RBC Economics
Daily Economic Update

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Hawkish Fed kicks off tightening cycle

- Fed funds rate increased by 25 bps for the first time since 2018
- Dot plot suggests six more hikes this year; restrictive policy in 2023
- Balance sheet reduction to begin "at a coming meeting" expected

Today's rate hike was widely expected and essentially a foregone conclusion following Chair Powell's remarks to Congress earlier this month. But those thinking today's meeting would be a non-event will have been surprised by a hawkish dot plot suggesting six further rate hikes this year (potentially 25 bps at each remaining meeting). That's 100 bps more tightening than the Fed signaled just three months ago, and two more hikes than assumed in our latest forecast. Adding to the hawkishness, those rate hikes weren't simply brought forward from 2023—the committee median is for three to four additional rate increases next year, lifting the fed funds rate above its longer-run level and effectively making monetary policy restrictive (i.e. above the long-run neutral estimate) by the end of 2023 and throughout 2024.

The driver of this hawkish shift: inflation. Today's statement pointed to pandemic-related supply-demand imbalances, higher energy prices and "broader price pressures" contributing to elevated inflation. The Fed now sees headline PCE ending this year at 4.3% and core PCE at 4.1%, up from less than 3% in its December projections. Inflation is seen slowing but remaining uncomfortably high by late-2023 (headline and core at 2.7% and 2.6%, respectively) hence the committee signaling monetary policy will have to become somewhat restrictive to bring inflation back to target. The Fed didn't raise its policy rate above neutral in its last tightening cycle, and indications that it will do so next year are likely to feed fears of a policy error that slows the economy too much. The committee is projecting a soft landing with the unemployment rate expected to remain below 4% over its forecast horizon while inflation returns to 2% by the end of 2024.

Today's policy statement said the impact of the Russia-Ukraine conflict on the US economy is "highly uncertain" but will likely mean additional upward pressure on inflation in the near-term and could weigh on economic activity. The committee lowered its estimate for 2022 GDP growth (on a Q4/Q4 basis) by more than a percentage point. We think that had more to do with the US economy's slow start to the year, and limited room for above-potential growth to continue, than Russia-Ukraine impact—though Chair Powell wasn't clear on that point in his press conference. From a policy standpoint it looks like inflation concerns trumped growth worries, though geopolitical uncertainty and market volatility likely kept some FOMC members from voting for a larger 50 bp hike today (Bullard was the only hawkish dissenter). Larger moves are clearly on the table going forward with 7 of 16 committee members expecting to raise rates faster than 25 bps per meeting over the remainder of 2022.

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