EDITORIAL

FEDERAL RESERVE: HIGH FOR LONGER, THE SEQUEL

The message following the FOMC meeting of 30 April-1May, was unambiguous. It will take longer than expected to reach the point of confidence on the inflation outlook that would warrant a cut in the federal funds rate. Consequently, we are back in a 'high for long' environment for the federal funds rate, like in the fall of last year. At the current juncture the key question is whether the economy can remain as resilient if the federal funds rate stays at its current level until the latter part of the year, or even longer, or whether the risk of a hard landing is increasing. The latest Federal Reserve's Financial Stability Report gives some comfort – private sector balance sheets are sound- but also comes with a warning about the debt-servicing capacity of smaller, riskier businesses in case of a sharp downturn in economic activity. More than ever, the focus will remain on the economic data, in terms of inflation -in view of its influence on the monetary policy outlook- and, in order to gauge the resilience of the economy, demand and activity.

At some point in a monetary policy cycle, the word confidence takes a central role in the communication and press conferences of central banks: confidence that the restrictive policy stance will succeed in bringing inflation under control, confidence that there will be room to lower official interest rates. In the US, in Jerome Powell's press conferences that follow the FOMC meetings, the number of references to 'confidence' -by journalists as well as the Fed Chair- has jumped this year (chart 1). It reflects an expectation that, with the target range of the federal funds rate having been raised to 5.25% to 5.50% more than 6 months ago[1] , the time would soon be ripe for the Federal Reserve to start cutting rates. The statement of the January 2024 FOMC meeting hinted in that direction[2], hence the numerous questions of journalists during the press conference about when and why the FOMC would be sufficiently confident that the decline of inflation would warrant a lowering of the policy rate. In March, Jerome Powell's comments before the Senate Banking Committee reinforced the expectation that rate cuts were coming[3]. However, more recently, the pendulum has swung back in the opposite direction, on the back of disappointing inflation data. At the post-FOMC press conference on 20 March, a journalist asked whether the recent inflation data had dented the Fed's confidence that inflation was continually moving down. Unsurprisingly, the Fed Chair replied "*It certainly hasn't improved our confidence—it hasn't raised anyone's confidence.*[4]"

The message following the FOMC meeting of 30 April-1May, was even stronger: "*What we said is that we need to be more confident and we've said, my colleagues and I today said that we didn't see progress in the first quarter and I've said that it appears then that it's going to take longer for us to reach that point of confidence, so I don't know how long it'll take, I can just say that when we get that confidence, then rate cuts will be in scope and I don't know exactly when that will be.*[5]"

Consequently, we are back in a 'high for long' environment for the federal funds rate. Previously, we had entered in such a regime in the fall of 2023, reflecting a view that the policy rate was probably at its cyclical peak -the terminal rate- but that it would take considerable time before an easing could be envisaged[6]. It feels like watching the sequel of a movie, including the question whether it will be as good as the first one. In the US, the first 'high for longer' era saw a resilient economy -labour market, GDP growth in the fourth quarter of 2023- but at the current juncture the key question, which was not asked during the latest press conference, is whether the economy can remain as resilient if the federal funds rate stays at its current level until the latter part of the year, or even longer, or whether the risk of a hard landing is increasing. To a large degree, the answer depends on the interest rate sensitivity of the US economy, which in turn is influenced by the degree of leverage of businesses and households, whether debt is at fixed or variable rates as well as the resilience of earnings and income. The Federal Reserve's Financial Stability Report which was published in April, gives some comfort – "*balance sheets in the nonfinancial business and household sectors remained sound*" but also warns that "*a sharp downturn in economic activity would depress business earnings and household incomes and could reduce the debt-servicing capacity of smaller, riskier businesses with already low ICRs as well as particularly financially stretched households.*[7]" Clearly, more than ever, the focus will remain on the economic data, in terms of inflation -in view of its influence on monetary policy- and, in order to gauge the resilience of the economy, demand and activity.

NUMBER OF REFERENCES TO "CONFIDENCE" IN JEROME POWELL'S PRESS CONFERENCES

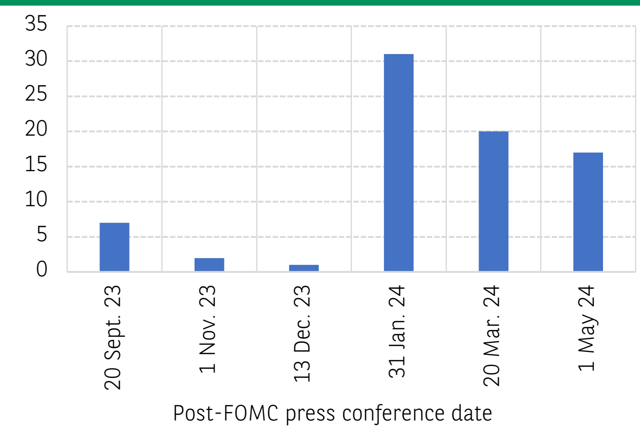

CHART 1

SOURCE: FEDERAL RESERVE, BNP PARIBAS

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1 On 26 July 2023, the FOMC decided to raise the target range for the federal funds rate to 5.25% to 5.50%.
2 *"We believe that our policy rate is likely at its peak for this tightening cycle and that, if the economy evolves broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year."* Source: Federal Reserve.
3 *"We're waiting to become more confident that inflation is moving sustainably at 2%... When we do get that confidence — and we're not far from it — it'll be appropriate to begin to dial back the level of restriction."* Source: *Fed Is 'Not Far' From Confidence Needed to Cut Rates, Powell Says*, Bloomberg, 7 March 2024
4 The question was from Michael McKee of Bloomberg Radio and Television.
5 Source: Federal Reserve, Press conference of Jerome Powell, 1 May 2024.
6 See Federal Reserve: high(er) for longer (bnpparibas.com), 25 September 2023.
7 Source: *Financial Stability Report, Board of Governors of the Federal Reserve System*, April 2024.