates, which had been in the double digits, started to decline. By 1983, Inflation had fallen to single-digit levels.

2. **Recession:** The flip side of high-interest rates was a severe economic downturn. Many businesses and consumers found it costly to borrow, leading to reduced spending and investments. The ending effect was that it contributed to a recession that lasted from 1981 to 1982.
3. **Unemployment:** High-interest rates also increased unemployment as companies cut back on hiring and, in some cases, laid off workers due to the economic slowdown.
4. **Strengthened Dollar:** The policy of high-interest rates attracted foreign capital, strengthening the U.S. dollar. While this helped to control Inflation by reducing the cost of imported goods, it made American exports more expensive, impacting trade balances.

Mid-1980s Onward – Stabilization

As Inflation gradually receded and the economy stabilized, the Federal Reserve began to ease its tight monetary policy. Interest rates were lowered, providing a stimulus for economic growth.

The analysis of how Inflation compelled the Federal Reserve to increase interest rates from the 1970s to the early 1980s illustrates the challenging trade-offs central banks face. While high interest rates successfully tamed Inflation, they came at the cost of a severe recession and increased unemployment. The long-term impact of this period was a stronger focus on inflation control by central banks and the recognition of the importance of maintaining a delicate balance between economic growth and price stability.

Late 1980s to Early 2000s - The Great Moderation

After the turbulence of the early 1980s, the U.S. economy entered a period known as the "Great Moderation". Inflation remained relatively low and stable during these decades. The Federal Reserve continued to adjust interest rates as needed, but the focus shifted from combating Inflation to promoting economic growth and stability.

2008 The Great Financial Crisis

The 2008 financial crisis presented a different set of challenges. The Federal Reserve aggressively lowered interest rates and implemented unconventional monetary policies like quantitative easing to counter the severe economic downturn. These measures were aimed at preventing a collapse of the financial system and reviving economic activity.

Post-2008 Recovery and Inflation Concerns:

In the years following the financial crisis, interest rates remained historically low for an extended period to support the economic recovery. However, as the economy improved, concerns about Inflation began to resurface, especially after the Federal Reserve's large-scale asset purchase programs.

2020 Pandemic Response - Unprecedented Actions:

The COVID-19 pandemic in 2020 prompted another extraordinary response from the Federal Reserve. Interest rates were reduced to near zero, and the central bank initiated massive asset purchases to stabilize financial markets and support the economy through the crisis.

Inflation Resurgence in 2021 to today

By 2021, Inflation became a significant concern. Various factors, including supply chain disruptions, fiscal stimulus, and pent-up demand, led to a price surge. The Federal Reserve initially affirmed that Inflation was "temporary", it resited increasing rates even though Inflation by August of 2021 had reached 4.16% and was 108% above the Fed's 2% target. The Fed would continue to claim that Inflation was temporary until March 2022, when Inflation reached 8.54% or 327% above the Fed 2% target and finally began to increase rates. It did so comprehensively and quickly; the next FOMC meeting is this week, from 9/19 to 9/20 when the Fed may or may not raise rates again. However, Inflation experts expect the annual headline Consumer Price Index to remain above 3% between now and next January, which may indicate that the Fed's 2% target may not be achievable.

FOMC Meeting		Rate Change	Federal Funds Rate
1.	9/20/23	?	?
2.	7/26/23	0.25%	5.25% to 5.50%
3.	5/3/23	0.25%	5.00% to 5.25%
4.	3/22/23	0.25%	4.75% to 5.00%
5.	2/1/23	0.25%	4.50% to 4.75%
6.	12/14/22	0.50%	4.25% to 4.50%
7.	11/2/22	0.75%	3.75% to 4.00%
8.	9/21/22	0.75%	3.00% to 3.25%
9.	7/27/22	0.75%	2.25% to 2.50%
10.	6/16/22	0.75%	1.50% to 1.75%
11.	5/5/22	0.50%	0.75% to 1.00%
12.	3/17/22	0.25%	0.25% to 0.50%

The challenge of addressing Inflation while simultaneously supporting the ongoing economic recovery was a high-wire act, as discussed below.

