September 2023

Interest Rates Could Remain High Heading Into 2024

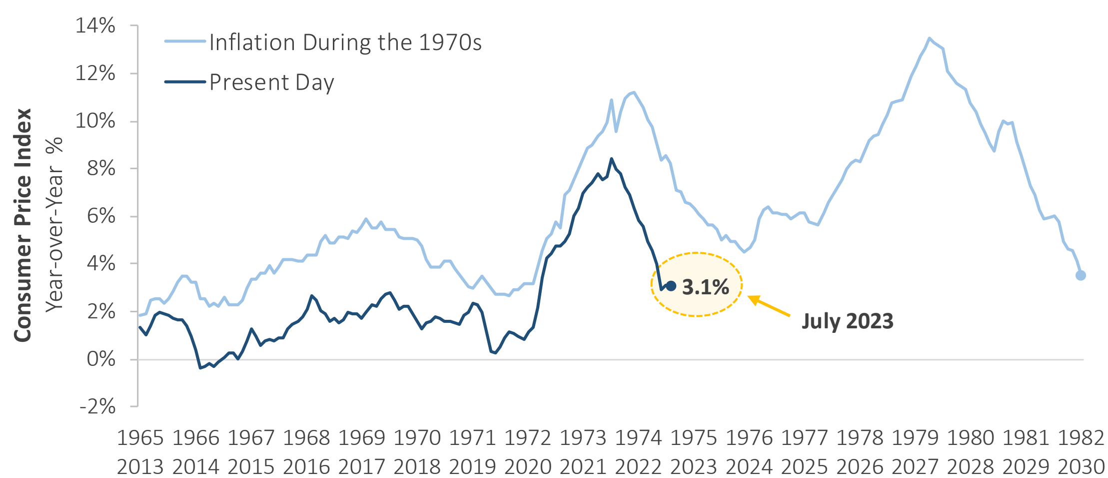
The current economic environment is drawing comparisons to the 1970s. In the early 1970s, oil prices surged following OPEC's oil embargo, and U.S. fiscal deficits expanded as government spending increased. Today, oil prices are elevated due to supply concerns, and fiscal deficits are expanding as the government invests in infrastructure improvements and renewable energy. While the 1970s and today share rising oil prices and budget deficits, the most direct link between the two periods is high inflation, as shown in Figure 1 below.

The chart compares the path of inflation during the 1970s and today. The numbers differ, but a similar pattern emerges. In both periods, inflationary pressures began building early when interest rates were low in the 1960s and 2010s, respectively. Inflation subsequently eased as economic activity slowed around the 1970 recession and the 2020 COVID pandemic. However, inflation later reversed higher in both periods, with oil prices spiking in the early 1970s and supply chain disruptions following the 2020 pandemic. In both instances, the Fed responded by aggressively raising interest rates, causing inflation pressures to ease.

However, the 1970s serve as a cautionary tale, as inflation reaccelerated to over 13% by the end of the decade. The rapid rise in inflation prompted the Fed to take drastic action and raise the federal funds rate to a staggering 20% in early 1980. An inflation resurgence like the late 1970s is the primary risk today, which is why the Fed is hesitant to declare victory despite the recent dip in inflation. The Fed's fear is that the economy will reaccelerate, and inflation will run away like in the late 1970s. While this is not necessarily the Fed's forecast, it is widely discussed as a potential risk.

The Fed is determined to avoid repeating its errors from the 1970s. The implication is that the Fed may decide to keep interest rates higher for longer, which could keep the cost of capital high in the coming years. Consumers may find it more expensive to buy homes and vehicles or refinance their existing mortgages. Likewise, businesses may find it more expensive to fund operations, finance inventory, and reinvest in their business. Given this uncertainty, it is wise to take a long-term perspective when dealing with interest rates. Borrowers can put themselves in a difficult position if they take out a loan with the expectation of refinancing, only to find that rates remain high.

FIGURE 1 – Inflation as Measured by the U.S. Consumer Price Index (Year-Over-Year % Change)



Source: Department of Labor. Data is seasonally adjusted (December 1965 to December 1982; December 2013 to July 2023).