Congressional Research Service
Informing the legislative debate since 1914

INSIGHT

The Federal Reserve and Inflation

February 25, 2022

By statute, the Federal Reserve (Fed) has been tasked with setting monetary policy to maintain maximum employment and stable prices. The two goals can involve a tradeoff—Fed actions that can boost employment can spur inflation, and actions that fight inflation may also reduce employment. The Fed has defined stable prices as an inflation rate of 2% since 2012. In response to the large decline in employment caused by the Coronavirus Disease 2019 (COVID-19) pandemic, the Fed set the federal funds rate (FFR), its main monetary policy tool, near zero. As the economy has recovered, it has maintained that target, even though unemployment has fallen to 4% and inflation (as measured by the personal consumption expenditures (PCE) index) has risen to 6%, the highest it has been since 1982. The Fed has signaled that it is planning to begin raising the FFR soon. This Insight provides historical context on whether the Fed has waited too long to raise interest rates in response to rising inflation. For a basic explanation of how monetary policy affects the economy, see CRS In Focus IF11751, *Introduction to U.S. Economy: Monetary Policy*. For more information on why inflation has risen, see CRS Report R46890, *Inflation in the Wake of COVID-19*.

What Does History Tell Us About Monetary Policy and Inflation?

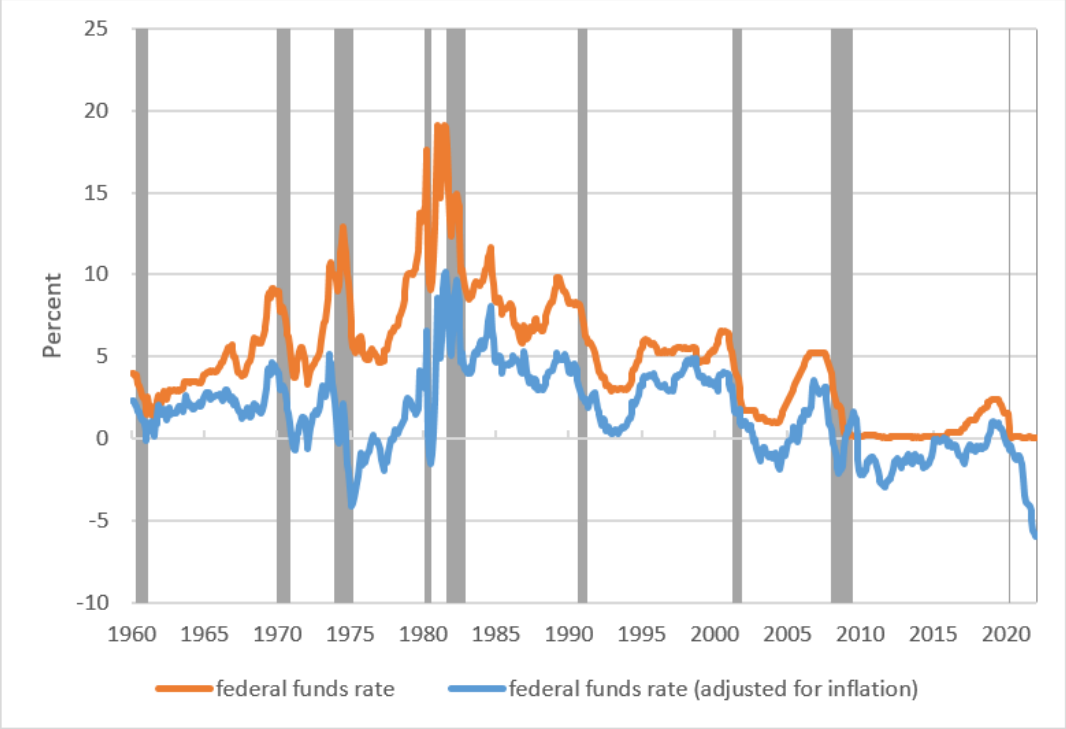
At a certain point in each economic recovery since the expansion beginning in 1958, the Fed has initiated a series of increases in the FFR. (That year is the first full expansion for which FFR data is available, although the FFR was not the explicit policy target of the Fed until 1992.) As a recovery gains strength, the Fed raises rates to gradually remove the monetary stimulus it put in place to boost spending during the preceding recession.

Two things stand out as unusual about the current stance of monetary policy. First, this is only the second episode ever where the Fed has reduced interest rates to zero. The other time was beginning in 2008 (see **Figure 1**), during the financial crisis. In both cases, the Fed did so to provide as much stimulus as possible in response to the two deepest recessions since the Great Depression. (The Fed also took other extraordinary actions to stimulate the economy during both crises.) After adjusting for inflation, rates look even more stimulative today compared to the historical record. As seen in **Figure 1**, the FFR is currently negative (–6%) when adjusted using prevailing inflation rates, meaning investors' compensation when repaid has less real purchasing power than the amount initially lent out.

