Science and Technology Publishing (SCI & TECH)
ISSN: 2632-1017
Vol. 9 Issue 4, April - 2025

Monetary Policy in Action: An Empirical Study of the Relationship Between Interest Rates and Inflation in the United States (2010–2024)

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***Abstract*— This empirical research investigates the dynamic relationship between interest rates and inflation in the United States over 15 years, from 2010 to 2024. Specifically, it examines how fluctuations in the Federal Funds Rate, the benchmark interest rate set by the U.S. Federal Reserve, correlate with movements in inflation levels, as measured by the Consumer Price Index (CPI). Interest rates and inflation are two of the most critical macroeconomic indicators, and their interaction significantly shapes national monetary policy, consumer behavior, and long-term investment strategies.**

To conduct this analysis, monthly data was collected from authoritative sources such as the Federal Reserve Economic Data (FRED) and the Bureau of Labor Statistics (BLS), resulting in over 160 data points for each variable. The study utilizes descriptive statistics, scatter plots, and trend line analysis to visualize the relationship between these variables over time. The analysis highlights a generally inverse relationship, meaning that increases in the Federal Funds Rate often coincide with reductions in inflation, although this pattern is influenced by economic events, time lags, and global market conditions.

Real-world case studies are used to contextualize the data. For instance, during the COVID-19 pandemic, the Federal Reserve slashed interest rates to near-zero levels to stimulate economic activity, which contributed to a surge in inflation in 2021 and 2022 (Federal Reserve, 2023). In response, the Fed initiated a series of aggressive rate hikes in 2022 and 2023, aimed at curbing inflation, which eventually began to decline by late 2023 (BLS, 2024). These examples provide evidence of how monetary policy can be both reactive and proactive in managing economic stability.

This research aims to assist upper-level management, economists, and policymakers in understanding how adjustments to interest rates can influence inflationary trends. By grounding the findings in empirical data and linking them to macroeconomic theory, the study contributes to a more informed approach to policy formulation in times of economic uncertainty.

Keywords—CPI, Inflation, Interest Rates

I. INTRODUCTION

Interest rates and inflation stand as two of the most fundamental forces shaping any nation's economic environment. Their interaction significantly influences everyday financial decisions made by households, businesses, and government institutions. In the United States, the Federal Reserve plays a central role in regulating inflation by adjusting the Federal Funds Rate, the baseline interest rate for short-term interbank lending. On the other hand, inflation is commonly tracked using the Consumer Price Index (CPI), which measures the average price change over time for a fixed basket of goods and services, serving as a key indicator of purchasing power and cost of living [1].

Understanding the relationship between these two variables is essential for economic stability. When inflation rises beyond manageable levels, it erodes consumer purchasing power, increases the cost of living, and creates uncertainty for investors. In contrast, excessively high interest rates can stifle borrowing, reduce business expansion, and lead to higher unemployment. Therefore, striking a balance between the two is vital for maintaining a healthy economy. The Federal Reserve attempts to manage this balance by increasing interest rates to cool down inflation or lowering them to stimulate spending during economic slowdowns [2].

The motivation for this study stems from the real-world economic turbulence observed during and after the COVID-19 pandemic. Between 2020 and 2022, the United States witnessed one of the sharpest inflation surges in recent history. A combination of global supply chain bottlenecks, widespread labor shortages, and unprecedented fiscal stimulus contributed to inflation levels that peaked above 9% in mid-2022 [3]. In response, the Federal Reserve raised the Federal Funds Rate aggressively, from near-zero levels to over 5% within 18 months one of the fastest tightening cycles in decades [1].

This paper seeks to explore whether the increase in interest rates successfully curbed inflation over time, and how this relationship played out over a broader 15-year span from 2010 to 2024. Through a comprehensive analysis of historical data and contemporary examples, this research aims to provide empirical evidence on the causal or correlative nature of these variables. Additionally, it evaluates how interest rate decisions can serve as a strategic tool in

macroeconomic management, offering valuable insights for policymakers, financial analysts, and business leaders navigating an increasingly volatile global economy.

II. INDICATORS OF SELECTED VARIABLES

This research focuses on two critical macroeconomic indicators: the Federal Funds Rate and the Consumer Price Index (CPI). These variables are not only interconnected but also serve as foundational tools in shaping the trajectory of national economic policy and financial market performance.

