EDITORIAL

FEDERAL RESERVE: WHEN WILL IT STOP HIKING?

The FOMC has started a new tightening cycle and its members project 6 additional increases in the federal funds rate this year and 4 more in 2023. This hawkish stance is unsurprising. After all, the policy rate is very low, inflation is exceptionally high and the economy is strong. Given the Fed's dual mandate, the pace and extent of rate hikes will depend on the evolution of inflation as well as the unemployment rate. Previous tightening cycles suggest that concerns about the risk of an increase in the unemployment rate have played an important role in the decision to stop hiking. The central bank will have to hope that inflation has dropped sufficiently by the time that this risk would re-emerge.

The FOMC has started a new tightening cycle[1] and the message from Jerome Powell during his press conference was hawkish. This is understandable. After all, the policy rate is very low, inflation is exceptionally high and the economy is strong. This means that it should be able to cope with higher interest rates but it also raises the question how many rate hikes will be necessary to bring inflation back under control. The question of the cumulative tightening matters for the level of US Treasury yields, the pricing of various other asset classes – equities, corporate bonds, real estate, etc. – but also for the real economy, given the role of interest rates in investment and spending decisions by companies and households. It is also of importance for public finances and, considering the global role of the dollar, for international capital flows. Policy actions by the Federal Reserve tend to have global spillover effects, in particular in developing economies[2].

The median projection of the FOMC members is 6 additional increases in the federal funds rate this year and 4 more in 2023, with the federal funds rate reaching 2.8%[3]. This is 40 basis points above their longer run projection for the policy rate. In 2024, this rate would be stable. In that year, inflation is projected at 2.3%, which, it seems, is sufficiently close to target not to warrant further rate increases. Interestingly, despite the monetary tightening and the ensuing growth slowdown – from 2.8% in 2022 to 2.2% in 2023 and 2.0% the year thereafter – the unemployment rate projection is remarkably stable: 3.5% this year and next and 3.6% in 2024. This suggests that the FOMC is aiming for a soft landing –bringing inflation back to target without causing a recession-, although history shows that such an outcome is difficult to achieve[4]. Given the Fed's dual mandate, the evolution of both the unemployment

1. At its meeting on 15 and 16 March, *"the Committee decided to raise the target range for the federal funds rate to 1/4 to 1/2 percent."* It anticipates that ongoing increases in the target range will be appropriate. In addition, it expects to begin reducing the size of its balance sheet at a coming meeting. Source: Federal Reserve, FOMC statement, 16 March 2022.
2. For an analysis, see *International monetary spillovers*, BIS Quarterly Review, September 2015.
3. This concerns the midpoint of the target range.
4. The tightening cycle that started in 1994 was followed by a soft landing. Writing about the current situation, Larry Summers, in an op-ed for the Washington Post, recently argued *"there can be no reliable progress against inflation without substantial increases in real interest rates, which mean temporary increases in unemployment."* Source: *The Fed is charting a course to stagflation and recession,* The Washington Post, 15 March 2022.

FEDERAL RESERVE TIGHTENING CYCLES

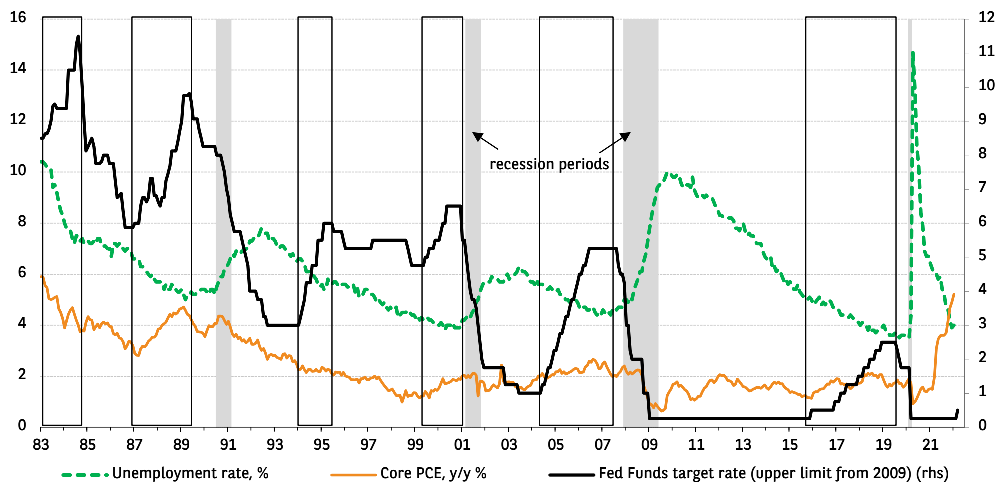

CHART 1

SOURCE: FEDERAL RESERVE, BLS, BNP PARIBAS

> The FOMC is facing a balancing act of bringing down inflation whilst hoping that the labour market would not suffer too much from higher interest rates.

rate and the inflation rate, will determine the pace and extent of monetary tightening but the question is which will matter most in its reaction function. Historically, the first phase of a tightening cycle has been associated with an ongoing decline in the unemployment rate but in a second phase, this was followed by a stabilization of the unemployment rate and an ending of the tightening cycle (chart 1 and charts 2-7 for a closer look at the individual cycles).

