It's a Pause, Not a Pivot: A Recap of the Fed's Latest Decision

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At its June meeting, the Federal Reserve, after ten consecutive increases in the benchmark borrowing rate, elected to take no further action, a decision which had been anticipated by markets. Nonetheless, the central bank left open the possibility of raising rates in the near future by at least two more 25-basis-point rate hikes this year.

It is worth remembering that the Federal Reserve's primary goals are price stability, maximum employment, and moderate long-term interest rates. By adjusting monetary policy, such as altering interest rates or buying (selling) bonds, the Fed can simultaneously reach its objectives and regulate financial markets. When inflation figures started to significantly surpass the Fed's target of 2%, compromising one of its primary objectives, it shifted its loose monetary policy and began to raise rates in the early part of 2022. At the beginning of the interest rate hike cycle, the aim was apparent; to raise borrowing costs at a faster rate than the Fed had in the past forty years, and then observe the lagging economic effects. With the Fed funds rate now having reached its highest point since September 2007, at 5%-5.25%, the situation has become more complex.

Desired economic conditions are simply not there yet as indicated by the Fed Chair, Jerome Powell, "We have been seeing the effects of our policy tightening on demand in the most interest rate-sensitive sectors of the economy," he said. He later said, "It will take time, however, for the full effects of monetary restraint to be realized, especially on inflation". Financial markets have been questioning when the Fed will pivot from its current tightening policy. By certain standards, some would believe such a shift has already occurred, as evidenced by the recent smaller rate hikes or even a pause in increasing rates. Given its implications on Saudi Arabia's monetary policy, this article will provide some historical context, examine key macroeconomic indicators, and discuss the rationale behind maintaining restrictive rates as a tool for inflation control.

SOME HISTORICAL CONTEXT & MACROECONOMICS INDICATORS

Since the adoption of Fiat money as a store of value, controlling inflation has been a paramount concern for most economies. In recent years, numerous central banks have turned to an approach known as inflation targeting in order to regulate the overall increase in prices.

Central banks utilize forecasts of future inflation to compare to the target inflation rate prescribed by the government as being optimal for the economy. Should there be a discrepancy between the forecast and the target, adjustments to monetary policy will be necessary. For this framework to work, two conditions must be in place. First, the central bank must be able to conduct monetary policy with some degree of independence (i.e., fiscal policy considerations cannot influence monetary policy). Second, monetary authorities must be willing and able to avoid targeting other indicators, such as wages, employment, or exchange rates.

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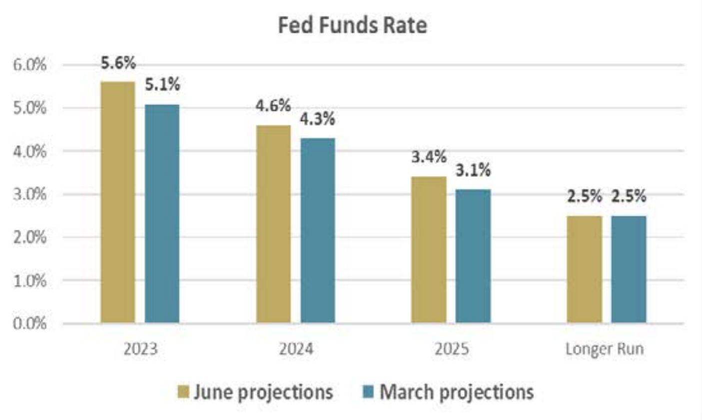
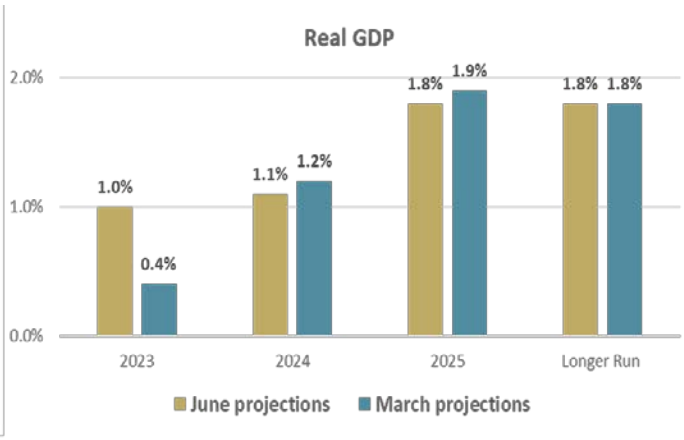
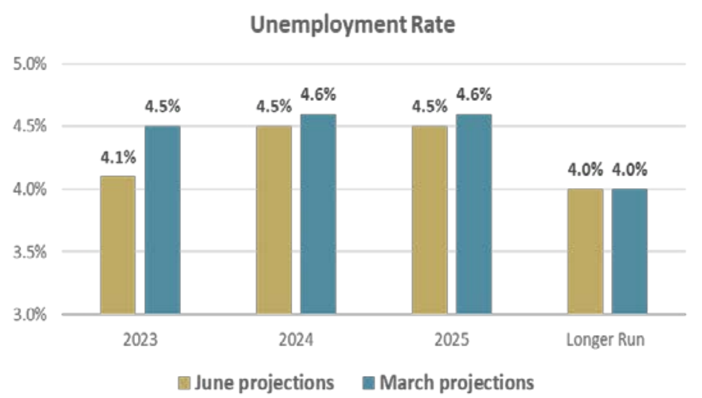
In 1989, New Zealand became the first country to employ inflation targeting, a policy adopted by many other economies worldwide since then. It wasn't until 2012 that the U.S. embraced a similar policy, declaring an inflation rate target of 2%. However, such a policy is by design unproductive in a currency peg setup, where inflation targets will typically be anchored to that of the pegged currency.

