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U.S. ECONOMY

Fed Weighs Wait-and-See Approach on Future Rate Increases

Under an evolving 'data dependent' strategy, the Federal Reserve could step back from the predictable path of quarterly raises

Markets rallied last week when Fed Chairman Jerome Powell said short-term rates are "just below" a range of estimates of where a neutral rate might be. PHOTO: CLIFF OWEN/ASSOCIATED PRESS

By Nick Timiraos

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Federal Reserve officials are considering whether to signal a new wait-and-see approach after a likely interest-rate increase at their meeting in December, which could slow down the pace of rate increases next year.

Officials still think the broad direction of short-term interest rates will be higher in 2019, according to recent interviews and public statements. But as they push up their benchmark, they are becoming less sure how fast they will need to act or how far they will need to go, and they want to assess how the economy is holding up under moves they have already made.

How they manage this new, less-predictable approach will depend in large part on the performance of the economy and markets in the weeks ahead.

On Thursday, the Dow Jones Industrial Average tumbled as much as 785 points before paring those losses. The rebound accelerated late in the session after The Wall Street Journal reported on the Fed's evolving thinking on rates. The blue-chip index ended down 79.40 points, or 0.32%, to 24947.67, and the S&P 500 lost 4.11 points, or 0.15%, to 2695.95.

Under the evolving "data dependent" strategy, the Fed could step back from the predictable path of quarterly hikes it has been on for most of the past two years, raising the possibility it might delay rate increases at some upcoming meetings, according to recent interviews and statements.

Under the old pattern, the Fed would raise rates again in March, but officials now don't know when their next rate move will be after December.

Recent market turbulence for now hasn't much dented the Fed's view that the U.S. economy is on solid footing, with growth strong and unemployment low. But inflation has softened in recent months, and falling oil prices portend further declines, reducing the Fed's sense of urgency about raising rates to prevent the economy from overheating.

"We need to be attuned to...the possibility that the U.S. economy could look very different in the first quarter, first half of 2019 than it does now," said Dallas Fed President Robert Kaplan in an interview Thursday.

Restrained price pressures give the Federal Open Market Committee "and me, as a central banker, some latitude to be patient," Mr. Kaplan said. He added, "There are times when the smartest thing you can do is turn over a few cards and do nothing."

If growth or inflation heats up unexpectedly, the Fed could decide to go further than planned.

Federal Reserve Chairman Jerome Powell compared the Fed's policy strategy to walking into a living room when the lights suddenly go out. "What do you do? You slow down and you maybe go a little bit less quickly, and you feel your way more," he said in a speech last week. "So under uncertainty of this kind, you be careful."

The next important data release comes Friday, when the Labor Department releases November employment data.

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Officials are intensely reviewing how to communicate any shift from the predictable path of quarterly increases for past two years. As part of its shifting plans, officials are weighing how to modify language in a central bank policy statement that since December 2015 has described plans for "gradual increases" in the fed-funds rate. In January, officials qualified the phrase by adding the word "further" to signal greater conviction in their plans.

Beginning at their Nov. 7-8 meeting, officials discussed ways to walk this language out of the statement over the course of several meetings, given their increased uncertainty about how much further to go and at what pace.

"We shouldn't be offering guidance if there's this much uncertainty about the future path of interest rates," said Minneapolis Fed President Neel Kashkari in an interview. If that guidance "ends up being wrong, it hurts or undermines our credibility."

Since December 2016, officials have deviated from quarterly increases just once, in September 2017, to phase in a reduction in their $4.5 trillion bond portfolio. A rate increase at the Dec. 18-19 meeting would be the Fed's ninth such move in the last three years, bringing the federal-funds rate to a range between 2.25% and 2.5%.

President Trump has criticized the Fed repeatedly for raising rates this year. Fed officials have said they will respond to economic data and not the White House when they set policy.

In September, nine of 16 officials projected the Fed would raise rates three or more times next year, while seven projected two or fewer rate rises.

