Infographic on

INFLATION

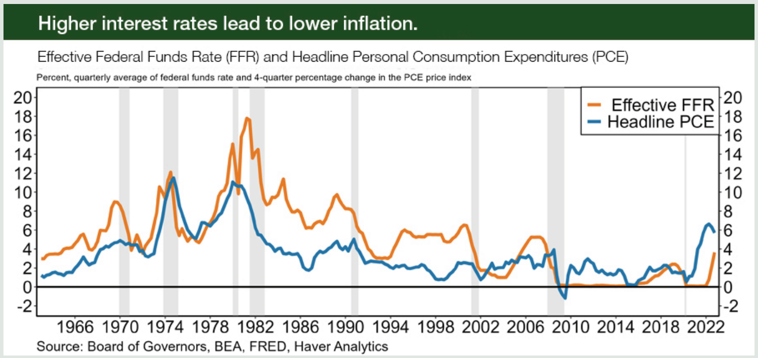
How does raising interest rates help to lower inflation?

When inflation rises and is expected to remain at unacceptably **high** levels, **policymakers** at the Federal Reserve act to return inflation to the Fed's longer-run goal of 2 percent. To achieve this outcome, policymakers mostly rely on **raising interest rates**. But how does this work?

Inflation depends on three factors: demand conditions, supply conditions, and inflation expectations. While **the Fed can't influence the *supply*** of goods and services, it **can influence *demand*** for goods and services. The Fed does this by changing an interest rate called "the federal funds rate," which, when increased, usually causes other interest rates to eventually rise.

Higher interest rates make borrowing more costly for mortgages, auto loans, and credit cards, and this in turn **slows the demand** for houses, vehicles, and other items bought with credit.

The effects of higher interest rates eventually spread from sectors that are sensitive to interest rates to other parts of the economy. For example, when auto loans become more expensive, slowing the demand for vehicles, the demand for steel slows, too. Steel mills may respond by slowing their demand for raw materials required for production.



When overall demand for goods and services in the economy **starts to slow, inflation should start to move down**.

An increase in interest rates can also lower inflation by influencing inflation expectations, or the rate at which the public expects prices to rise in the future.

Economic decisions not only depend on past and current events, but also on what is expected in **the future**: If businesses and households expect inflation to remain elevated, they will incorporate this belief into their savings and investment decisions as well as the prices they charge and the wages they bargain for. Once this happens, it is much more difficult and costly to bring inflation down.

Interest rate increases should **keep inflation expectations stable and help** the Fed **put inflation on a downward path** back to 2 percent.

THE BOTTOM LINE

When Fed policymakers view the trajectory of inflation as unacceptably high, the Fed increases the cost of borrowing money to slow people's demand for goods and services and to stabilize people's inflation expectations in order to achieve its 2 percent inflation objective.

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