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Do the Effects of Interest Rate Changes Depend on Inflation?

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When inflation is persistently high, the economy reacts to monetary policy more slowly and with more volatility.

Inflation, as measured by the 12-month change in the consumer price index, fell from a peak of 9 percent in June 2022 to 3.7 percent in August 2023. Despite this decline, inflation remains well above the Federal Open Market Committee's longer-run objective of 2 percent. In recent decades (starting in the mid-1990s), inflation generally averaged below 2 percent, contrasting with periods of high inflation in the 1970s and 1980s. Accordingly, many economists have interpreted inflation rates over time as being persistently "high" or "low." These regimes may influence how monetary policy affects the economy.

In this article, Dimitris Christopoulos, Peter McAdam, and Elias Tzavalis assess whether U.S. monetary policy (represented by the path of the federal funds rate) has different effects on the economy depending on which inflation state the economy is in. They find that the economy reacts more slowly and with more volatility to a change in monetary policy in a high-inflation state than in a low-inflation state. They also find that in a high-inflation state, interest rates must be held higher for longer to bring inflation back down relative to a low-inflation state.

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