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ECONOMY

Fed stares down rising inflation and a murky path to rate cuts

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By Rachel Siegel

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It wasn't long ago that the Federal Reserve looked on track to cut interest rates this spring. But those optimistic days sure feel like they've slipped away.

Since the start of the year, central bankers' hopes to take pressure off the economy with lower borrowing costs have gotten dimmer and dimmer. Inflation is heating back up, and economists fear the stickiest drivers of rising prices are getting harder to scrub away. The unwelcome surprises now have forecasters eyeing fewer cuts, closer to the end of the year — which would put the Fed squarely in the middle of a heated election season, and possibly inflame a kind of political firestorm central bankers try to avoid.

Officials will contend with this murky world when they gather for their two-day policy meeting starting Tuesday.

"The last few data points have certainly created whiplash around the Fed's thinking," said Eswar Prasad, an economist at Cornell University and a senior fellow at the Brookings Institution. "If inflation stays where it is, or if it continues going up, that makes any shift in policy highly unlikely."

Fed officials aren't expected to make immediate changes to interest rates. After officials sprinted to hoist borrowing costs to their highest levels in more than 20 years, the central bank's benchmark rate now sits between 5.25 and 5.5 percent. So far, rising inflation hasn't convinced Fed watchers that rates should go even higher. Instead, the thinking is that rates can stay at their current level for as long as necessary. The annual inflation rate fell from a high of 9.1 percent in June 2022 to 3.1 percent in January, but it's been stuck around that level for several months.

At a news conference Wednesday, Fed Chair Jerome H. Powell is likely to get questions on where inflation is headed and if the Fed thinks it is losing ground in its fight to control prices. Powell has already said there isn't a rush to cut rates. But he'll probably be pressed for specifics on how many cuts are in store and when they could unfold, particularly since financial markets are eager for a timeline.

“The recent data have clearly not given us greater confidence, and instead indicate it’s likely to take longer than expected to achieve that confidence,” Powell said earlier this month.

Fed leaders are no strangers to the economy’s twists and turns. In just the past few years, inflation, the job market, economic growth, wages and consumer spending have all behaved in bizarre ways. Now policymakers are still trying to understand the economy after the coronavirus and, crucially, which of their conventional models aren’t a match for it.

Econ 101 teaches that high rates slow hiring, tame consumer spending and bring down inflation. But instead, the job market has stayed hot, with the unemployment rate continuing its longest stretch below 4 percent in five decades. Consumer spending has softened a bit, and the U.S. economy slowed at the beginning of this year. But overall, growth has beaten expectations and people are still splurging on concerts, vacations and more.

Fed leaders entered this year on a high note, saying they needed just a few more months of progress to be sure inflation was moving toward the normal 2 percent target. Once they had that confidence, they’d be ready to cut.

But hotter-than-expected data this year zapped that momentum. The figures have been heading in the wrong direction, too. In March, the Fed’s preferred inflation gauge clocked in at 2.7 percent over the year before, up from 2.5 percent in February. Housing costs have been a consistent driver of high inflation. And even though real-time measures show rent costs cooling, the official statistics aren’t budging much, keeping a 2 percent target beyond reach.

Forecasters broadly expect rate cuts have now been pushed back well into 2024 — and even then, only if inflation turns around soon. Economists are increasingly looking to the Fed’s September meeting as a possible kickoff. After that, cuts could come during the Fed’s meetings in November — the same week of the presidential election — and December.

“There is nobody on the [Fed] who would say they would not make a decision they deem necessary because of the political calendar,” Prasad said. “But given the political history surrounding the Fed, I think they would just be very uncomfortable, and would prefer to take any action — at least the initial move — well before the election season hits its peak.”

Joe Brusuelas, chief economist at RSM, said he is still eyeing two or three cuts, possibly starting in September. (The last time Fed officials made projections for the year, in March, they were also expecting three cuts.) He doesn’t think the recent inflation figures upend the Fed’s inflation fight altogether, so much as they interfere with a tricky stretch of policymaking at an already-tricky time.

“That doesn’t exactly cry out ‘major crisis,’” Brusuelas said. “This is just about how many rate cuts we get. … It just got pushed back.”

Part of the reason Fed leaders had been more open to cuts is because it is risky for rates to stay too high for too long. The fear is that undue pressure on the economy could suddenly cause employers to stop hiring or lay off workers. Growth could slow too much, especially if people drastically scale back and save money for gloomy days ahead. A recession could follow.

In a speech earlier this month, Boston Fed President Susan Collins said she used to be concerned about monetary policy getting too tight. But now those hazards are less front-of-mind, especially since the job market has stayed so strong.

The Fed's forecasts might show the economy slowing down over time. But until that happens, Collins isn't seeing an urgent need to cut.

"The slowdown in economic activity necessary for achieving price stability remains more in the forecast," Collins said, "than in the actual data."