This suggests mounting concern within the FOMC about the risk of an imminent increase in the unemployment rate that could lead to a recession. After all, historically, even a small increase in the unemployment rate usually happened in a recession environment[5].

It makes the current cycle particularly challenging because, compared to previous cycles, inflation is far more above target, which, a priori, should justify many rate hikes. However, the unemployment rate is lower than when previous tightening cycles started. This could mean that the cyclical minimum in the unemployment rate would be reached more quickly. It remains to be seen whether by then inflation, which is abnormally high, will have declined sufficiently to justify and end to the tightening cycle. If not, the Fed will face a difficult choice of either continuing to fight inflation and risk causing a recession or of protecting growth and the labour market thereby possibly jeopardizing its inflation fighting credentials. Jerome Powell, testifying before Congress recently was asked whether he would be willing to do what is necessary to bring down inflation, just as Paul Volcker has done in the early eighties. He replied in an unequivocal way by saying "*I hope history will record that the answer to your question is yes*[6]".

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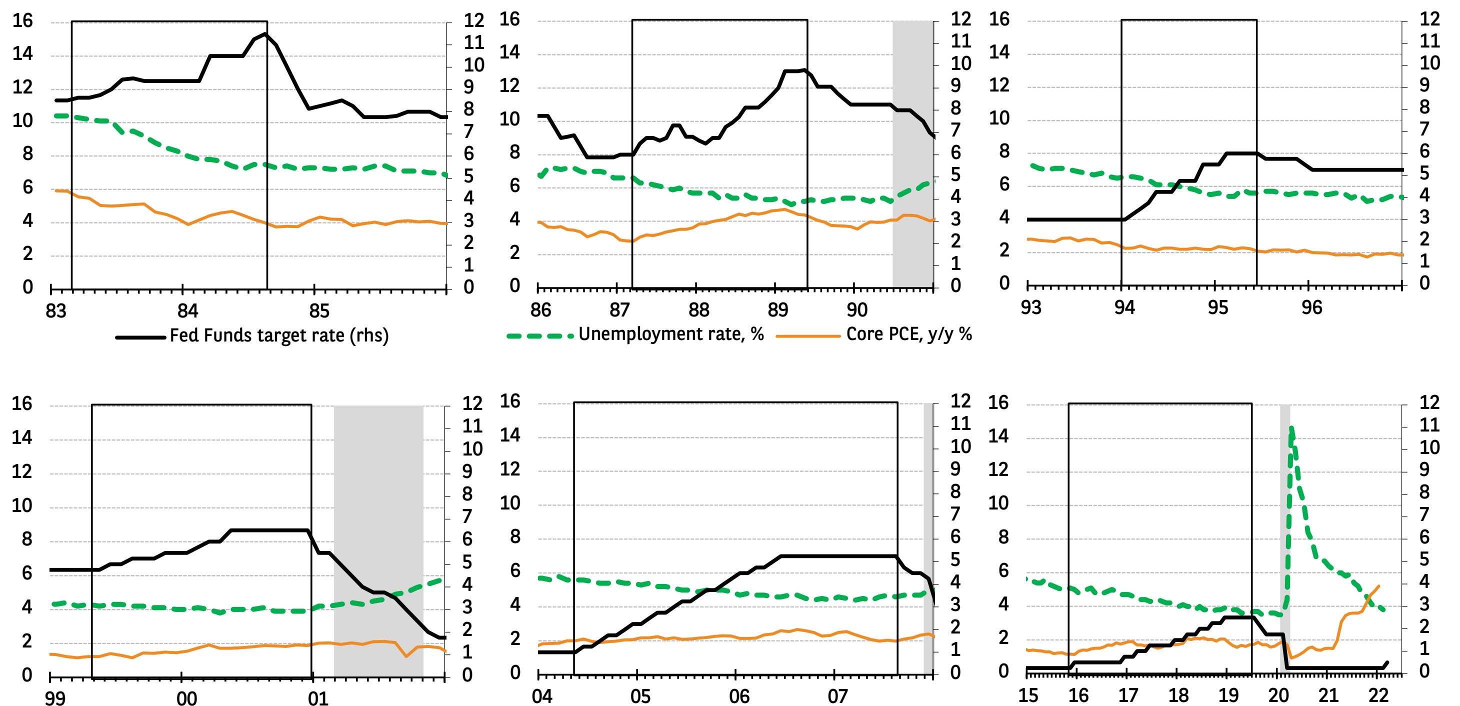
5. This refers to the so-called Sahm rule, which is based on the observation that since 1970, "*Even a modest rise in the unemployment rate such as 0.50 percentage points has occurred only during or closely following recessions*." Source: Claudia Sahm, Direct stimulus payments to individuals (brookings.edu), 16 May 2019.

6. Source: *Jay Powell channels his inner Paul Volcker with tough stance on US inflation*, Financial Times, 17 March 2022.

FEDERAL RESERVE TIGHTENING CYCLES



CHARTS 2-7

SOURCE: FEDERAL RESERVE, BLS, BNP PARIBAS