In a speech Thursday, Atlanta Fed President Raphael Bostic said the Fed was "within shouting distance" of a rate the central bank considers to be neutral, meaning it is neither so low that it fuels added economic growth nor so high that it slows growth down.

"I'm not seeing clear signs of overheating, nor am I seeing any indications of a material weakening in the macroeconomic data at the moment," he said. In an environment when the economy is stable and rates are near neutral, he said, the Fed needs to "proceed cautiously, with a keen eye on the data."

In addition to raising rates, the Fed has been removing easy money from the financial system by shrinking its crisis-era holdings of Treasury and mortgage bonds this year. The holdings have fallen to $4.1 trillion and are set to decline by another $500 billion next year.

Officials have no intention to use the run-off to calibrate monetary policy, either by speeding it up or slowing it down. But they are watching for signs that the run-off is making financial conditions tighter, which could influence how they set their benchmark rate.

Fed officials are poring over a range of shifting signals about the economic outlook.

While U.S. economic data hasn't much changed since officials last raised rates in September, global growth is moderating. Moreover, a stronger dollar, falling stock prices and rising rates on corporate and other debt have tightened financial conditions and could restrain domestic growth.

Meanwhile, the recent drop in oil prices has made any near-term acceleration in inflation less likely. A measure of core inflation that excludes food and energy prices, at 1.8% in October, was below where the Fed projects it will be on average in the fourth quarter.

Fiscal policy is another uncertainty. A key source of growth in the near-term, it is set to lose some impetus when a two-year package of federal spending increases expires next September. It is unclear whether lawmakers and the White House will come up with a new agreement for additional spending going into an election year or allow fiscal restraint to take hold.

Officials have stressed that the broad direction of interest-rate policy hasn't shifted, even if incoming data prompts them to drag out the pace of increases in the months ahead.

In addition, Fed officials have stressed they are paying greater attention to the delayed impact of their own policy moves.

"Further gradual increases over the next year or so still make sense," given current economic momentum, said New York Fed President John Williamson Tuesday.

In September, Fed officials estimated that a neutral rate might be between 2.5% and 3.5%. On Monday, Randal Quarles, vice chairman for bank supervision, hinted that the Fed's ultimate destination could sit within that band.

"Where we will end up in that range will depend on the data that we receive," he said.

Carefully communicating a turn has become even more important given recent market volatility and confusion among investors over an off-the-cuff observation Mr. Powell made in early October.

At a moderated discussion, Mr. Powell tried to deflect attention away from questions about whether officials would move rates up past neutral in an effort to slow down a fast-growing economy. He brushed off such conjecture as premature, saying the Fed was still "a long way" from where a theoretical neutral rate might be.

Some frightened investors took the comment to mean Mr. Powell planned many more rate increases, a signal he wasn't trying to send. Markets rallied last week when Mr. Powell dialed back the earlier comment, saying short-term rates are "just below" a range of estimates of where a neutral rate might be.

Central bankers a generation ago prided themselves on silence and opacity. "I spend a substantial amount of my time endeavoring to fend off questions and worry terribly I might end up being too clear," former Fed Chairman Alan Greenspan joked in 1995.

Mr. Greenspan experimented with interest-rate guidance in 2003, when inflation was low and the job market soft. The Fed offered an assurance to investors that short-term rates—then 1%—would remain low for a "considerable period."

The Fed raised rates in quarter percentage point increments at 17 straight meetings between June 2004 and June 2006, and along the way assured investors it would proceed at a "measured" pace. In December 2005, as officials started considering stopping the rate increases, they modified their statement to say "some further measured policy firming" could be needed.

Many believe the Fed's "measured pace" guidance was a mistake because it locked them in to predictable rate changes and betrayed their own uncertainty about the outlook.

"We'd probably not like to repeat a sequence in which there was a measured pace and [quarter-percentage-point] moves at every meeting," Fed Chairwoman Janet Yellen said in a December 2014 press conference. "I certainly don't want to encourage you to think that there will be a repeat of that."

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