The Fed takes a leaf from the BOJ's book and applies gradualism

Balancing interest rate adjustments with growth and inflation expectations

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As anticipated by markets, the Federal Reserve (Fed) kept interest rates on hold on 29 January, while signalling potential further easing in the coming months. Federal Open Market Committee (FOMC) members voted unanimously to keep overnight rates on hold at 4.25-4.5%. However, Fed Chair Jerome Powell characterised interest rates as still "meaningfully above neutral". This implies that the Fed is not yet at the end of its easing cycle and the market can anticipate further easing, although it may not happen immediately. The Fed's stance of not needing to "hurry to adjust [its] policy stance" is reminiscent of the gradualist policy approach adopted by the Bank of Japan (BOJ).

Granted, the Fed is normalising by making policy less restrictive while the BOJ is gradually withdrawing accommodation. However, the BOJ's rhythm of rate adjustments could still serve as a reference. The BOJ delivered only two interest rate adjustments in the form of hikes in 2024. In January 2025 the central bank did raise rates again for its third rate hike since it ended negative interest rates in March 2024, but its rhythm has been gradual. Most of the BOJ's monetary policy announcements have been focused on providing guidance, rather than making adjustments to overnight rates.

The FOMC has a dual mandate: to stabilise inflation expectations (and thus future inflation) and to ensure employment is as close to "full" without inviting inflation. On this front, the Fed's assessment of unemployment, which it described as "stabilised" after an initial rise, and the labour market, which it characterised as "solid", significantly support its wait-and-see stance. Moreover, inflation "remains somewhat elevated", according to the Fed's statement. It is also worth noting that references to the "progress" inflation had made toward the FOMC's "2% objective" have been removed from the statement.

What's next? Uncertainty brings two-sided risks, including those related to inflation

Keeping in mind that the Fed's trajectory is still aimed toward the removal of restrictive policies, it is necessary to remember the potential risks. The risks could involve fewer-than-expected rate cuts if inflation remains stickier than expected. But the Fed could also cut sooner than anticipated in response to unexpected economic weakness, or cut rates more frequently or in greater increments than anticipated. The uncertainty associated with the inflationary impact of trade tariffs is most likely a longer-term upside risk. This is due to the need to wait for the actual tariffs to materialise, as well as recognising that recent tariff implementations have hit consumers with a lag. In the meantime, with actual core inflation still above the Fed's 2% target, it is rational for the Fed to signal that it is not becoming complacent on potential inflation risks even as it remains committed to gradually easing restrictive policy.

Potential for greater than usual seasonal "hangover" may keep rate cuts on the table

Although the Fed remains vigilant about inflation risks, there are also factors contributing to the ongoing deceleration of inflation. These include the stabilisation of owners' equivalent rent, which has been slower to adjust following an earlier rise in rental prices that has since decelerated. Of course, one factor that may have encouraged the Fed to remain on hold this month could have been the especially brisk pace of holiday consumption and hiring. Retail control group sales in December 2024, excluding volatile items, far exceeded expectations.

However, seasonal trends do tend to show a slowdown in the first quarter of the year, in the post-holiday and pre-tax period. One reason to wait and see is the possibility that holiday spending may have overshot expectations. If this is the case, the corresponding downswing in consumption may be exacerbated in 2025, particularly if the buoyant conditions in financial markets were big contributors to the splurge in seasonal spending.

The aftermath of wealth-effect spending could exacerbate the seasonal slowdown because taxes on investment income, unlike employment income, are typically not subject to the "smoothing" effect of monthly tax withholding. Households usually pay taxes on investment income at the end of the fiscal year (now through early April). Gains on investment portfolios realised in 2024 may come with a higher bill in 2025, which may cause a greater temporary wave of consumption restraint than usual prior to the tax season, all else being equal. If this happens, and the softer consumption affects both hiring and prices, the conditions for an additional rate cut may well be met within the first quarter of 2025. Such a move would theoretically bring the Fed even closer to "neutral" rates.

We may only observe "neutral" policy once we get there

Central banks seem fond of reminding us that as rates approach "neutral", adjustments should naturally slow as the discovery process of "neutral rates" takes place. Whether one or two rate cuts will take the Fed to "neutral", or whether this notional rate will be even lower, will most likely be determined in hindsight. One significant—and more volatile—input affecting "natural rates" is long-term inflation expectations. The Fed notes that long-term inflation expectations are still "anchored", yet few measures indicate that they are at or near its 2% target. It remains to be seen whether inflation expectations will indeed continue to moderate. If they do not, it could mean that the "neutral" rate is higher now than it was in past cycles when inflation expectations were persistently low. That inflation expectations are still in flux is another reason to remain cautious about the Fed's policy timing. This, again—though the direction of rate normalisation is opposite—is reminiscent of the BOJ's gradualist rate normalisation trajectory.

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