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High interest rates, rising inflation: The economy still isn't normal

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The economy still isn't behaving the way anyone expected.

The job market is growing at a blockbuster pace, even though high interest rates usually slow hiring or cause layoffs. Consumers are spending on essentials and extravagances alike, suggesting people don't fear trouble ahead. The stock market is up, and worries of a recession have largely faded.

But inflation, after easing remarkably in 2023, has stayed unexpectedly hot since the start of the year. And that's confounding economists and Federal Reserve officials who are still struggling to understand the post-pandemic world.

Higher borrowing costs were widely expected to tackle inflation with full force, to bring the roaring economy crashing down — or both. Instead, things seem to be settling in a confusing spot, with price increases still above normal, but other parts of the economy holding strong, too. The result is more uncertainty for experts, consumers and businesses alike about what might happen next in an economy that is still resisting the usual rules.

"We got through some of that 'transitory' part," said Diane Swonk, chief economist at KPMG, referring to more temporary sources of inflation that drove price increases in 2021 and 2022, such as supply chain problems and energy prices. "We haven't gotten to the fundamental part — and the hard part."

When the year started, it appeared the Fed and White House had pulled off the unthinkable: no recession, easing inflation and a still-booming job market. That momentum led Fed leaders in December to pencil in three interest rate cuts this year, projections they repeated last month.

But then January and February price data came in unexpectedly high. For a while, policymakers hoped those were bumps in the road, not a more worrisome trend. But March data, released this week by the Bureau of Labor Statistics, cemented any lingering doubts.

Officials have long said they need a bit more assurance that inflation is trending down before they can cut rates. But after March's disappointing report, central bankers might be losing the confidence they already had. So long as other strengths like the job market hold up, the Fed won't have a compelling reason to cut rates and take pressure off the economy while inflation keeps festering.

As a result, financial markets and Fed watchers are no longer banking on June for an initial rate cut. The farther the timeline gets pushed back — possibly to Fed meetings in July, September or November — the closer the central bank bumps up against the presidential election, despite concerted attempts to avoid politics at all costs. On the flip side, the longer the Fed leaves rates high, the more it risks softening a generally strong economy just as President Biden and former president Donald Trump duel over who can best manage it.

"The Fed doesn't want to be influenced by the political calendar," said Eswar Prasad, an economist at Cornell University and a senior fellow at the Brookings Institution. "The closer we get to November for that interest rate pivot, the more uncomfortable that is going to be."

Part of the reason officials would otherwise want to cut rates is because too much pressure on the economy can cause other problems, even if inflation ebbs. Rates that stay high for a long time can eventually wear on the job market, persuading employers to stop adding jobs or lay off the staff they already have.

That leaves the Fed to balance its precarious inflation fight against daunting risks. The central bank is charged with keeping inflation in check and maximizing employment at the same time, even though those goals can conflict.

"If we ease too much or too soon, we could see inflation come back," Fed Chair Jerome H. Powell said at a news conference last month. "And if we ease too late, we could do unnecessary harm to employment and people's working lives."

When the Fed raced to hoist interest rates two years ago, the underlying picture was different. Broken supply chains sent prices up for all kinds of goods as people rushed to buy used cars, at-home office equipment and backyard furniture. A jolt of government stimulus also injected fresh demand into the economy, sending checks into peoples' pockets as they filled restaurants, concert venues and hotels that were hobbling back from the pandemic.

The Fed was late to respond. To catch up, officials doled out whopping interest rate hikes to get borrowing costs high enough to slow the economy. The overwhelming expectation was that those moves would cause a recession. Powell warned of pain ahead.

Not only did the Fed avoid a downturn, but inflation came down significantly, too: After peaking at an annual rate of 7.1 percent in mid-2022, the Fed's preferred inflation gauge clocked in at 2.5 percent in February. (Another inflation measure released this week peaked at 9.1 percent in June 2022 and now sits at 3.5 percent.)

Yet it isn't entirely clear how much of that progress came from interest rate hikes alone. Econ 101 teaches that high rates cool demand by making it more expensive to get a mortgage, buy a car or grow a business. But surprises came there, too. The housing market, for example, went through a brief downturn but rebounded quickly. Home prices are still inching up, and many buyers haven't shied from mortgage rates around 6 or 7 percent.

Much of the relief on inflation came from supply chains getting back into gear. Gas and energy costs also fell dramatically, a welcome pivot after they surged following Russia's 2022 invasion of Ukraine.

The stickiest inflation category — which includes services like housing, hospitality, leisure and health care — still hasn't had a major breakthrough.

"We're probably in a much better place than many of us thought we'd be, in terms of a year ago," said Jason Furman, a former Obama administration economist now at Harvard University. "We're in a much worse place than we were hoping three months ago."

At his news conference last month, Powell outlined what it would take to get inflation to hit the Fed's 2 percent target — and put the economy on a path to rate cuts. Goods prices would need to keep simmering down. Housing costs would need to fall in line. Services inflation would need to cool, too.

But he also acknowledged what's still unknown.

"Some combination of those three things" will be necessary, Powell said, "and it may be different from the combination we had before the pandemic."

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