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Inflation Unease Muddies Fed Path On a Cut

Powell faces misgivings from some officials on pace of rate easing

BY NICK TIMIRAOS

Federal Reserve Chair Jerome Powell had to reassure some skeptical colleagues that the central bank wouldn't inadvertently send signals of distress when he led them to start lowering borrowing costs at the end of the summer with a gutsy, larger-than-usual halfpoint reduction.

Now, they are confronting another potential hinge point. Officials lowered their benchmark rate again in November, by a quarter point. Investors widely expect a third consecutive rate cut this week.

Powell is trying to find the right gear amid signs the labor market is less wobbly and inflation is a touch firmer than they appeared in September. He faces misgivings from some colleagues over continuing to cut and less conviction from others who strongly backed those first two moves. One option this week would be to cut by a quarter point, then use new economic projections to strongly hint that the central bank is ready to go more slowly on the reductions. *

"Right now, either a cut or a hold could be justified," said Jon Faust, who served as a senior adviser to Powell from 2018 until earlier this year. What officials say about the path of the fed-funds rate is

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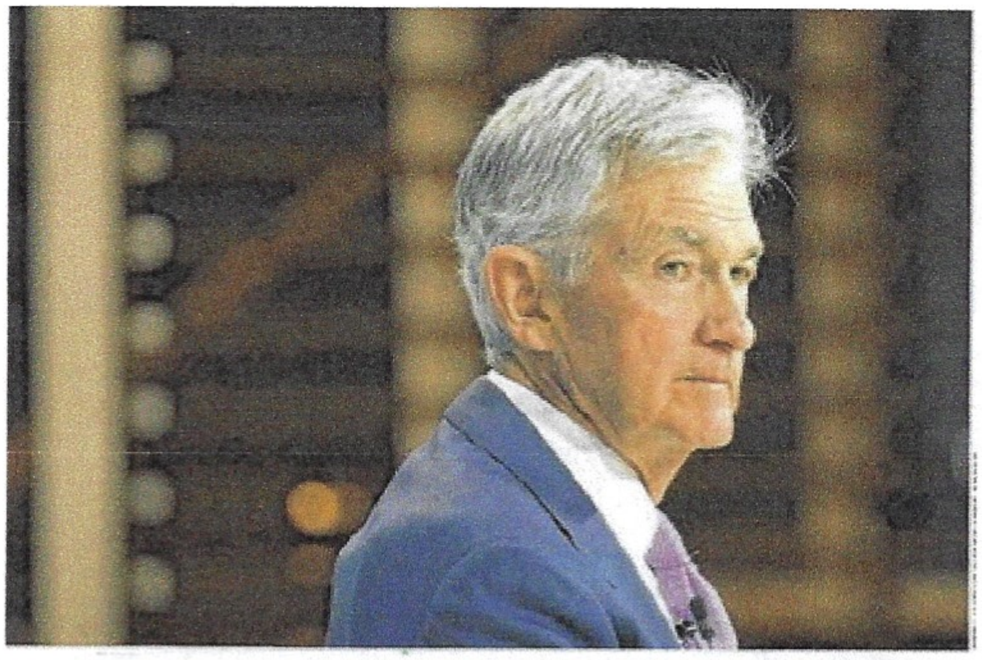

Jerome Powell typically lays out the case for three different Fed policy choices before a decision. SETH WENIG/ ASSOCIATED PRESS

likely to be "more important than whatever they decide about the December meeting in particular."

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The fed-funds rate influences borrowing costs throughout the economy, including rates on mortgages, credit cards and auto loans. Raising it tends to curb hiring, spending and investment, while lowering it spurs such activity. But those effects work with what economists call long and variable lags, which means central bankers might not know for a year or more if they have tightened too much or too little.

A few officials have suggested they would argue against cutting this week. These "hawks" are fearful of squandering the Fed's credibility by allowing inflation to remain well above their target for a fourth or fifth year.

Even if officials still think price growth will gradually slow to their target, some could be less confident in that forecast due to promises by President-elect Donald Trump to deport workers and impose tariffs when he takes office next month. Those steps could reverse two developments that have underpinned officials' sanguine inflation forecasts: falling prices of goods and a slowdown in wage growth.

"If I were sitting on the committee right now as a voting member, I would dissent against a cut," said Eric Rosengren, who served as Boston Fed president from 2007 to 2021.

