The intentions behind hawkish federal funds rate projections

SAI YABUKI
ECONOMIC RESEARCH OFFICE

MUFG Bank, Ltd.
A member of MUFG, a global financial group

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At its meeting in September, the Federal Open Market Committee (FOMC) raised interest rates by 0.75% points for the third meeting in a row. The midpoint of FOMC participants' projections for the federal funds rate as of the end of 2025 (first forecast of this figure) is 2.9%. This exceeds the longer run projection (2.5%), which indicates that participants believe a tight monetary policy will remain in place over the long term.

As Chair Powell mentioned during the FOMC press conference, this hawkish stance has not changed since the Jackson Hole conference in late August. At that conference, Powell spoke about lessons that had been learned during a period of high inflation in the 1970s and 1980s: central banks should be held responsible for price stability by curbing demand (even if high rates of inflation are caused by supply factors) and must maintain a restrictive policy stance until stability is restored. Even though the growth rate of labour demand (sum of the number of employees and job openings) is slowing in the tight labour market, it has not started to decrease (Chart 1) and the inflation rate is some way off 2% (Chart 2).

Nevertheless, there is a possibility that the path indicated by September's federal funds rate projections will be too restrictive. Based on FOMC participants' economic projections released at the same time, the real GDP growth rate will continue to fall below the potential growth rate and the negative GDP gap will widen. Meanwhile, the inflation rate will fall to around 2.0-2.5% YoY in the fourth quarter of 2024. Therefore, as was the case in the 1980s under Chair Volcker, the policy rate is significantly higher than the theoretical value (appropriate level) calculated using the GDP gap and inflation rate (Chart 3). If the Fed maintains its credibility and long-term inflation expectations are kept stable, it will not be necessary to keep the policy rate at a level that greatly exceeds the theoretical value after the inflation rate falls.

As Chair Powell says each meeting, the federal funds rate projections are not a decision or a plan. This latest meeting is no different. By showing a decisive stance towards price stability, it seems that the FOMC sought to prevent premature easing of current monetary conditions while also anchoring long-term inflation expectations.

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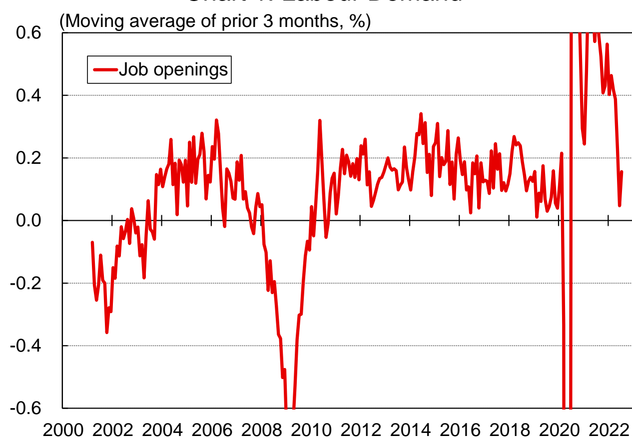
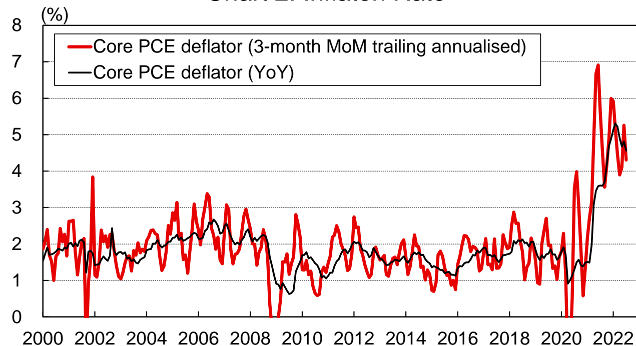
Chart 1: Labour Demand



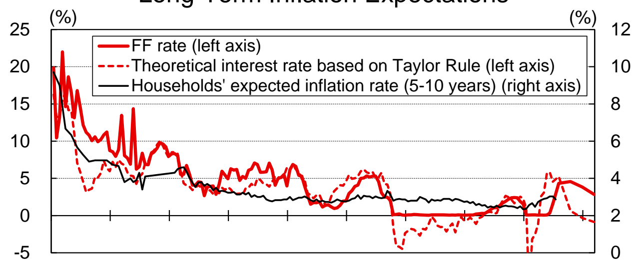
Source: U.S. Bureau of Labor Statistics,
MUFG Bank Economic Research Office

Chart 2: Inflaton Rate



Note: The FOMC's inflation target refers to the PCE deflator, but Chair Powell referred to the 3-month, 6-month and 12-month averages (YoY) of the core PCE month-on-month average as a measure of inflation at the press conference after the meeting.
Source: U.S. Department of Commerce,
MUFG Bank Economic Research Office

Chart 3:Federal Funds Rate and Long-Term Inflation Expectations



Note: FF rate is quarterly-end figure of effective interest rate. Based on the Taylor Rule, the FF rate = neutral interest rate + 2 + GDP gap + 1.5 x (YoY core PCE deflator - 2). From 2022, 4th quarter of each year is calculated based on the median of FOMC participants' outlook for the FF rate and economy
Source: US Department of Commerce, Congressional Budget Office, Federal Reserve Bank of New York, University of Michigan, Bloomberg, MUFG Bank Economic Research Office

Translation by Elizabeth Foster

For further details, please contact the Economic Research Office, MUFG Bank

Managing Director, Rei Tsuruta <rei_tsuruta@mufg.jp>

Written by Sai Yabuki <sai_yabuki@mufg.jp>

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