

# Is Fed too confident about inflation?

Some economists think so; chairman says there is no 'risk-free path'

BY COLBY SMITH

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Jerome Powell, chairman of the Federal Reserve, says there is "no risk-free path" for the central bank now that the labor market has cooled and inflation has picked back up. If officials focus on stamping out price pressures by keeping interest rates elevated, they risk harming the labor market. If they take steps to shore up the labor market by cutting borrowing costs, inflation could prove harder to contain. - Note

So far, Powell appears more willing to take a gamble on inflation. His rationale is that the risks to the labor market have grown much more pronounced after a sharp slowdown in hiring this summer. All signs point to the Fed cutting interest rates for a second time this year when it meets next, at the end of the month. Projections released in September showed that most officials saw room for another quarter-point reduction at its final gathering of the year, in December.

But the Fed may not have wiggle room to cut interest rates much more than that if the labor market does not weaken. Doing so would risk getting inflation stuck above the central bank's 2% target, some economists warn. - Note

"The idea that we stay at levels that are meaningfully away from target is a real risk for the Fed," said Matthew Luzzetti, chief U.S. economist at Deutsche Bank. "Easing policy at the margins will help to keep inflation at higher levels for longer."

Powell's more sanguine view on inflation — which is shared by other members of the Federal Open Market Committee — stems from his belief that President Donald Trump's tariffs will result in only a one-off rise in consumer prices rather than successive rounds that will lead to persistently higher inflation. He has also made the case that a weaker labor market will keep a lid on how much consumer prices can ultimately rise, especially as wage growth stays subdued, unemployment rises and spending slows overall.

So far, the impact of the president's levies — which include broad-based tariffs on nearly all the country's trading partners as well as sector-specific duties — has been more muted than officials at the Fed initially expected. Not only has it taken longer to show up in the consumer price data than anticipated, but the rise in prices for everyday items has also been less intense than expected.

But what has made some economists, and in fact some Fed officials, wary is that measures of underlying inflation show that progress has stalled toward the central bank's target.

"That is a signal that there's more to what's going on with inflation than just tariffs," said Loretta Mester, who was president of the Cleveland Fed until last year. - Note

One gauge, which strips out volatile food and energy prices, is currently running at an annualized pace of 3.5%. Stephen Stanley, chief U.S. economist at Santander, argues that an even more accurate metric is one that removes travel-related components like airfares and hotel rates, given that they tend to "gyrate wildly."

That measure is running at an even higher annualized pace of 3.9% as of the August data, which is the most recent because of the government shutdown. Stanley said that metric suggested "progress toward 2% is substantially less than meets the eye and certainly insufficient to allow the FOMC to let down its guard on inflation just yet."

Another point of concern is what happens if the labor market stabilizes rather than deteriorates further from here, a possibility given that some of the recent slowdown in monthly jobs growth stems from a reduction in the supply of workers because of Trump's crackdown on immigration as opposed to a pullback in demand for new hires.

Note

"The risk here is that we just never get enough weakness to cause inflation to go back to 2%," said Dean Maki, chief economist for Point72, a hedge fund. A "full-blown recession" would eliminate any lingering concerns about services inflation, he added, but so far no Fed official is forecasting such a significant downturn. Neither is Maki. Instead he expects core inflation to stay above 3% most of next year as the unemployment rate rises to 4.8%. It stood at 4.3% in August.

What has given officials at the Fed some comfort is that expectations from consumers and investors about future inflation over a longer time horizon have so far stayed contained, suggesting that people are not yet losing faith in the Fed's ability to eventually get price pressures under control again.

But for former officials like Mester, the foremost concern is whether that will start to change. She said the Fed had already lost some of its credibility with the public after inflation surged in the aftermath of the pandemic. It has now been roughly five years since inflation has been at the Fed's 2% target.

Note