Impact of High Inflation Concerns

1. **Interest Rate Policy Shift:** The Federal Reserve started signaling a shift in its policy stance in 2021. While interest rates remained low, discussions about tapering asset purchases and eventually raising interest rates became prominent in response to rising inflationary pressures.
2. **Financial Markets Reaction:** The anticipation of higher interest rates "impacted financial markets. Stock markets experienced volatility, and bond yields began to rise.
3. **Housing Market and Consumer Behavior:** Higher interest rates can affect the housing market, making mortgages more expensive. Additionally, consumers might reduce spending due to concerns about rising borrowing costs.

As the Federal Reserve faced the challenges of managing inflationary pressures while supporting economic recovery from the COVID-19 pandemic, it added the "temporary inflation' concept to its discussion, an idea that was in time proven wrong by the persistently high inflation data, forcing the central bank to shift its stance and monetary policy to address rising inflation concerns, impacting financial markets and consumer behavior and the year marked another chapter in the complex relationship between Inflation, interest rates, and the U.S. economy.

The Last Word: Impact of Inflation on U.S. GDP

1. **Demand-Pull Inflation:** The Inflation experienced from 2021 to late 2023 is described as "demand-pull" Inflation. Demand-pull Inflation occurs when there is excessive demand for goods and services compared to their supply. As consumers and businesses tried to catch up on spending delayed by the pandemic, demand for products surged, driving prices higher.

2. **Impact on Real GDP:** In the short term, the surge in demand contributed to strong economic growth. Real GDP, which measures economic output adjusted for Inflation, thrived. Businesses were operating at or near capacity to meet demand, leading to increased production and economic activity. The US GDP grew in the second quarter at 2.10% GDP, and the latest GDPNow was released on 9/14/23, showing a 4.90% GDP for the third quarter, a solid growth forecast.
3. **Supply Chain Disruptions:** However, supply chain disruptions and shortages of critical inputs, such as semiconductors, contributed to production bottlenecks. This limited the economy's ability to fully capitalize on the surge in demand, potentially constraining GDP growth in specific sectors.

Impact of Inflation on Unemployment

1. **Labor Market Dynamics:** Rising Inflation can have a mixed impact on the labor market. On one hand, strong demand for labor as businesses expand can lead to job creation and lower unemployment. On the other hand, higher prices can erode real wages, impacting workers' purchasing power.
2. **Unemployment Rate:** the U.S. unemployment rate has been below 4% since February 2022, reached its lowest percentage of 3.40% in January 2023, and has been hovering between 3.40% and 3.80%, a number it reached in August 2023. The labor market adjusted to changing economic conditions. As the economy recovered and demand for labor increased, unemployment rates gradually declined. However, the U.S. Job Openings remain high, with 8.827 million open jobs and only 5.752 million job seekers, creating a deficit of -34.83%.
3. **Wage Pressure:** The labor market's dynamics also led to upward wage pressure in some sectors. Workers in industries with labor shortages or essential roles often saw wage increases to attract and retain employees. This Wage Growth last year rose as high as 6.60%, and last month, it fell to 5.30%; however, it remains higher than the long-term average of 3.87%.

From 2021on to today, the resurgence of Inflation had complex effects on the U.S. economy. It initially fueled strong GDP growth as demand surged, but supply chain disruptions and labor market dynamics created challenges. The labor market saw fluctuations in unemployment rates and wage pressures in various sectors. The Federal Reserve fumbled its response initially as it maintained that Inflation was temporary; however, it came back to its senses with a vengeance, increasing rates 11 times to taking rates from 5.25% to 5.50% and taking Inflation to 3.67%, or 83.5% above the Fed's target rate of 2%. Inflation and rising interest rates are like two sides of the monetary policy coin; when one goes up, the other tends to come down, and finding the right balance is a constant challenge for central banks, and without harmony, economies falter.

Former Fed Chairman Alan Greenspan said it best "The challenge of central banking is to keep the economy on the path of price stability while avoiding the wide fluctuations in economic activity that historically have been associated with booms and busts"

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