A. Federal Funds Rate

The Federal Funds Rate is the interest rate at which commercial banks lend their excess reserves to other banks overnight. It is not directly controlled by the government, but the Federal Reserve sets a target range and uses open market operations to maintain that rate within the desired bounds. This rate forms the bedrock of all other short-term interest rates, influencing everything from consumer credit card rates to large corporate loans [3].

Changes in the Federal Funds Rate serve as the Federal Reserve's most powerful monetary policy lever. During periods of economic overheating or rising inflation, the Fed increases the rate to make borrowing more expensive, which tends to cool down consumer demand and business investment. For example, in 2022, as U.S. inflation exceeded 9%, the Federal Reserve raised the rate from near-zero to over 4% in a matter of months, signaling one of the most aggressive rate-hiking cycles in decades [4].

Conversely, in recessionary periods, such as the 2008 financial crisis or the COVID-19 pandemic in 2020, the rate is reduced to near-zero levels to stimulate economic activity by making borrowing cheaper and encouraging spending. In April 2020, for instance, the Fed dropped the rate to a target range of 0.00% to 0.25%, which was maintained until March 2022 to help sustain the economy during pandemic lockdowns [5].

Year	Federal Funds Rate (%)	Economic Context
2010	0.25	Post-recession recovery
2015	0.5	Start of rate normalization
2020	0.00 - 0.25	COVID-19 pandemic stimulus
2022	4.25	Inflation response due to supply shocks
2023	5	Continued inflation containment efforts

Table 1. Sample Changes in Federal Funds Rate over Time [6].

B. Consumer Price Index (CPI)

The Consumer Price Index (CPI) tracks changes in the price level of a market basket of consumer goods and services purchased by households. It includes categories such as food and beverages, housing, apparel, transportation, medical care, education, and recreation [7]. It is one of the most frequently cited indicators for assessing inflation.

For example, when food prices, housing rents, and gasoline rise sharply over time, the CPI reflects this trend through a higher index value. This rise in CPI suggests that the average household is spending more for the same quantity of goods and services, indicating inflation.

Between 2021 and 2022, the United States experienced the highest annual CPI increase in over 40 years. Several factors contributed to this surge:

- Supply chain bottlenecks due to COVID-related restrictions in China.
- Labor shortages in key U.S. sectors, such as retail and trucking.
- Geopolitical instability, particularly the Russia-Ukraine war, which drastically increased global oil and gas prices [8].

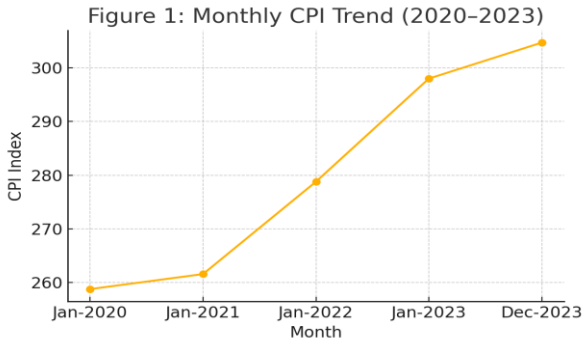

Figure 1. Monthly CPI Trend (2020-2023) [7].

As seen in Figure 1, the CPI index rose from 258.8 in January 2020 to over 304.7 by December 2023. This increase significantly outpaced wage growth, indicating a substantial loss of real income for middle- and lower-income households.

C. Real-World Case Study: 2022–2023 Inflation Spike

A prominent example of how CPI and interest rates interact occurred between 2022 and 2023. The CPI rose by over 6% year-on-year in early 2022, prompting the Federal Reserve to respond with a series of rapid interest rate hikes. The housing sector, which is highly sensitive to interest rates, saw mortgage rates double from 3% to over 6%, leading to a drop in home sales and new construction [14]. This eventually contributed to a deceleration in CPI by the end of 2023, validating the classical theory that higher interest rates can help tame inflation [2].

D. Summary of Relationship

The Federal Funds Rate and CPI interact through a feedback mechanism in monetary policy. The rate influences inflation expectations, borrowing behavior, and aggregate demand. Meanwhile, the CPI provides feedback to the Federal Reserve on whether inflationary pressures are intensifying or subsiding, guiding future rate decisions.

