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Fed Resets Clock on Cuts and Questions If Rates Are High Enough

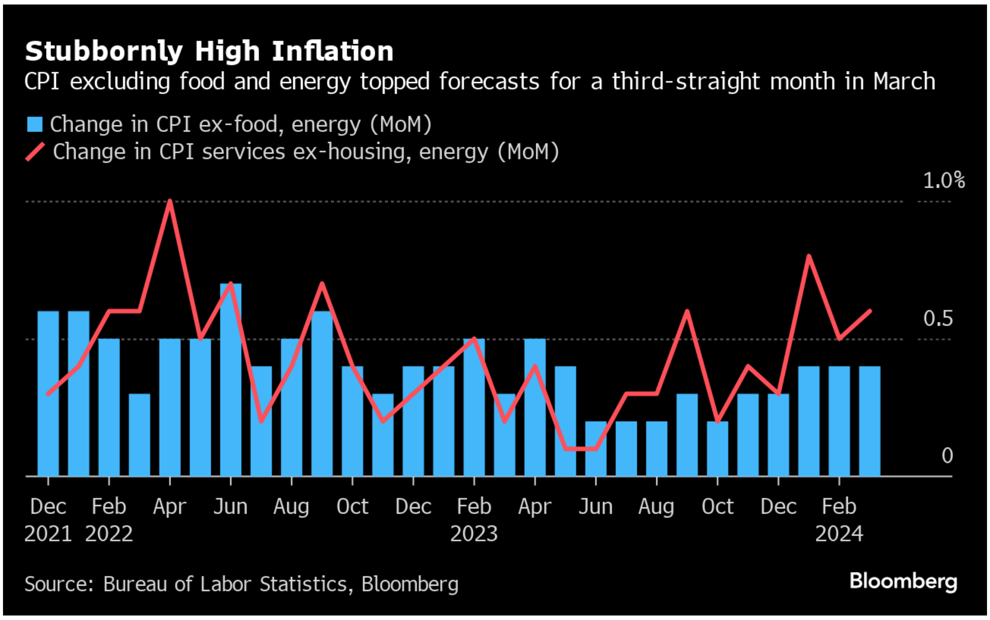
- String of consumer price data muddles inflation trajectory
- Policymakers, including Powell, see little urgency to cut

By Catarina Saraiva

(Bloomberg) -- A string of disappointing inflation data has forced the Federal Reserve to reset the clock on its first interest-rate cut and re-evaluate the trajectory of price growth.

Chair Jerome Powell cemented that message this week when he said it's likely going to take "longer than expected" to gain the confidence needed to lower rates, dashing hopes for more than two cuts in 2024. Some worry there may be none at all.

"This is confirmation that the Fed's willing to wait it out," said Diane Swonk, chief economist at KPMG LLP. "There's concern of how little it took to stimulate the economy, that there's still a lot of demand."



Powell's lack of urgency to adjust rates echoes that of his colleagues. But the enduring strength of the economy and labor market, alongside a market rally at the start of the year, has also reignited a debate about just how restrictive monetary policy is.

Fed officials are increasingly voicing concern high borrowing costs may not be doing enough work to rein in demand, increasing anxiety among investors and analysts that the central bank may need to raise rates further.

Most policymakers have made clear they expect interest rates are at their peak, but some Fed officials have expressed an openness to the idea should it be necessary to tame price growth.

New York Fed President John Williams, who describes current policy as restrictive, said Thursday that raising rates is not his baseline expectation. But he added it's possible if the economic data warrant higher rates to reach the Fed's inflation goal.

WATCH: NY Fed President John Williams said, "I definitely don't feel urgency to cut interest rates."

Read More: Treasuries Stumble on Mere Mention of Fed Rate Hike by Williams

Boston Fed President Susan Collins cheered last year's rapid disinflation in a recent speech, but expressed concern that without cooling demand, prices will continue to be pressured higher.

"This implies that demand will need to moderate for the Fed to achieve its price–stability goal," Collins said in an April 11 speech. "So, while resilient activity is good news, it also raises questions about the extent to which the stance of monetary policy is actually restraining demand."

Economists now expect two cuts this year, down from three forecast in March, according to the median estimate in a Bloomberg survey.

Is Policy Restrictive? Or Not So Much?

