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CENTRAL BANKS

Pro Take: Should Fed Stick to Script With Rate Hike as Inflation Wanes?

Some economists say 'the job is done' on fighting inflation, while others see the threat still lurking

Federal Reserve Chair Jerome Powell has voiced concern over how higher wages in the services industry can fuel inflation.

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By Bob Fernandez

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Federal Reserve leaders believe that the central bank shouldn't surprise markets and Wednesday's decision on interest rates seems unlikely to veer off a script that strongly calls for a rate hike.

The federal-funds futures market, which bets on the direction of Fed rate moves, is pricing in a nearly 99% chance of a quarter-percentage-point rate hike, according to options trading firm CME Group.

But has the Fed gotten locked into a rate hike while fresh economic data show solid gains in bringing inflation to its 2% target and a softening U.S. labor market?

Inflation data for June came in below expectations and at the slowest pace in two years. The U.S. government has revised downward the estimates of job additions. In other areas, disinflationary forces are expected to push down housing costs. Oil prices are weak compared with the spike when Russia invaded Ukraine in early 2022, and China factory prices are falling at their fastest pace in years.

The risk the Fed faces now may not be fighting inflation, some experts believe, but whether it could push the U.S. into a harder landing with more worker cuts than there needs to be.

“The job is done. I know they are concerned about wage inflation, but the driving force is shelter,” Campbell Harvey, the Duke University finance professor and pioneer of looking at Treasury yields to predict recessions, said Monday.

Shelter—or rent and homeownership—costs are a big component of the closely tracked consumer-price index. Harvey estimates that most of the 3% headline CPI inflation reading in June was associated with shelter. But shelter costs in the government data lag behind reality and they should decline substantially in coming months, Harvey said.

“I have no idea what is going through their heads. I think they believe they have to check the box that says ‘put more people out of work,’” Harvey said. “In the next couple of months, we will drop some very low inflation numbers.”

While first calling surging inflation transitory in 2021, the Fed backtracked and attacked it with vigor. The central bank has hiked interest rates 10 times since early 2022. Last month, the Fed took a timeout and didn’t raise them. But Fed Chair Jerome Powell has indicated that the rates could be raised again.

Inflation eats away at consumers' purchasing power and Fed officials have said they would do everything they need to bring it down. Powell has voiced concern over how higher wages in the services industry can fuel inflation.

Other Fed officials have indicated rates could go higher as well.

"I believe a somewhat tighter policy stance will help achieve a better balance between the risks of tightening too much against the risks of tightening too little," Loretta Mester, the president of the Cleveland Fed, said earlier this month.

"Inflation has surprised us on the upside for some time," said Mester, who isn't currently a voting member of the Federal Open Market Committee that sets rates.

J.P. Morgan economists also say that the inflation threat lurks.

"Core goods prices are now set to slow inflation in the face of manufacturing weakness and the removal of supply-side constraints. However, accumulating evidence of an underlying shift in the inflation process—reflected in labor market tightness, wage- and price-setting behavior, and persistently high short-term expectations—suggests this disinflationary impulse will be limited," they recently wrote.

"We thus downplay near-term recession risks, while also expressing skepticism that a soft landing can be achieved in which inflation returns to central bank comfort zones on a sustained basis without a downturn," they added.

But Rajeev Dhawan, the director of economic forecasting at Georgia State University, doesn't believe the evidence supports a rate hike. The U.S. economy has continued to add jobs, but the majority of them are in lower-wage occupations such as hospitality and healthcare, he said Monday.

The economy has slowed, he added, and "it's a white-collar, middle-management, middle-class recession going on."

The Fed missed the early stages of inflation, delaying its campaign to tamp it down. The timing of when the Fed calls off the campaign will be critical to hundreds of thousands of workers, maybe millions, who could lose jobs in a recession. Each Fed decision on rate hikes now is likely to have consequences.

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