Congressional Research Service
https://crsreports.congress.gov
IN11868

Figure 1. Federal Funds Rate

1960-2022

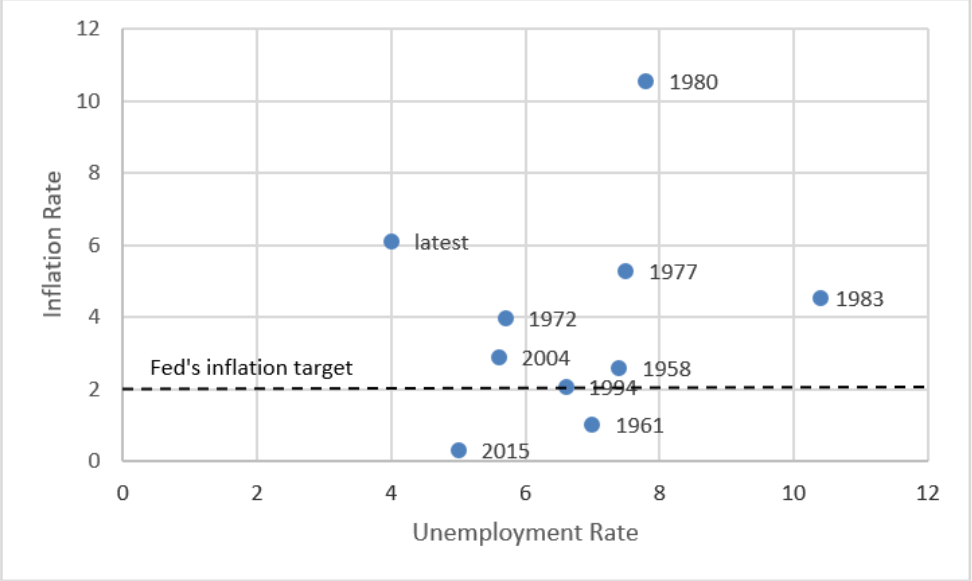


Source: CRS calculations based on data from Federal Reserve and BEA.

Notes: Adjusted for inflation using the PCE. Shaded bars denote U.S. recessions.

Second, the Fed has waited an unusually long time to raise rates given the current rates of unemployment and inflation. As seen in **Figure 2**, if the Fed were to begin raising rates now, it would be starting when the unemployment rate (4%) was lower than in any other expansion in the sample. (Other labor market indicators provide mixed signals on how tight the labor market currently is.) In the past, the Fed began raising rates before unemployment became very low, because either inflation was already high or the Fed feared that inflation would become high. However, in 2020, the Fed released a statement replacing this earlier approach with a pledge to only react to "shortfalls of employment from its maximum level." Inflation today is also the second highest of the episodes considered in **Figure 2**. As the figure shows, inflation was often above the Fed's 2% target at the onset of monetary tightening, but it was only above 4% during the 1970s and early 1980s episodes, when the inflation rate was persistently high. Between 1969 and 1983, inflation averaged 6.6%. Although the FFR might seem to be high during that period, it was negative when adjusted for inflation—as is the case today.

Figure 2. Inflation and Unemployment When the Fed Began Raising Rates and Latest Following Recessions Since 1958



Source: CRS calculations based on data from BEA and BLS.

Note: Inflation is measured as the 12-month change in the PCE.

With the FFR so much lower than the inflation rate, the Fed may have to increase it significantly before monetary policy stops being stimulative. It may also take a considerable period of time for policy to stop being stimulative if the Fed raises rates at its typical pace of 0.25 percentage points every six weeks (at most). The Fed prefers gradual interest rate increases so that financial markets are not disrupted by large and sudden changes. If the Fed decided to raise rates more quickly than normal, it would be more quickly than financial markets are expecting. On the other hand, a structural decline in global interest rates could mean that the Fed might not need to raise rates as much before monetary policy ceases to be stimulative. After all, the inflation-adjusted FFR was negative for about a decade after the financial crisis—albeit not as negative as it is now—without triggering high inflation.

These considerations raise questions about whether the Fed is "behind the curve" today on addressing inflation, and whether price stability can be quickly restored. The Fed believes price stability can be restored quickly, but that largely depends on whether the public's inflation expectations have remained stable despite the recent rise in inflation and whether the Fed is willing to raise rates as much as it takes to reduce inflation. Low inflation was not restored during the periods of monetary tightening beginning in 1972, 1977, or 1980, when inflation expectations were high and the Fed was unwilling to tighten policy sufficiently. If price stability is not restored quickly, it could ultimately become more costly to restore later. In the early 1980s, when inflation expectations were high, low inflation was eventually restored, but only after the Fed raised the FFR to 19%, contributing to an unusually long and deep recession.

Author Information

Marc Labonte
Specialist in Macroeconomic Policy

Disclaimer