Policymakers have different views on how rates are impacting the economy

Fed official	Comment
Lorie Logan, Dallas Fed	"I'm concerned that the stance of monetary policy may not be as restrictive as most forecasts assume." -- April 5
Michelle Bowman, Board Governor	"I think it is restrictive. I think time will tell whether it is sufficiently restrictive." -- April 17
Austan Goolsbee, Chicago Fed	"At this level of restrictiveness, where rates are relatively high compared to inflation, I think you've got to pay attention to how long do you want to be that restrictive." -- April 8
Jerome Powell, Chair	"Given the strength of the labor market and progress on inflation so far, it is appropriate to allow restrictive policy further time to work and let the data and the evolving outlook guide us." -- April 16
Susan Collins, Boston Fed	"Economic activity has remained robust despite high interest rates. While this resilience is good news, it raises questions about the restrictiveness of the policy stance and broader financial conditions." -- April 11
John Williams, New York Fed	"I do think we have restrictive monetary policy. I do think policy is tight." -- April 15
Raphael Bostic, Atlanta Fed	"Right now where our stance is -- I think is a restrictive stance-- it will slow the economy down and eventually get us to 2%." -- April 18

Source: Bloomberg

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Much of the inflation progress seen last year can be attributed to improvements in the supply side of the economy: tangled-up supply chains finally unraveling and a huge influx of immigrants helping fill vacant jobs.

All the while, demand remained strong. In the second half of 2023, the economy grew at the fastest back-to-back pace in two years. And just last month, retail sales grew 0.7%, exceeding economists' forecasts.

But because demand is the main channel through which monetary policy works, its persistence is fueling skepticism about how much policy is constraining the economy.

"If you don't know how restrictive you are, you almost have to wait to see it," said Sarah House, senior economist at Wells Fargo & Co. "Uncertainty around how restrictive policy is likely draws out the timeline of the current policy setting."

Austan Goolsbee, president of the Chicago Fed, echoed that sentiment Friday, when he said progress on inflation had stalled out.

"Right now, it makes sense to wait and get more clarity before moving," he said, adding that it'll likely take longer to get inflation to the Fed's 2% target than previously thought.

Financial Conditions

Financial conditions have also played a role. When Fed officials started talking more about cuts at the end of last year, markets rallied.

The S&P 500 climbed, and the 10-year Treasury yield — which moves opposite of prices — plummeted from near 5% in

October to under 4% at the start of 2024. Yields have climbed in recent weeks amid the disappointing inflation data.

Read More: Inflation's Stubborn Start to 2024 Blamed Partly on Powell Pivot

"We started worrying about the financial conditions easing again and the potential for the progress on the inflation to stall at an elevated rate, and unfortunately that's what it's looking like is happening," said Marc Giannoni, chief US economist at Barclays Plc and a former Fed economist.

Fed Governor Michelle Bowman offered a similar thought Wednesday, when she said progress on inflation may have stalled. Bowman described policy as restrictive, but added, "time will tell whether it is sufficiently restrictive."

There "is a lot of financial market activity and a lot of continued growth that we wouldn't have expected if policy was sufficiently tight," Bowman said.

But there's also a question of how much the Fed will ultimately reduce rates.

High Rates to Stay

Some policymakers are increasingly coming around to the idea that the post-pandemic economy is fundamentally different from the years leading up to it, whether that be potentially higher productivity or the rise of remote work.

"You have to be open to the notion that the level of restrictiveness is less than you think, and you would learn that through the economy," Richmond Fed President Thomas Barkin said in an April 16 interview on Bloomberg's Odd Lots podcast. "You learn that through demand accelerating more than you'd think it would and that's something you have to be attentive to."

But it could also lead to an economy with higher borrowing costs than many Americans have grown accustomed to.

Cleveland Fed President Loretta Mester said she revised up her estimate of the long-run fed funds rate at the central bank's meeting last month. She cited both the economy's resilience in the face of higher interest rates as well as climbing estimates of the so-called neutral rate of interest, or r-star, a level of lending costs that neither stimulates nor restricts activity.

Eight other policymakers projected a longer-run fed funds rate above 2.5%, where the median was for most of the past five years. That's up from four officials a year ago.

"Why are they telling us they are going to cut rates when we have inflation and a good economy?" said Michael Bordo, an economics professor at Rutgers University. "The Fed may not have to really cut much. It may be that r-star has gone up."

(Updates with comments from two Fed officials.)

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