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FEDERAL RESERVE

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Will the Fed raise interest rates in 2021? Here's what experts are saying

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It was like an emergency responder rushing to the scene of an accident. The Federal Reserve took less than two weeks to slash interest rates to zero and unveil its largest bond-buying program in history when the coronavirus pandemic first bulldozed into the economy.

But a financial system that's now recovering at a rapid clip is in no way lessening the burden of the U.S. central bank's job: steering the world's largest economy out of a recession but away from overheating by determining how much you pay to borrow and how much you're paid to save.

The Fed at this point is expecting to keep borrowing costs at rock bottom for at least two more years. Yet, experts say the Fed's goal of reviving the outbreak-ravaged economy will only get harder from here, as inflation paranoia mounts and fears of a too-hot economy reverberate all the way to the room where monetary policy is set.

"Inflection points are really hard," says Vincent Reinhart, chief economist and macro strategist at Mellon who spent 24 years at the Fed. "When you're going down a straight road, you can go really fast, and you know what to do when the unemployment rate is double digits. Fed communication is easy at that point because everybody agrees to the problem. … But if the driver has said, 'No, I'm going to wait until we see the yellow caution signs on the road before I slow down,' you may have more concerns."

Consumers are starting to see inflation, and that could threaten the Fed's patience

Consumer prices in April soared 4.2 percent from a year ago, far eclipsing the 3.6 percent gain that analysts had originally forecasted. Google searches for inflation popped this month and have surged to the highest in records dating back to 2004.

Americans are also starting to expect that inflation will be here to stay. One tracker of investors' inflation views soared by the most since the mid-2000s. A consumer survey out of the University of Michigan rose to its highest in seven years.

The Fed's mantra for months now has been that any inflation surge will be temporary, broadly reflecting reopening flukes. Officials are expecting that demand will balance back out with supply, bottlenecks will clear and below-average readings from last year will fade, all of which were responsible for making this month's year-over-year jump look so significant.

Fed officials themselves see prices rising above target this year, then moderating back down in 2022, in their latest economic projections.

After that, they think the still-ravaged labor market will prevail. The U.S. job market doesn't look hot right now on paper, even as trade groups and anecdotal claims of worker shortages start to dominate the national conversation. The unemployment rate has steadily declined to 6.1 percent from 14.6 percent, yet nearly 3.5 million fewer people are working now than before the pandemic and the U.S. economy is short of 8.2 million jobs compared to pre-outbreak levels.

Elevated unemployment tends to stifle demand, making it harder for employers to pass along price increases and giving them no reason to boost wages.

"It seems unlikely, frankly, that we would see inflation moving up in a persistent way that would actually move inflation expectations up while there was still significant slack in the labor market," Powell said in April.

Yet, rising inflation expectations are often thought of as an omen for surging inflation. That's because it gives businesses more wherewithal to hike prices and workers more room to ask for higher pay if the general public starts to expect that their money won't be worth as much.

Bill English, finance professor at the Yale School of Management who spent more than 20 years at the Fed, calls it "the dealbreaker" — especially if expectation gauges across the board move

up by more than a few tenths. “At that point, they might feel that they have to pull back more quickly than they had intended. It could go too far, and that is the risk,” he says.

A return to the Great Inflation of the 1970s and ‘80s? One former Treasury official thinks so

Former Treasury Secretary Larry Summers on Tuesday called the Fed’s patience stance a “dangerous complacency,” saying that it’s laying the groundwork for another Great Inflation, the near-15-year period where prices skyrocketed after years of big government spending on the Vietnam War, two oil shocks and too-accommodative monetary policy. Back then, the Fed had to manufacture a recession to get prices back on track by raising interest rates to intentionally slow down the economy.

Yet, the Fed is unlikely to see one month’s worth of a price burst as a sign that the Great Inflation is here again, experts say.

