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Why the Fed Made a U-Turn: Perceived Risks to Growth Shifted

Fed Chairman Jerome Powell sets aside the central bank's key framework
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The Federal Reserve reversed course earlier this past week when it put interest rate rises on hold, prompted by rising risks to U.S. growth in the months ahead, rather than any signs the economy's health is faltering now.
Fed Chairman Jerome Powell signaled on Wednesday the central bank will move to the sidelines to see whether the threats—including from the slowing global economy, trade tensions and the effect of the Fed's rate increases over the last two years—generate a sharper-than-anticipated slowdown for a U.S. economy that continues to look solid by most measures.

The Fed's new stance marked a U-turn from six weeks earlier when it raised rates and penciled in two increases in 2019.
To understand what happened, consider the two risks officials have confronted over the past few years.

One is the risk that inflation accelerates as economic slack disappears, forcing the Fed to raise rates rapidly. This framework is embodied by the Phillips curve, which holds that tighter labor markets will drive stronger wage growth and faster price increases. While this relationship has broken down in recent decades, it strongly animates thinking inside the Fed.

The second risk is that a world of slower growth and an excess of savings over investment means the economy can't tolerate interest rates as high as they used to be. This is sometimes called "secular stagnation." It is one reason Japan's aborted efforts to raise interest rates in the 1990s and early 2000s kept throwing its economy into recession.

After many years of historically slow U.S. growth, the economy accelerated last year. Fed officials began worrying more about the inflation risk, which under the Phillips curve framework called for lifting rates to pre-empt those price pressures. For more than a year, the unemployment rate has been at or below the bottom of a range—from 4% to 4.6%—that Fed officials estimate is consistent with stable inflation.

In addition, tax cuts and federal spending increases last year provided new economic stimulus. A similar episode during a low-unemployment spell in the late 1960s led to high inflation.

But this time, inflation hasn't taken off, and has instead stayed just below the Fed's 2% target. With the economy facing new headwinds, Mr. Powell said Wednesday the inflation risks had diminished—and with it, the need for additional, pre-emptive rate rises.

"They have shifted to being more worried about secular stagnation than they are about the risk of late-'60s inflation," said Lewis Alexander, chief U.S. economist at Nomura Securities.

While global growth had shown signs of stumbling last year, data for Europe and China turned worse last fall. One problem for the Fed is that its main macroeconomic model doesn't neatly account for global economic and financial linkages that began buffeting markets last year, said

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Andrew Levin, a former Fed adviser who now teaches at Dartmouth College.
“You’re in an environment where U.S. rates seem low but they’re actually high” compared to other rich economies, said St. Louis Fed President James Bullard in an interview.

Meanwhile, the Fed’s moves to raise rates had started to bite. Steven Blitz, chief U.S. economist at TS Lombard, traces the market’s recent swoon and the ensuing Fed pivot to late September, when the central bank pushed interest rates above the inflation rate for the first time in a decade.
For investors, higher rates meant something they hadn’t seen in a while: the ability to earn money holding cash. The return of cash as a viable asset class contributed to the repricing that has taken hold across other investment classes, said Mr. Blitz.
Mr. Blitz said Mr. Powell’s background colors his perspective. Mr. Powell isn’t trained as an economist and spent part much of his career in finance. “He is a credit-markets guy and is reacting to this market swoon sooner than his predecessors would have to keep this expansion going,” said Mr. Blitz. “He has to battle the Fed-model view that money is still cheap to say, ‘No, actually, it’s not.’”
Officials in early December had begun thinking about slowing their rate increases in 2019 and how to communicate this shift publicly.
They raised rates at their Dec. 18-19 meeting and sought to signal this milder policy path, said Mr. Bullard.
Their projections charted a shallower path of future rate increases. Mr. Powell tried to signal greater uncertainty about that path at his press conference. And the Fed’s policy statement watered down its language signaling future rate increases.
“All of that was not enough,” said Mr. Bullard.

Markets were already nervous about slowing global growth, trade tensions and the Fed’s rate plans before the December meeting. Investors turned even gloomier when Mr. Powell sounded more committed to tighter policy than many thought was warranted by the gathering growth risks.
Market volatility in the following days fueled a sudden rise in borrowing costs for businesses and households and falling stock prices. Short-term bond yields began rising above longer-dated yields, a so-called inversion of the yield curve that often precedes recessions by a year or two.
Inverted yield curves can steer lenders away from long-term loans to more-profitable short-term debt, constraining the availability of credit.
These tighter financial conditions shifted the way Fed officials perceived the risks to their forecast, particularly because it looked like poor communication about their intentions might be responsible for the narrowing in bond-yield spreads.
Financial markets settled down on Jan. 4 after Mr. Powell signaled more strongly that rate increases would be on hold.
Fed officials are calculating the combined effects of tighter financial conditions and a slowdown in foreign economies could keep a lid on domestic inflation, even if U.S. economic growth remains solid this year.
“Inflation is not running away from us,” said Dallas Fed President Robert Kaplan in an interview Friday. “My base case for the next couple of quarters would be that we take no action.”
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