MarketWatch

How high will the Fed have to push up interest rates to cool down inflation? No one knows

By Greg Robb July 19, 2022

Market participants see benchmark rates peaking in 3.5-3.75% range followed by rate cuts next summer, but they may be too optimistic

One of the most vexing questions for Federal Reserve policy makers is just how high they will have to push up interest rates to cool down the U.S. economy and inflation. This projected peak in the Fed's benchmark interest rate is called the "terminal rate" by economists.

At the moment, if you ask 100 economists what the terminal rate is, you're likely to get 100 answers.

"Nobody knows what the terminal rate is going to be. We're in an economy we've never seen before," said Tim Duy, chief economist at SGH Macro Advisors.

After a series of swift and large moves since March, the Fed's policy rate is now in a range of 1.5%-1.75%.

So far, in the way the Fed thinks about things, this level of interest rates is still boosting economic growth.

Not that the economy needs it. The latest Beige Book survey of current economic conditions showed an economy where prices — for goods, services and labor — are popping higher. The core rate of consumer price inflation has risen by an average 0.6% over the past three months. The unemployment rate remains at 3.6%, suggesting tight labor market conditions.

Fed Chairman Jerome Powell has said the Fed wants to see "compelling evidence" that inflation is coming down before it stops hiking rates

Fed officials are expected to raise the fed-funds rate by 0.75 percentage points at their meeting on July 26-27, bringing it to a range of 2.25-2.5%.

That gets rates closer to a level that may not be boosting or slowing down the economy.

The key is how far the Fed might have to go into "restrictive territory", generally seen around 3% or higher, to bring inflation down.

The Fed has penciled in getting its fed funds rate to around 3.4% this year. And then slightly higher to 3.8% range in 2023. However 5 of the 18 Fed officials did think the terminal rate would be above 4%.

Market participants think the Fed rate hike cycle will peak in December in a range of 3.5-3.75%, followed by rate cuts early next year. This is consistent with expectations of a recession.

The trouble is this time could very well be different. Inflation is exceptionally high. So some economists think the market is being too optimistic.

"What makes us nervous…is this time inflation is much higher than anything we have seen in the modern Fed era," said Roberto Perli, head of global policy at Piper Sandler.

"We are not saying that the Fed would ignore the effects of a recession — it certainly wouldn't. But we are saying the Fed's response to a recession that comes with high inflation and a tight labor market will be much more delayed and slower than in the past," he said.

At a minimum, the Fed isn't likely to cut rates so soon, Perli added.

Some economists see the Fed's terminal rate well above 4%.

A widely used rule for monetary policy, devised by Stanford University economist John Taylor, calls for the Fed to raise rates higher than 4% to bring inflation down in the current environment.

Former Fed Governor Lawrence Lindsey said a useful rule of thumb is that the CPI will have to be lower than the Fed funds rate before there will be significant disinflation.

This is daunting, given that consumer inflation is running at 9.1% and the Fed's benchmark rate will likely be around 2.5% next week.

Many economist say the old rules don't apply.

"What is so exasperating is that this is an inflation cycle unlike any in the past. It's a global inflation problem triggered by global shocks," wrote **Bernard Baumohl, chief global economist at The Economist Outlook Group.**

"The Fed can ratchet up rates to the point where it sucks all the oxygen out of the economy and you still will not make much of a dent in bringing inflation close to the Fed's 2% target. It's like firefighters pouring water on a building when the actual blaze is happening across town," he said.

Brian Bethune, economics professor at Boston College, said if the Fed keeps hiking until it sees disinflation "it will be too late" for the economy.

Sam Bullard, chief economist at Wells Fargo, has forecast a roller coaster ride for the Fed and the economy.

He expects the Fed to push its benchmark policy rate "well into restrictive territory, with the Fed funds rate reaching a range of 4-4.25% by the end of the year.

As the economy cools, he thinks the Fed will then reverse course next summer and cut rates by 100 basis points over the remainder of 2023.

Fears that aggressive rate increases by the Fed will push the economy into recession have weighed on stocks, analysts say, overtaking inflation as a top worry. The S&P 500 SPX, +2.76% tumbled into a bear market earlier this year and remains down around 18% year to date, while the tech-heavy Nasdaq Composite has dropped nearly 26% and the Dow Jones Industrial Average DJIA, +2.43% has slumped around 13%.

Treasury yields have soared, with the 2-year yield trading above the 10-year, resulting in an inversion of the yield curve that, if prolonged, is viewed by many economists and traders as a historically reliable recession warning flag.

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