They are also uneasy that euphoric conditions in the stock market and for speculative assets such as bitcoin could provide grist for spending that keeps inflation entrenched. Given recent economic activity, "it's hard to think that the level of interest rates is restrictive at this point," said Fed governor Michelle Bowman in a speech this month.

What is 'normal?'

Dallas Fed President Lorie Logan warned against cutting too far on what she views as a mistaken belief that a more "normal" interest rate for the economy is much lower. She compared the situation to a ship captain whose depth finder might mistake mud for water.

Another group of officials, including Powell, have suggested they share that concern but don't think the Fed is at risk of cutting too much—yet—given how high they lifted rates over the past two years.

"We're mindful of the risk that we go too far, too fast, but also of the risk that we don't go far enough," Powell said last month. "It seems like we're right where we need to be."

Labor markets remain in a delicate equilibrium. Hiring rates are low, but so are layoffs. The economy has added more than 140,000 jobs on average over the six months through November, a respectable figure. But the unemployment rate has drifted up to 4.2%, from 3.7% at the beginning of the year.

The sectors of the economy that are most sensitive to high rates, such as housing, have been slow to benefit from recent cuts.

A big part of Powell's job is to forge agreement among a sometimes-unwieldy committee of 18 other officials. That has been difficult at times because inflation has declined in fits and starts over the past year.

Some hawkish officials who had been averse to signaling an end to rate hikes began to change their tune one year ago, after a string of friendlier inflation reports. In economic projections at the December 2023 meeting, Fed governor Christopher Waller penciled in six cuts of a quarter point for 2024—more than any of his colleagues. (Later, when inflation stalled in the spring, Waller suggested that the Fed could stand pat until the end of this year.)

Making the first cut

For months, Powell and his colleagues insisted they needed a credible entry point to start cutting. "The first time you change direction, it takes on perhaps more importance than it should," said Faust. "People take it as a signal of the all-clear being given."

By Labor Day, Powell was growing more nervous of the risk that the central bank, humbled by getting inflation so wrong in 2021, would overcompensate by keeping rates too high as rate-sensitive sectors of the economy froze.

The labor market began to send signs of a potentially sharper-than-expected slowdown, with the unemployment rate ticking up to 4.3% in data released in August. Inflation had resumed its earlier decline.

Fed officials typically prefer to choreograph big moves without provoking surprise in markets. On Sept. 6, the last day before officials began to observe their traditional premeeting "quiet period," a pair of speeches led investors to think a smaller quarter-point cut was preferred.

But behind closed doors and huddled with a smaller circle of advisers, Powell concluded they should start with the larger half-point cut. The idea took a page from former Fed Chairman Alan Greenspan, who often persuaded his colleagues by framing policy choices as managing different risks.

In this case, the risk of regretting the bigger rate cut was deemed to be very low. They had waited so long to cut rates that, even if the economy zipped along, most officials thought they could simply slow down several further anticipated cuts. By contrast, making a smaller cut only to discover the labor market was slowing sharply would be a much more difficult problem to fix.

Powell typically consults by phone with all 12 regional bank presidents and meets with the six other Washing--ton-based governors on the Thursday and Friday before the coming week's meeting. Powell and his staff also circulate a series of briefing documents that lay out the arguments for three different policy choices.

A lone dissent

Some needed little convincing to start big. Others were uneasy. Past reductions of a half point coincided with more dramatic financial stress. Bowman, who had been warning of latent risks of morestubborn inflation, knew when she saw those policy briefing materials that she wouldn't be able to support Powell's proposal. She ended up casting a dissenting vote—the first since 2005 by a Fed governor.

To avoid multiple dissents and win over colleagues who shared her reservations, Powell convinced them that he could sell the decision in subsequent public remarks as a recalibration made from a position of strength, and not the start of a panicky sprint to lower rates.

"There's nothing…that suggests the committee is in a rush to get this done," Powell said at a press conference after the meeting. Instead, he characterized the "good, strong start" to cutting rates "as a sign of our commitment not to get behind."

Revisions to government data a few weeks after the meeting showed income growth and personal savings rates had been stronger than initially reported. That removed sources of anxiety about a potential recession—and suggested maybe the larger move hadn't been needed.

Waller, who had initially favored a smaller cut but was persuaded to back the larger move, dismissed a question recently over whether he regretted the decision. He compared it to buying car insurance.

"You say, 'Why am I buying car insurance? Because I might have an accident,'" he said at an event this month. "The accident didn't happen. Do you say, 'Man, it was a stupid decision to buy car insurance?' No."

