Congressional Research Service
Informing the legislative debate since 1914

INSIGHT

Why Is the Federal Reserve Keeping Interest Rates "High for Longer"?

July 3, 2024

The Federal Reserve (Fed) responded to the post-pandemic spike in inflation by rapidly raising short-term interest rates between 2022 and 2023. Since July 2023, the Fed has maintained a target range of 5.25%-5.5%, the highest target since 2001. As inflation subsequently fell, futures markets expected the Fed to begin reducing rates this spring. Instead, rates have remained unchanged through the first half of the year—a stance that has been popularly referred to as keeping rates "high for longer." This Insight examines why.

Inflation and Monetary Policy

The Fed has a statutory mandate to promote "maximum employment, stable prices, and moderate long-term interest rates." The Fed has defined 2% inflation—as measured by the personal consumer expenditures price (PCE) index—as consistent with its price stability mandate. Economists view monetary policy as the primary policy tool for influencing inflation.

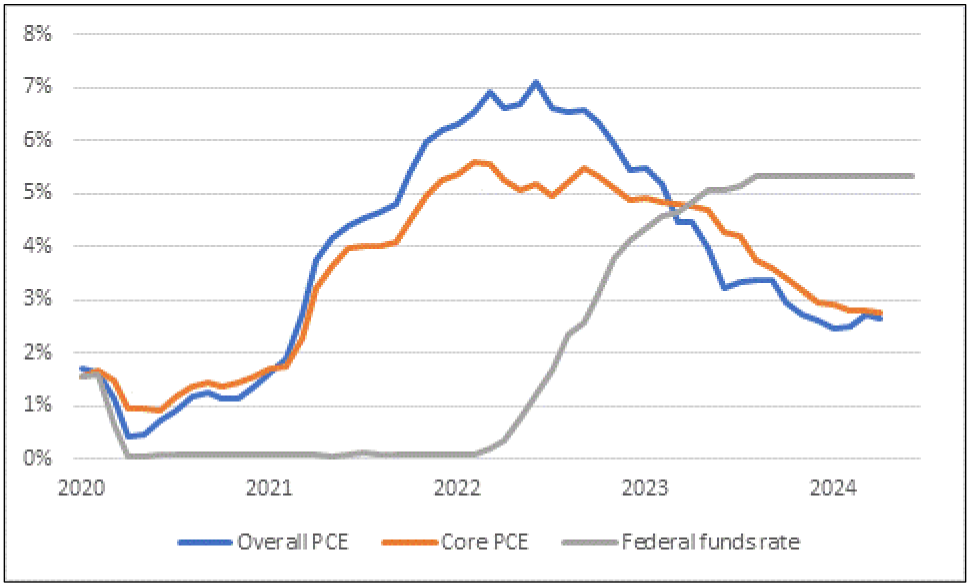
External factors can lead to short-term changes in inflation, but the Fed has demonstrated in recent decades that monetary policy has the ability to guide inflation to the Fed's desired target over the medium term. To carry out monetary policy, the Fed targets the federal funds rate (the overnight bank lending rate), as explained in CRS In Focus IF11751, *Introduction to U.S. Economy: Monetary Policy*. When the Fed raises the federal funds rate, it reduces interest-sensitive spending, causing overall demand (spending) to cool off and inflation to fall, all else equal.

Recent Trends and Policy

Inflation was mostly near the Fed's 2% target for decades until supply and demand disruptions caused by COVID-19 and the invasion of Ukraine caused inflation to rise rapidly (see CRS Report R47273, *Inflation in the U.S. Economy: Causes and Policy Options*). As seen in **Figure 1**, inflation has exceeded 2% since March 2021 as measured both by total PCE and core PCE, which excludes volatile food and energy prices. Overall inflation peaked above 7% in June 2022—its highest level since 1981. (By contrast, unemployment has been below 5% since 2021, so the Fed has not had to focus on supporting its employment mandate.)

Figure 1. Inflation and Interest Rates

January 2020 to April 2024



Source: Bureau of Economic Analysis and Federal Reserve.

Notes: The figure plots the 12-month change in prices and the effective federal funds rate.

Inflation fell rapidly in the second half of 2022 and 2023, falling below 3% by the end of 2023 because most supply disruptions were resolved and energy prices declined rapidly for most of 2023. September 2023 was the first meeting where the Fed left rates unchanged. The Fed reasoned that lags between changes in monetary policy and their effects on the economy meant that earlier rate increases would continue to reduce inflation. In December 2023, most Fed officials anticipated that the Fed would reduce rates by a projected cumulative 0.5-1.25 percentage points in 2024. In January 2024, with new data that overall and core inflation were both below 3%, the Fed shifted its language from "additional policy firming" to "moving into better balance," which market participants interpreted as the Fed planning to begin reducing rates in the first half of 2024. For example, after the Fed's January meeting, futures markets predicted a 94% chance that rates would be cut by May 2024.

The Fed would like to eventually reduce rates, because it believes, as articulated by the chair, that the current interest rate target is too high to be consistent with maintaining full employment and a robust expansion once inflation has returned to 2%. It would like to avoid a "hard landing," where high interest rates trigger a recession. Therefore, the Fed's goal is to reduce rates but not until it "has gained greater confidence that inflation is moving sustainably toward 2%." According to this position, inflation does not have to fall to 2% before rates are cut—rather, the Fed must have confidence that inflation is heading toward 2%. It first used this language in January 2024. Since then, it has backed off near-term rate cuts because the deceleration in inflation has stalled out. Since December 2023, overall inflation has not changed, and core inflation has fallen by less than ¼ of a percentage point. Although it is close to 2%, those measures of inflation cover the past 12 months, which includes several months of very small changes to the price indices in 2023 that bring down the average. By contrast, the one-month changes in prices in most months in 2024 have been high enough—with the exception of May, which was very low—that, were they to continue in the coming months, the 12-month inflation rate would start rising again as the low inflation months from 2023 drop out of the data. In June, most Fed officials anticipated that the Fed would reduce rates by a cumulative 0.25-0.5 percentage points in 2024, but some did not anticipate that rates would be cut at all.

Looking Ahead

Because rates have been above 5% for over a year, the lagged effects of monetary policy are largely working through the economy at this point. It is increasingly unlikely that the current stance of monetary policy alone will cause a hard landing, and private forecasters have lowered their probability of the economy entering a recession in the near term. So far, the Fed believes that the current level of rates will eventually reduce inflation to 2% if left in place long enough. One reason that it might prove to be correct is because, as inflation has fallen and nominal (i.e., not adjusted for inflation) interest rates have stayed the same, real (i.e., inflation-adjusted) interest rates have risen. Because economic activity is primarily influenced by real rates, the same nominal rate is more contractionary today than it was in July 2023. But at some point, if the decline in inflation continues to stall out, the Fed may need to consider whether somewhat higher rates are needed to reduce inflation and how that would affect the odds of a recession.

Author Information

Marc Labonte
Specialist in Macroeconomic Policy

Disclaimer