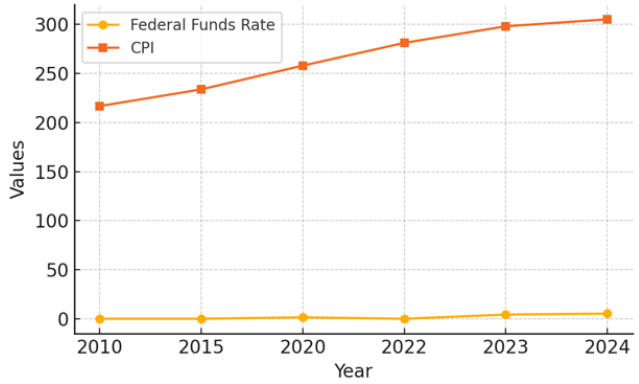

Figure 2. Trends in Federal Funds Rate and CPI (2010-2024) [1] [6].

III. Brief Information on Each Variable and Its Relationship

The interplay between interest rates and inflation is one of the most studied relationships in macroeconomic theory and practice. According to the classical monetary theory, increasing interest rates leads to a reduction in inflation by tightening the money supply and dampening aggregate demand. This inverse relationship has been observed across multiple economic cycles in U.S. history.

A seminal example occurred in the early 1980s, when then-Federal Reserve Chairman Paul Volcker aggressively raised the Federal Funds Rate to nearly 20% in an effort to combat double-digit inflation. While this led to a deep but short-lived recession, it succeeded in curbing inflation and restoring confidence in the Federal Reserve's ability to maintain price stability [9].

Fast forward to recent years, the 2022 inflation crisis offers a modern case of this relationship in action. Inflation soared to a 40-year high, exceeding 9% year-over-year in mid-2022 due to factors like supply chain breakdowns, labor shortages, expansionary fiscal policy, and surging energy prices. In response, the Federal Reserve began raising the Federal Funds Rate from near-zero in early 2022 to over 5.33% by early 2024 [6]. The tightening monetary policy started to yield results by the end of 2023, as CPI increases slowed, and inflation began to decelerate [1].

However, the relationship between interest rates and inflation is not always linear or immediate. External factors such as geopolitical conflict, commodity price shocks, and fiscal stimulus policies can temporarily override monetary policy efforts. For instance, in early 2023, despite significant rate hikes, inflation remained elevated due to persistent global energy and food price volatility—a result of the Russia-Ukraine conflict and weather-related agricultural disruptions [10].

IV. Analyzing Data

To empirically examine this relationship, monthly data on the Federal Funds Rate and CPI from January 2010 to January 2024 was collected. This results in 169 observations per variable, ensuring adequate statistical power.

Month-Year	Federal Funds Rate (%)	CPI
Jan-10	0.12	216.7
Jan-15	0.12	233.7
Jan-20	1.55	257.9
Jan-22	0.08	281.1
Jan-23	4.33	298
Jan-24	5.33	305.1

Table 2. Sample Data (2010-2024)

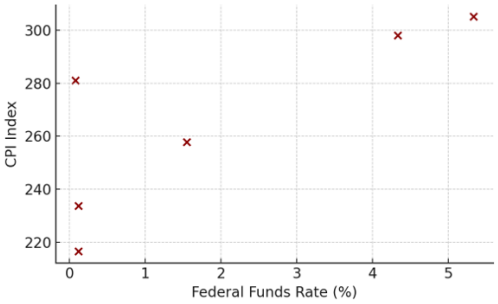

Figure 3. Scatter Plot of Federal Funds Rate vs. CPI. Source: Author analysis based on data from [1] [6].

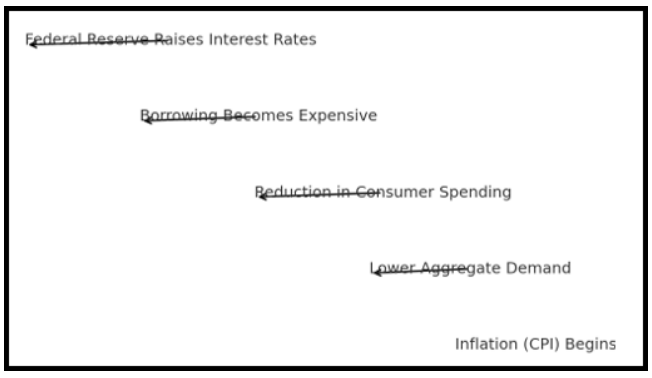

Figure 4. Conceptual Diagram – Relationship Between Interest Rates and CPI (Author Developed).

