How is Inflation Shaping the Post-Pandemic US Economy?

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Abstract

Today, the federal funds rate sits at 5.25%-5.50%, a record high since February 2001. The Federal Reserve Bank has been increasing interest rates largely because of stubborn inflation. Since 2021, America has seen high inflation, prompting the Fed to raise rates. This has had a ripple effect on the entire US economy, affecting both consumers and businesses. This literature review was written to understand the cause of the inflation and the effects that inflation has had on businesses, banks, consumers, workers, and families. In conclusion, it can be deduced that increased consumption as a result of the stimulus checks contributed to the high inflation, and when the Fed raised rates, that triggered a series of layoffs, bank failures, and change in consumer behavior.

Keywords
Stimulus Package, CPI, Federal Reserve, Rate Hikes, Layoffs, Unemployment

Introduction

The decisions that those in authority make today will have a profound impact on tomorrow. For example, when the Federal Reserve Bank raised interest rates after the Covid-19 pandemic, inflation had the potential to harm both corporations and the average American citizen. Corporations were faced with expensive credit and consumers faced layoffs as inflation caused more difficult conditions for employment (Alisa 1).

Key Definitions

CARES Act: An act implementing a variety of programs to address the issues onset by the COVID-19 pandemic (“About the CARES Act and the Consolidated Appropriations Act”)
COVID-19 Pandemic: Global outbreak of coronavirus starting in December 2019, an infectious disease caused by the SARS-CoV-2 virus (“Coronavirus disease (COVID-19) pandemic”).
CPI: The Consumer Price Index measures the change in prices of a basket of goods typically consumed by urban households
Monetary Inflation: Rate of increase in prices over time (Oner)
Dovish: Opposite of hawkish; monetary policy favoring achieving maximum levels of employment. Typically achieved by the Fed lowering interest rates (Rodini)
*Rate Hike*s: When the Federal Reserve Bank increases its federal funds rate
Interest rate: Income earned on the funds utilized by the person holding the same .
The Federal Reserve: Central Bank of the US. It provides the nation with a stable monetary system.

The Covid-19 Pandemic Bailout

Recent inflation concerns began when the world locked down in the wake of the March 2020 COVID-19 pandemic. Stores and factories temporarily closed, with many businesses in limbo. The general public’s expectation was that the world would reopen after a few weeks, but as weeks turned into months, the world became anxious. More importantly, businesses became concerned as the jobs deemed non-essential–those not in healthcare or in government–forced workers to “stay-at-home.”

Moreover, United States economic activity came to a halt, with the GDP falling 4.6% quarter over quarter ("Annualized growth of real GDP in the United States from the first quarter of 2013 to the second quarter of 2023"), which prompted a government bailout. A $2.2 trillion stimulus plan, called the CARES Act (Coronavirus Aid, Relief, and Economic Security Act), provided Americans earning less than $75,000 individually or $150,000 as a household with $1,200 or $2,400 stimulus checks, respectively (Sauter).

This included $260 billion in increased unemployment benefits, $350 billion in forgivable loans to small businesses to help cover employee salaries, and $500 billion to large corporations for the same purpose (Snell). According to the Congressional Budget Office, this bill would add $1.7 trillion to the deficit from 2020-2030. A subsequent $900 billion stimulus bill was passed in January 2021, which gave an additional $600 per person or $1200 per household, further increasing the deficit.

The Federal Reserve During the Covid-19 Pandemic

The federal body in charge of controlling the flow of money within the economy is the Federal Reserve. The Federal Reserve also monitors the country's inflation rate. To explain, the inflation rate refers to the rate at which a standard basket of household goods increases in price from one year to the next. In a stable economic climate, as companies hire workers and households have additional income, demand increases, which increases these prices. This is considered healthy inflation, and the federal reserve's inflation target rate is about 2% year over year. This ensures that the US dollar remains stable, with demand and prices remaining predictable. It also encourages the US dollar to remain strong in the global economy.

The Effects of the Stimulus Checks in 2020

However, in 2020, people received thousands of dollars in stimulus checks and benefitted from extended unemployment benefits. This prompted some affected employees to choose to not return to work (Ferguson). This was damaging to an economy that was trying to reopen after the pandemic. Most companies were on a hiring spree as they hoped to return to pre-pandemic profits. Instead, corporate America found previous wages no longer sufficient to hire (Haddon 2). This forced firms to increase wages. Businesses passed on this added cost to consumers in the form of rising prices. These price increases are recognized as inflation.