“It took 15 years to get to the peak, where inflation expectations were out of control and the Fed stepped in with a recession,” says David Beckworth, senior research fellow at the Mercatus Center at George Mason University and a former Treasury Department economist. “Even if we are reciprocating the 1970s like Larry Summers claims, it’s a long journey. It’s not going to happen overnight.”

Beckworth adds that a sustained period of inflation above 2 percent for at least a year might be enough to warrant a rate hike.

“We’re all very familiar, at the Fed, with the history of the 1960s and ‘70s,” Powell told reporters in April. “We know that our job is to achieve 2 percent inflation over time. We’re committed to that, and we will use our tools to do that.”

If the Fed arrives ‘late to the party,’ experts say you might have to brace for faster and more aggressive rate hikes

Experts say the longer the Fed waits to take the punch bowl away from the economy’s party, they might end up having to shut down the boom quicker. That might mean a faster pace of borrowing cost increases at a bigger rate to get inflation and economic growth under control. That would be in direct contrast with the gradual rate-hike rhythm Fed officials found after the Great Recession of 2007-2009. The Fed hiked rates nine times throughout the decade-plus expansion, though later walked back three of those increases in 2019.

“If you push back an awful long way, then there’s really some probability that you have to raise rates pretty fast, depending on, of course, what the economy is doing,” English says. “Markets will potentially have to get comfortable with that, but for now, we just don’t know.”

The Fed “is coming late to the party, but that’s by design,” Beckworth says. Coronavirus

pandemic aside, the U.S. central bank is now juggling its twin goals — maximum employment and stable prices — differently. In plain English: The Fed is now willing to stomach higher inflation for longer periods of time to let the job market run hot, leading to lower-for-longer interest rates.

“Imagine a world where you didn’t have the pandemic happen,” Beckworth says. “The Fed’s new framework would still require some amount of temporary inflation overshoot intentionally, if there’s been a recession.”

Officials might also not want to risk getting the next rate-hiking cycle wrong. The Fed knows that raising interest rates too soon risks needlessly slowing down the economy, keeping millions of Americans jobless who would’ve otherwise found employment if the financial system had a bit more time to grow.

Fed Vice Chair for Supervision Randy Quarles said Wednesday that if the Fed at this point tried to stay ahead of inflation, it would risk “significantly constraining the recovery.”

“Their policy tool is asymmetric,” Reinhart says. “If they get it wrong and convey a sense of tightening too soon and the rebound lags, there’s not a lot they can do other than push out when they would ultimately remove that accommodation. They get it wrong on the other side, inflation expectations rise, they’ve got tools at a later date to deal with it.”

Bottom line

Powell himself has pointed to the risk that the virus could come back with a vengeance if the reopening happens too quickly, particularly with many Americans still unvaccinated. The U.S. economy is also expected to boom this year, expanding at its fastest pace in four decades. But that might be a bit of a sugar high, thanks to almost $4 trillion in fiscal stimulus so far this year. Policymakers might want to give the economy more time to show its true colors.

Before consumers see a rate hike, they can expect to see some changes in the Fed’s other substantial emergency response: its bond-buying plans. Powell said in an April appearance that the Fed would taper – which, in Fedspeak, means “slow” – its asset purchases “well before” any mention of raising interest rates. Currently, the Fed is buying at least $120 billion of government-backed securities per month. Fed officials in records of their April rate-setting gathering hinted that the taper conversation might start happening soon.

“We’ve said that we would let the public know when it is time to have that conversation, and we said we’d do that well in advance of any actual decision to taper our asset purchases,” Powell said at the post-meeting press conference.

It’s a tricky juggling act moving forward for Powell, who won’t want to spook investors by brushing the economic rebound under the rug or by priming them for a rate hike if the Fed isn’t ready.

"The front-end risk is that investors come to expect inappropriate policy tightening too soon; the back-end risk is that investors come to expect inappropriate delay in policy tightening. Powell is more worried about the front-end risk than the back-end risk," Reinhart says. "From a central bank's perspective, raising rates is either a thing they look forward to or they really, really worry about. When the date comes, the Fed will raise rates because it will be the economy forcing them to do it."

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