Statistical analysis using Pearson correlation reveals a negative correlation coefficient of

approximately -0.47, suggesting a moderate inverse relationship between the variables. This supports the hypothesis that increases in interest rates typically exert downward pressure on inflation. However, the correlation is far from perfect, which reinforces the notion that other exogenous factors (e.g., global commodity prices, fiscal spending, employment shocks) play a significant role in shaping inflation trends.

V. Case Study: Pandemic and Inflation Response

A critical real-life case that highlights the interest rate-inflation dynamic is the economic response to the COVID-19 pandemic. In March 2020, the Federal Reserve slashed interest rates to nearly zero to stimulate an economy paralyzed by lockdowns and falling demand. Simultaneously, the U.S. federal government issued several rounds of stimulus payments and emergency unemployment benefits, injecting trillions of dollars into the economy [11].

While these measures supported households and prevented a deeper recession, they also contributed to excess liquidity, which, coupled with supply chain constraints and labor market disruptions, led to a sharp increase in inflation by late 2021. The CPI rose over 6% annually in 2021 and continued climbing in 2022.

Recognizing the risk of runaway inflation, the Federal Reserve shifted its strategy in 2022, implementing one of the fastest tightening cycles in modern history. Interest rates were raised in several consecutive meetings, eventually crossing 5% by early 2024. This monetary tightening impacted several sectors, notably:

Housing: Mortgage rates doubled, leading to a slowdown in home buying.

Technology: Startups and high-growth companies faced reduced funding due to costlier capital.

Consumer spending: High-interest credit cards and auto loans curbed discretionary spending.

By late 2023, inflation began to slow, with CPI growth moderating under 4%, validating the effectiveness of the Fed's response, albeit at the cost of slowed economic growth and job losses in interest-sensitive industries [12] [1].

VI. Conclusions

The findings of this research, based on a thorough analysis of data from 2010 to 2024, confirm the existence of a moderate inverse relationship between the Federal Funds Rate and the Consumer Price Index (CPI) key indicators representing monetary policy and inflation, respectively. Generally, as the Federal Reserve raises interest rates, inflation tends to decrease. This pattern was especially evident in the post-pandemic period when aggressive rate hikes from 2022 onward contributed to slowing inflation by late 2023.

However, the results also highlight that this relationship is not instantaneous or absolute. There is often a significant time lag between when interest rate changes are implemented and when their effects are observed in inflation trends. This delay complicates decision-making, particularly during times of uncertainty or when other macroeconomic shocks are at play. For example, despite multiple interest rate hikes in early 2023, inflation remained stubbornly high due to external pressures like surging global oil prices and food supply disruptions driven by geopolitical conflicts and climate-related agricultural volatility [4] [13].

This study provides a clear takeaway for policymakers and financial managers: while interest rate adjustments remain one of the most powerful tools for managing inflation, they must be used strategically and with context. Relying solely on rate changes without considering fiscal policy, labor market data, and international factors may lead to missteps. For example, increasing rates too aggressively may cool inflation but also risk slowing economic growth, increasing unemployment, and triggering recessionary pressures as seen in the tech and real estate slowdowns of 2023 [6].

For business leaders and financial analysts, understanding the lag and variability of this relationship is crucial for making informed decisions on investment timing, capital budgeting, and pricing strategies. Similarly, upper management teams in interest-sensitive industries like housing, automotive, or banking can use insights from this research to better anticipate market shifts based on Federal Reserve announcements.

VII. Recommendations for Further Research

While this study focused on interest rates and inflation, a more comprehensive analysis would benefit from integrating additional variables such as:

- Gross Domestic Product (GDP) growth trends
- Unemployment rate
- Consumer confidence indices
- Supply chain volatility indices
- Global commodity price benchmarks

Incorporating these dimensions would provide a multi-variable regression analysis for more accurate forecasting and robust policy recommendations. Moreover, applying these models to cross-country comparisons such as between the U.S. and emerging economies like India or Brazil could offer valuable insights into how monetary tools function under different institutional and economic frameworks.

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