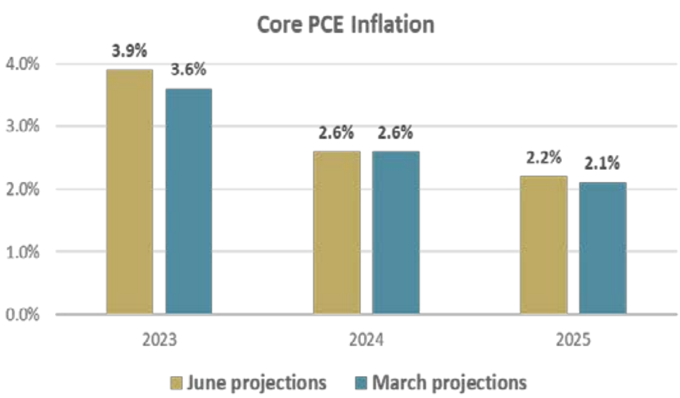
Combatting high inflation necessitates implementing periods of tight monetary policy. In the U.S., the Volcker era in the early 1980s is a good example of this. In the 1970s, the Fed introduced a tighter policy stance in light of the increased inflation rate. However, in the face of higher unemployment, the Fed decided to ease its policy before inflation had been addressed completely. The year-over-year inflation rate reached its lowest point of 5% in December 1976; however, it rose later on, peaking in 1980 at 11.6%. By then, the Fed funds rate had reached a record high of 20%. Eventually, by 1983, inflation had been subdued to levels below 4%, although this was achieved at the cost of two recessions and an unemployment rate of 10.8%, a postwar high that was not exceeded until the coronavirus recession of 2020. Thus, it required years of hardship to reach a point where it was prudent for the Fed to transition and begin lowering rates, which then enabled a sustained period of growth and low inflation.

At the June meeting, it was made evident that this pause does not signify that the Federal Reserve has reached its terminal rate; rather, further hikes are anticipated as indicated by the year-end June median projection of the Federal Fund rate when compared to the one in March *(upper left chart)*. Revisions to real economic growth (GDP) this year suggest that the U.S. economy is more resilient than the Fed had predicted, and it will still have to cool down to reduce the pressure on prices *(upper right chart)*. Similarly, participants lowered their prediction of this year's unemployment rate to 4.1%, down from the 4.5% projected previously, conceding that the job market is still tight, yet they still anticipate that the unemployment rate will increase to 4.5% by 2024 *(bottom left chart)*. Regarding the Federal Reserve's preferred method for gauging inflation, the Core Personal Consumption Expenditure (PCE), has been revised upwards for 2023, with the median participants now expecting 3.9% as opposed to the earlier prediction of 3.6%. This suggests that while inflation is slowing, it is doing so at a slower pace than previously anticipated *(bottom right chart)*.









Source: Federal Reserve

THE BALANCE OF RISKS

When the Federal Reserve refers to the "Balance of Risk", it generally means that it aims to consider all the factors that could potentially impact the economy when deciding on monetary policy. Such factors would range from economic and financial to geopolitical risks.

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The hawkish projections for the Fed Funds Rate are reflective of both the upwardly revised inflation forecasts and the persistent economic conditions over the course of the 15-month period since the central bank began its efforts to moderate the economy and manage rapid price increases. Some may debate the need for a pause at this point, as the case for rising rates further is compelling. However, the policy statement clearly outlined that by holding the target range steady at this meeting, the Committee will be able to assess further information and its implications for monetary policy.

You would also have to agree with the argument to take a wait-and-see stance considering the usual lagging effect of monetary policy on economic activity. This becomes even more relevant as the economy faces the threat of a recession and further bank stresses — referring to the failure of few regional banks in March and May of this year. Nevertheless, the Fed appears committed to its efforts to contain inflation, as noted by Chairman Powell's reference to former Chair Paul Volcker's determination to reduce inflation, despite pushback on his approach.

It is worth noting that inflation can also be managed via supply-side policies that attempt to increase the productive capacity of the economy. Nonetheless, these policies take time and would typically be accompanied with demand-side policies (such as monetary and fiscal policies) to control high levels of inflation. The risks associated with high inflation are devastating; it impacts consumer confidence, economic growth, and income inequality. Hence, I believe the Fed is likely to continue tightening monetary policy and maintain restrictive interest rates to control inflation. Such a stance would ensure long-term economic stability, considering the historical context and examining the current projections of relevant macroeconomic indicators. While this policy could cause short-term effects on growth and borrowing, these impacts, in my opinion, are justifiable in light of the envisaged long-term economic benefits.

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