February 6, 2023

Economic INSIGHT

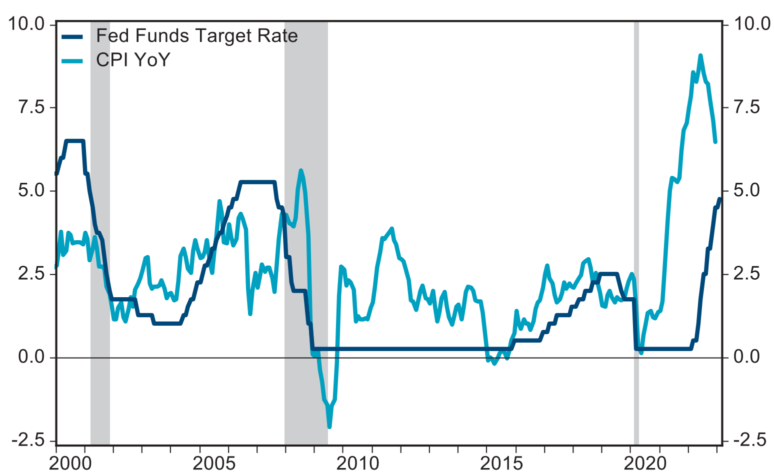
Policy Decision Shifts to Historically Normal Pace

Last week the Federal Reserve (Fed) opted to raise rates 25 basis points (bps), taking the upper bound of the federal funds range to 4.75%, the highest level in more than 15 years. At the same time, it was a retrenchment from recent larger-sized rate hikes. But while modest improvement in inflation may be enough to convince policy makers a slower pace of ascent is appropriate, uncomfortably high price pressures are making it clear more work needs to be done. In other words, a pivot in policy to smaller and historically more normal-sized hikes does not suggest policy makers are considering an outright end to tightening. The Fed may have notched a victory in bringing down peak price pressures, but the war against inflation rages on.

A MORE NORMAL ASCENT TO HIGHER RATES

After lessening the size of rate hikes from 75 bps to 50 bps in December, the Committee further reduced the step up of the federal funds rate to "just" 25 bps at the start of the year. The move returns Fed policy to a more normal upward trajectory and is markedly less aggressive than last year's policy pathway which included an unprecedented four 75-basis-point hikes and marked the fastest increase of the target range in nearly three decades.

Traditionally, as the Fed adjusts to tighter policy, incremental moves are taken in a slow and controlled manner with a baseline of 25 bps. For instance, over a two-year period that began in 2004, the Fed raised rates 17 times in 25-basis-point increments, taking the federal funds rate from 1.00% to 5.25%. Additionally, during a three-year period that began in December 2015, the Fed increased rates in 25-basis-point increments that brought the upper bound of the federal funds rate from 0.25% to 2.50% by the end of 2018. In fact, of the central bank's 50 last policy hikes, 38 have been 25 bps.



Sources: FRB, BLS/Haver

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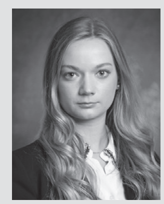

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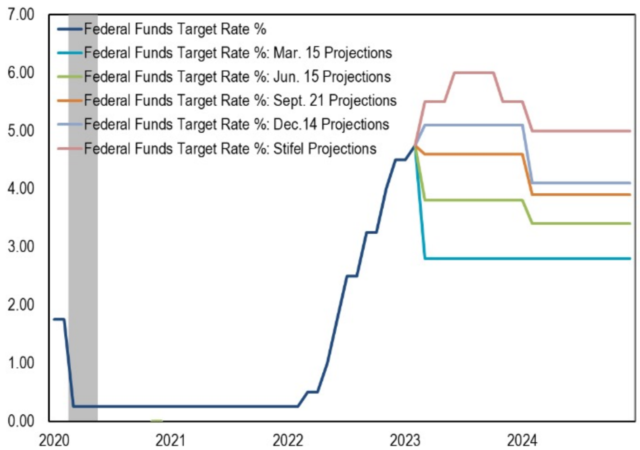
In ’04 and ’15, however, prices peaked at 4.7% and 3.0%, respectively. This time around, massive monetary and fiscal stimulus, supply-side constraints and the Fed’s incomparable commitment to its “transitory” assessment resulted in inflation above 9%, the highest level since the 1980s. Thus, with inflation arguably rising uncontrollably last year, the faster-than-normal increase in rates was warranted. But now, while the inflation battle is far from won, the recent improvement in cost pressures has seemingly convinced Fed officials that the worst of the inflation run up is behind us. In other words, the decision to ratchet up the pace of increases in 2022 reflected the unprecedented post-COVID inflationary environment. The decision to lessen the size of rate hikes reflects a return to a normalized arsenal of weapons in a more traditional battle with prices.

HOLD THE LINE, STAND YOUR GROUND

Looking into 2023, the pathway for rates remains increasingly uncertain. As the Fed seeks to achieve a “sufficiently restrictive” level of policy to reinstate the Committee’s desired condition of stable prices, the still-elevated level of inflation is less convincing to some that price pressures will continue to retreat, let alone that policy has moved into the proper range even under the most generous or optimistic assumptions.

Policy officials have been predicting a meaningful pullback in prices for the better part of the past two years, suggesting an under appreciation for the complicated nature of supply-side pressures. So, while the Federal Open Market Committee (FOMC) may be ushering in a new phase of reduced incremental increases, as long as inflation remains too high, policy will remain on an upward trajectory.



Source: Federal Reserve Board/Bloomberg

Inflation “has eased somewhat but remains elevated,” the February statement read. Therefore, “The committee anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time.” Thus, even with a slower rate of ascension, the terminal rate is still likely to be significantly higher than previously expected.

Inflation does not need to reach the Committee’s 2% target before the Fed backs off from ongoing policy initiatives, although Committee members – some more than others – are well aware that the risk of curtailing inflation-taming action too soon is sufficiently larger than overshooting. The former would potentially allow inflation to become permanently entrenched in the economy. The Fed made a policy mistake early on by maintaining crisis-level accommodation well beyond what was appropriate. Many at the Fed do not want to risk making a second mistake by standing down before the battle is won, a message Federal Reserve Chairman Jerome Powell clearly reiterated during his remarks at Wednesday’s press conference. “We will stay the course until the job is done,” Powell said.

Of course, while inflationary conditions remain far from ideal, some at the Fed are anxious to allow earlier policy initiatives to fully work their way through the system.

GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

YoY – Year over Year

Historically, the lag between monetary policy decisions and the impact on the real economy is said to come with a sizable lag of 6-12 months. New literature, however, suggests the increased level of policy transparency has resulted in more of an anticipatory reaction of financial market conditions, lessening the need for a pause or lookback. While acknowledging that the "full effects of rapid tightening are yet to be felt," Powell highlighted the need to look forward rather than backwards in the Fed's fight against inflation.

HIGHER FOR LONGER

As Powell noted at this week's FOMC meeting, while the Fed has taken "forceful actions to tighten the stance of monetary policy" and the "full effects" of earlier tightening have not yet been felt, "we have more work to do." "Price stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy," he said.

Inflation has improved, but price pressures remain well above the Committee's earlier expectations and well above the Fed's 2% target range. Thus, with 450 bps in tightening only having a modest impact on taming inflation, presumably additional rate increases will be necessary beyond earlier forecasts. Furthermore, if inflation remains elevated as the Fed nears a terminal level or a sufficiently restrictive level of policy, rates may need to remain at such an elevated level for longer than expected as well. The Fed has said higher is necessary, the question remains, how much higher? The answer will depend on inflation.

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