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Beyond the Numbers...



How the Federal Reserve Fights Inflation



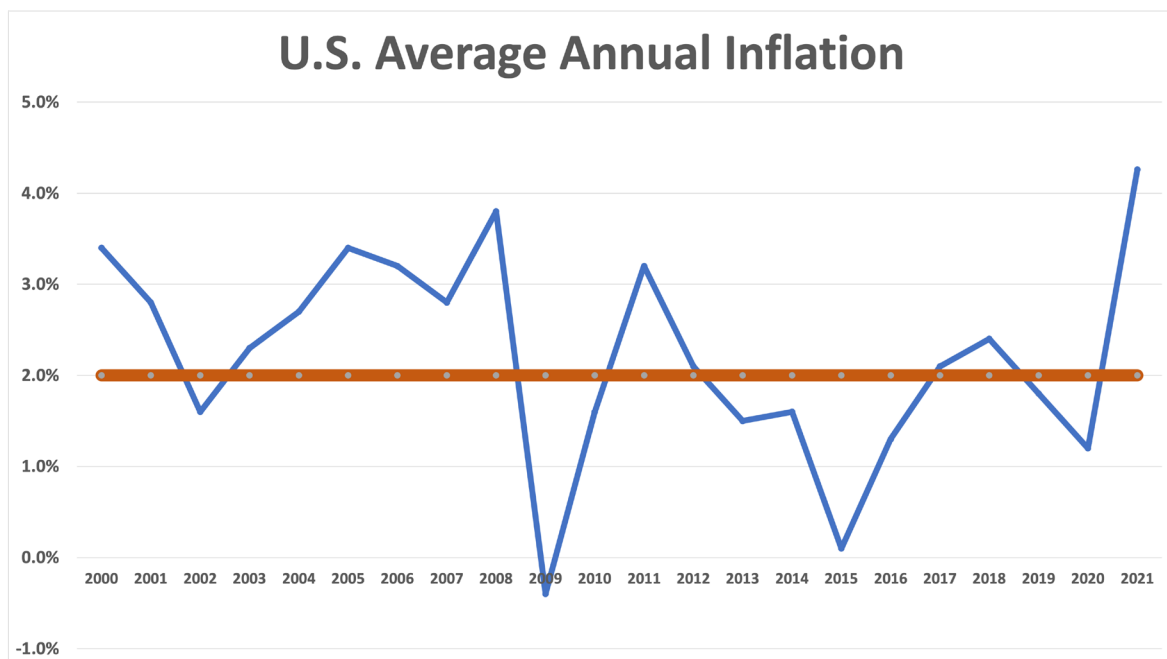
Whether it's inflation or interest rates, the U.S. Federal Reserve is always at the center of the conversation. With inflation recently rising to levels not seen in decades, the topic, and the Fed's role in it, is once again at the forefront of the economic and political dialogue.

The Fed plays a leading role in the conversation because of the two coequal goals Congress has assigned to it, known commonly as the "dual mandate." The first mandate is to reach maximum employment when all who are willing and able to work have the opportunity to do so. The second mandate is stable prices, keeping inflation in check and at a stable rate.

What is the ideal rate of inflation?

The Fed has set the ideal average rate of inflation at 2%, as measured by the annual change in the price index for personal consumption expenditures. While the 2% rate does not appear in the Congressional mandate, it is the level that Fed leaders have identified as being the healthiest for the overall economy.

As inflation has increased past the 2% mark, what are the Fed's tools to manage the inflation rate?



The Federal Funds Rate

The Federal Open Market Committee typically meets eight times a year to discuss and decide on monetary policy, which includes setting the target for the Federal Funds Rate, better known as the “interest rate.” This is the interest rate that financial institutions charge one another for loans in the overnight market for reserves. A change in the Federal Funds Rate creates shifts in other interest rates such as mortgage rates, credit card rates, or what a bank pays for deposits.

There is typically an inverse correlation between interest rates and inflation. When interest rates decline, consumers tend to borrow and spend, resulting in greater demand and economic growth. This tends to cause prices to increase and results in higher inflation. When interest rates increase, consumers tend to borrow less and save more, resulting in less demand, slower growth, and lower inflation.

Open Market Operations

When the Fed sets the target for the Federal Funds Rate, it uses Open Market Operations to achieve the target interest rate. More specifically, the Fed buys and sells U.S. government securities to bring the federal funds rate and the target rate set by the FOMC into alignment. To increase interest rates, the Federal Reserve will increase its sales of U.S. government securities such as U.S. Treasury Bonds, which drives the price of the bonds down and raises interest rates. Conversely, to decrease interest rates, the Federal Reserve will increase its purchases of U.S. Treasury Bonds, which drives the price of the bonds up and lowers interest rates.

The interest rate of a bond is determined by its price. For example, let's say a \$100 bond that comes due in one year costs \$80. The purchaser of that bond would earn \$20, which is 25% interest for the one year. If the price of the bond increased to \$90, it would provide \$10 in earnings or 11.11% in interest. Therefore, when the demand for bonds increases, the price of the bonds will also increase, and interest rates will come down.

When the Federal Reserve buys and sells bonds, it not only affects interest rates, but also changes the amount of money in the financial system. The Federal Reserve will purchase U.S. Treasuries with newly printed money to increase the money supply for banks and other financial institutions.



When banks have more cash, they will increase lending to consumers and businesses to earn interest on those funds. This lending has an expansionary effect on the economy by increasing consumer demand and putting upward pressure on inflation.

The Discount Rate

The other rate that the Fed sets is the Discount Rate which is the interest rate charged to financial institutions when borrowing money on a short-term basis from the Federal Reserve Bank. Banks take loans from the Federal Reserve as a last option for liquidity to remain solvent and typically only borrow from the Fed if they are unable to raise funds from other banks.

Raising the Federal Discount Rate, and thereby charging more to banks for short-term borrowing, is one of the ways the Fed fights inflation.

Reserve Requirements

Banks and depository institutions are required to maintain a certain level of cash reserve in relation to the amount of money they have lent to borrowers. Reserves help to ensure a bank has funds available in the event of sudden withdrawals. With authority given by Congress, the Fed has the discretion to set those reserve rates, which are another tool used to stave off inflation or increase it if necessary.

Reserves impact financial institutions by playing a role in how much they can loan out. For example, if an institution must keep a certain amount in the reserve, they cannot use those reserved funds for loans or other products. With less funds, lenders are likely to be more selective in their approvals which leads to less money in the financial system. The result is lower inflation.



Final Thoughts

Reserve requirements, the discount rate, and open market operations are all pieces of the Fed's toolkit to adjust long-term economic trends. As inflation continues to rise, we will surely see several of these tools deployed to stabilize the financial markets and prices. If you would like to discuss how inflation might affect you and your business and strategies you might employ to reduce its impact, please contact our office.



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