Another impact of the stimulus checks is that it helped create an unsustainable, artificial level of demand. For many people, the stimulus money exceeded their previous income. So what became of this additional disposable income? In many cases, it became a temporary spike in household savings ("United States Personal Savings Rate") and luxury spending (Baker et al. 2). Increases in demand caused prices to rise, spiking inflation. However, this increase in demand was artificial and unsustainable. As the stimulus money ended, many consumers were no longer able to afford these products. Prices, however, continued to increase ("12-month percentage change, Consumer Price Index, selected categories").

These price increases were reflected in the monthly Consumer Price Index (CPI) data. The CPI is the general indicator that investors and experts use to gauge inflation in America. According to the Bureau of Labor Statistics (BLS), the year-over-year percent change of the CPI exceeded the target rate of 2% in April 2021, when the CPI reported a 4.2% increase in prices year over year (2021). However, the Federal Reserve Bank remained dovish, opting not to raise interest rates so as to not stymie the labor market recovery (Schneider and Saphir).

The Fed's "interest rate" is the federal funding rate, and it serves as the rate at which banks can borrow money from the government. This rate is used as a benchmark for banks when lending to consumers. The rate from March 2020 to March 2022 was 0.25%, a historically low amount. This meant that banks, after taking into account inflation, had a negative or near-zero real interest rate.

Companies Take Advantage of Low Rates

Additionally, one way for the Fed to close the deficit is to increase this interest rate. But, the Fed did not want to raise interest rates too quickly out of fear that this would exacerbate unemployment. America was just coming out of the pandemic; businesses were finally opening back up, people were returning to work, and unemployment was going down. The Fed did not want to stunt and possibly reverse this recovery by increasing rates. Fed Chairman Jerome Powell testified before a House panel in June 2021 that he believed the price pressures from the rising demand and bottlenecks in supply would ease on their own.

As a result of the low cost of borrowing, many businesses, especially in tech, energy, and finance, initiated a hiring frenzy. Microsoft increased their workforce by 22% from June 2021 - June 2022, Meta increased theirs by 30% in 2020, and Alphabet added 15% to their workforce in 2021 (Leswing and Cortés). Low interest rates made it possible for companies, both big and small, to borrow large sums of money. Cheap capital allowed companies, especially start-ups, to grow their businesses meteorically. As a result, there was a rapid increase in demand in the job market. In the 4th quarter of 2021, the unemployment rate was 4.2%, down 2.8% year-over-year, with 5.4 million new jobs being added in 2021 (Edwards et al,.). This data further indicated that America was recovering from the pandemic. The Fed used this as rationale to keep interest rates low. However, at the start of 2022, CPI data began to show persistent inflation. This forced the Fed's hand into raising rates.

The Fed Makes Moves

When the Fed started raising interest rates, they increased it aggressively. Between March 2022 and May 2023, the Fed met ten times. From those meetings, the Fed raised rates from 0.25% to 5.25% (Tepper). Following some of these meetings, the Fed went as far as raising 0.75% in one instance. During this period, the CPI data continued to show persistent inflation. For example, from April 2021 to June 2022, annual price inflation increased from 4.2% to 9.1%. 9.1% inflation has not been reached in the US in the last 40 years.

This rapid increase was paused in June 2023 when inflation finally showed signs of cooling, and interest rates were left at 5.25% before resuming again in July (Tepper). The Fed opted to pause the increase to allow time for the rate hikes to fully take effect on inflation. Effects of interest rate hikes typically take anywhere from between 6 months to over 1 year to be felt in the economy.

Impacts of the Rate Hikes

However, inflation is not the only thing on which rate hikes had an impact. Rate hikes also left a profound mark on American businesses and consumers. Prior to the rate hikes, companies enjoyed low borrowing rates. Small businesses–especially tech startups–reaped the benefits of this opportunity. In 2020, small businesses received loans from banks at an average annual percentage rate (APR) of 2.77% (Mak). From 2021 to present day, interest rates for small business loans from banks have steadily climbed to 5.5% APR (Porter). For small

businesses, the rate increase diminished the benefits of borrowing. A lack of capital brought the growth of many small businesses to a grinding halt; they were no longer able to afford their rapid expansion (Griffith).

