Fed Meeting Preview: Loosening the Reins on Inflation

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In late August, the Federal Open Market Committee (FOMC) released a statement that raised some new questions about how it would set fed interest rates in the future. Next week's FOMC meeting could provide some answers to those questions.

A revision to the FOMC's long-term policy approach states that the Fed will be less concerned with controlling inflation in the near term.

That could have a huge impact on your finances, affecting everything from whether your savings account can keep up with inflation to how much you'll need to retire.

New Fed Interest Rate Policy is More Tolerant of Inflation

On August 27, the FOMC issued a revision to its Statement on Longer-Run Goals and Monetary Policy Strategy. These revisions give the Federal Reserve more wiggle room to let inflation rise at times.

The previous Statement on Longer-Run Goals and Monetary Policy Strategy issued in early 2012 stated that fed interest rate policy would be based in part on maintaining an inflation rate of 2%.

The recent revision softens that policy. While it states that the Fed's goal is still for inflation to average 2% over the long term, it will allow inflation to rise above 2% at times.

Significantly, the revised statement says that, following periods when inflation has been running below 2%, the Fed will be more likely to allow inflation to rise above 2% for a while.

Fed Rate Hikes are Less Likely Under the New Policy

It remains to be seen exactly how the FOMC will implement this policy adjustment. People will be watching next week's Fed meeting for clues, but it might be some time before the Fed takes action on the new policy.

In fact, the new approach might be more a matter of what the Fed doesn't do than what it does. When the economy begins to recover, the Fed might be very slow to raise interest rates even if inflation starts to rise.

Since inflation has consistently been below 2% for the past dozen years, the Fed's new policy gives it latitude to allow inflation to run above 2% for quite a while now to make up for it.

Interest rates are a key tool the Fed uses to try to control inflation. When concerned about rising inflation, the FOMC is more likely to increase the federal funds rate. This not only helps rates keep up with inflation, but it can put a damper on inflation by raising the cost of borrowing.

However, with the Fed now inclined to allow interest rates to rise above 2% for a while, a fed rate hike is less likely. The new policy suggests that we may not see fed rate hikes unless inflation starts to get out of hand, persistently rising above 2%.

A Backdoor to Negative Interest Rates?

Giving inflation more latitude to rise may be a backdoor to implementing a controversial policy that has been discussed a great deal over the past couple years - negative interest rates.

In response to the Great Recession and earlier this year in response to the coronavirus pandemic, the FOMC practically brought rates down to 0%. That's because low interest rates can stimulate the economy by making it cheaper to borrow money.

Some question whether rates should go lower than 0%. Central banks in some countries have actually set rates in negative territory in an extreme attempt to stimulate their economies.

It has not been proven whether negative interest rates actually help the economy. However, by allowing inflation to rise well above the fed interest rate, the FOMC could subtly accomplish the same thing.

With the prices of things rising faster than the cost of borrowing to buy those things, when adjusted for inflation interest rates would be negative. Thus, the FOMC can achieve rates that are effectively negative without having to make the controversial move of issuing negative interest rates.

What the New Fed Interest Rate Policy Means for Consumers

So what does all this mean to you?

The prospect of inflation being allowed to run well above interest rates could affect your finances in a number of ways:

The Fed is favoring borrowers at the expense of savers

The fed interest rate is already well below its historical norm, on both an absolute and inflation-adjusted basis. The Fed's new policy suggests more of the same may be on its way.

Lower-than-normal interest rates are great for borrowers. They're not so good for savers, who will see less reward for their savings.

Average savings account rates could lose more ground to inflation

The most recent MoneyRates.com America's Best Rates Survey found the average savings account rate to be 0.274%. Meanwhile, inflation over the past year has been about 1%.

When the inflation rate is higher than savings account rates, the money in savings accounts loses purchasing power. With the Fed stating that it may keep rates low even if inflation rises, expect more of the same.

There is one way to fight back against this. MoneyRates found some savings account rates that were more than a full percentage point above the industry average.

So, if you want to give your savings a better chance of keeping up with inflation, don't settle for average. Shop for one of the highest savings account rates.

Retirement planning just got harder

The Fed's new approach could deal a double blow to people saving for retirement.

Retirement planning includes two assumptions: how much your investments will earn over time and how much inflation will raise the amount of money you need for retirement.

Keeping interest rates unusually low could result in retirement savings earning a lower return. Meanwhile, allowing higher inflation could mean it will take more money to afford a decent retirement.

This puts pressure on workers to set aside more money for retirement and to consider investing more in riskier but potentially higher-returning investments.

More fuel for stock market speculation

The stock market has reached new highs this year despite a recession and no clear end in sight to the pandemic. This makes it seem as though the stock market has become unhinged from the actual economy.

Through the end of August, so far this year the price-to-earnings ratio of the S&P 500 had jumped from 23.16 to 35.30. That means, when you buy a typical stock, it costs you over $35 for every dollar in company earnings you are getting.

A Fed policy of low rates and more latitude for inflation drives investors toward the stock market. Safer investments seem less appealing because they can't keep up with inflation.

High valuations mean the stock market is already a pretty scary place. If the new Fed policy further encourages speculation, it might get scarier still.

The Fed's recent policy adjustment could have a far-reaching impact on your finances. The next Fed meeting might provide a little more clarity on what that impact will be.

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