3-19-25

WSJ Print Edition

Wait-and-See Path By Fed Obscures A Wider Strategy

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Federal Reserve officials are set to hold interest rates steady at the end of their two-day meeting Wednesday. But underneath the surface, their strategy is shifting.

In the central bank's new quarterly economic projections, most officials are expected to pencil in one or two rate cuts this year. At first glance, that would suggest little meaningful change in the rate outlook since the last set of projections in December, when most officials penciled in two cuts.

Those projections are a subject of intense focus on Wall Street. But they are likely to obscure how the Fed's waitand- see holding pattern has undergone an important reset because of the threat of an expansive trade war that sends up prices.

The Fed can cut because of good news—inflation has declined. That was the case last year. It can also cut because of bad news—the economy is sputtering.

The case for the first type of cuts has dimmed because sweeping tariff increases appear much more likely than they did just seven weeks ago, when Fed officials last met.

Tariffs represent an economic shock that can suddenly decrease the economy's ability to supply goods or services, sending up prices while weakening economic growth. Increased duties on imported goods threaten to roil interconnected global supply chains and, given their haphazard rollout, to chill new investment until businesses have more clarity on their underlying cost structure.

"It puts the Fed between a rock and a hard place," said Jay Bryson, chief economist at Wells Fargo. "If inflation goes up, you want to be tightening. On the other hand, if the unemployment rate goes up, you want to be loosening."

Consumer sentiment has grown gloomier recently amid comments from the president's senior advisers that they are willing to tolerate some short-term weakness in financial markets or the economy and amid high-profile cuts to the federal workforce. Moreover, the effects of the Fed's past rate increases con-tinue to cast a chill on some parts of the U.S. economy, including manufacturing and housing.

Fed officials have recent experience with a trade war— when President Trump imposed tariffs in his first term. Back then, the Fed lowered rates pre-emptively to shore up economic growth. It had the luxury of doing so because inflation was low.

By contrast, the current round of tariffs is shaping up to be larger than that previous episode. And inflation has been above the Fed's target for the past four years. Businesses have spent more time figuring out when and to what degree they might be able to pass along higher costs to customers.

"In 2019, this really wasn't on their minds," said Michael Reid, senior U.S. economist at RBC Capital Markets.

Several Fed officials have said they would be even more cautious if there were signs that the public was beginning to anticipate inflation will rise in a sustained fashion. Central bankers are particularly focused on making sure that consumers and businesses expect inflation to stay low, because those expectations can be self-fulfilling.

"Probably for the next six months, I would expect the Fed to be watching and not doing very much," said Eric Rosengren, former president of the Boston Fed. He said he had expected tariffs to keep the Fed on hold for much of the year. But he also said he had been surprised that the tariff increases that have taken effect and those that seem likely have been even larger than he anticipated.

The Fed's interest-rate projections don't easily capture the wide range of potential outcomes that could lead to rate cuts or keep the Fed on hold. Philadelphia Fed President Patrick Harker said last month he had been "on the fence between one and two cuts" when he had to make his submission in December. "I couldn't do 1½," he said in an interview.

Coming up with a forecast has only grown more difficult since then. "The uncertainty is going to be very high," Harker said. "None of us in the profession can say for sure what's going to happen."

Note uncertainty