As these businesses now lacked capital, they were forced to lay off workers. 17.6 million workers were laid off in 2022 alone ("U.S. labor market shows improvement in 2021, but the COVID-19 pandemic continues to weigh on the economy"). Tech companies were hit especially hard by this, including Meta, Google, and Microsoft (Trueman 2). A sea of layoffs and startup closures soon followed. Since this constriction in January of 2022, 250,000 jobs in the tech sector have been cut ("The Crunchbase Tech Layoffs Tracker").

Furthermore, companies that opted not to rapidly downsize may have passed increased costs to consumers in the form of higher prices. This trend is reflected by the persistent inflation consumers continue to experience ("12-month percentage change, Consumer Price Index, selected categories"). The core inflation rate (inflation rate without food and energy, both of which tend to fluctuate greatly) has followed a volatile pattern, varying between 4.3% and 6.6% (as of August 2023) since the Fed first started raising rates in March 2022. As consumers continue to grapple with higher costs, many have changed their spending patterns. To explain, when inflation increases, consumers "trade down" (finding cheaper alternatives to what was previously purchased) in 5 ways: choosing lower prices or lower quantities, switching to inferior goods, prioritizing promotions and discounts, buying in bulk or delaying purchases, and avoiding big-ticket items (Draxl).

Small Banks Collapse

A second ramification of the rate hikes was the failure of small banks. Bank failures occur when the institution is unable to meet its obligations to its depositors and lenders. In the past couple of years, there were numerous startup companies that needed loans to continue expanding. Mostly regional banks, like Silicon Valley Bank (SVB) and First Republic Bank (FRB) were willing to underwrite high leverage loans. Banks needed assets to fill out their balance sheet to meet investors' return requirements. However, higher rates, and less profits as a result of the recessionary environment meant that many of these startup companies defaulted on their loans. Consequently, banks had less capital, which meant they could not pay back their lenders. These defaulting borrowers contributed to pushing banks into a liquidity problem. Compounding the defaulting borrowers was the decrease in the value of treasury bills which hurt the banks' balance sheets. In March of 2023, the recessionary environment and the increasing withdrawals continued to strain the regional banks' reserves. Ultimately, some crumbled like Silicon Valley Bank and Signature Bank, with FRB collapsing in May.

In the aftermath, these collapsed regional banks were purchased by national banks like JP Morgan. As a result of 2023's bank failures, the FDIC agreed to fully insure all depositors. This was done to prevent panic (and potentially bank runs), and increase consumer confidence in the banking industry. Unfortunately, these behaviors also encourage banks to take more risk (Hakenes et al. 2). For example, in the 2008 financial crisis, banks' irresponsible lending practices were ultimately absorbed by the US government.

Conclusion

In conclusion, post-COVID inflation forced the Federal Reserve Bank to raise rates. This increase hurt both corporations and citizens, as corporations dealt with costly credit and citizens suffered layoffs. Stimulus money directly given to consumers led to many unemployed workers

who would not return to work. This created unhealthy wage growth which contributed to inflation, as corporations were forced to pass on the added cost of labor onto the consumers. Inflation also forced the Federal Reserve to aggressively increase interest rates. This put pressure on businesses, who were no longer able to continue their rapid growth as a result of high borrowing costs.

In fact, many startup companies defaulted on their loans. This put many small banks at risk, being the most likely to give out these high-leverage loans. These defaulting loans contributed to a wave of bank failures in March 2023. Due to a lack of capital, revenue dipped and businesses were forced to lay off employees. Those that chose not to lay off workers were instead forced to increase prices, passing on the costs to consumers. This further increased inflation.

A shift in consumer behavior followed, as they opted to trade down to combat rising costs. This catastrophic domino effect impacted people at all economic levels. Preventing a repeat of these events will require government decision-makers, the Federal Reserve Bank, businesses, and consumers to do their part. While the Covid Stimulus garnered great support early on, the longer term impact on the economy ultimately served to crush those it was intended to protect. Controlling inflation and maintaining economic stability and growth is key to preventing the recurrence of the hyperinflation.

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