BNY MELLON

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MACRO MORNING BRIEFING

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The Fed's 1994 Tightening Cycle In Perspective

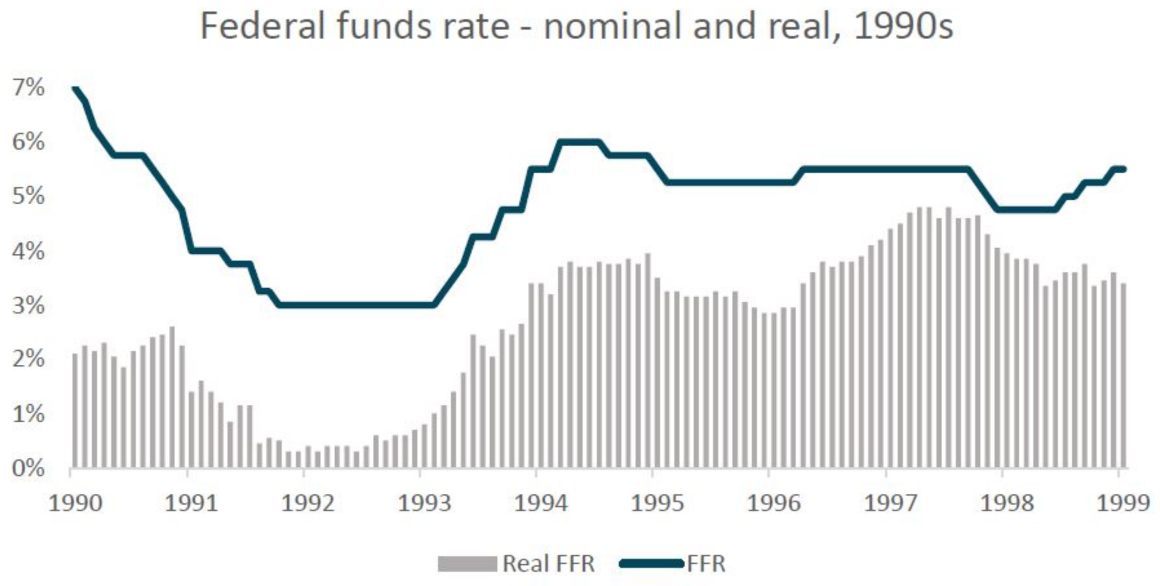
- Only recent time a hiking cycle did not precede a recession was in 1994
- Labor market kept improving, inflation kept falling - for most of the 1990s
- "High pressure", high productivity economy leads to higher real and nominal rates

We're often asked: when was the last time the Federal Reserve raised rates without a subsequent US recession? In the last 35 years, the most recent – and only – occurrence was the 1994-95 tightening cycle. Here we provide a brief history of that hiking cycle and compare and contrast economic conditions then with those now. We conclude that while the analogy to the mid-1990s is imperfect, it nonetheless has lessons for the present, especially regarding productivity growth – and the need for higher nominal and real rates in equilibrium.

The FOMC raised the federal-funds rate by 250 basis points (from 3.0% to 5.5%) via a series of rate hikes in 1994. The first move was a 25bp hike in February of that year, followed by a series of additional increases throughout the year. The tightening cycle ended with a final 50bp hike to 6.0% in February 1995. The funds rate stayed at 6% in nominal terms until July 1995, when the Fed made the first of three 25bp cuts that left the policy rate at 5.25% in January 1996, where it remained for a little more than a year. It was then nudged 25bp higher in March 1997 and remained at 5.5% until September 1998, when global financial stresses emerged and the Fed started cutting rates rapidly.

In sum, we witnessed a rapid increase in policy rates in the middle of the 1990s, followed by relatively steady monetary policy for well over two years. Note also that the real policy rate was brought to relatively high levels – well above 3% – and stayed there for most of the decade. This is a feature which we will reference below.

Rates Policy In The 1990s



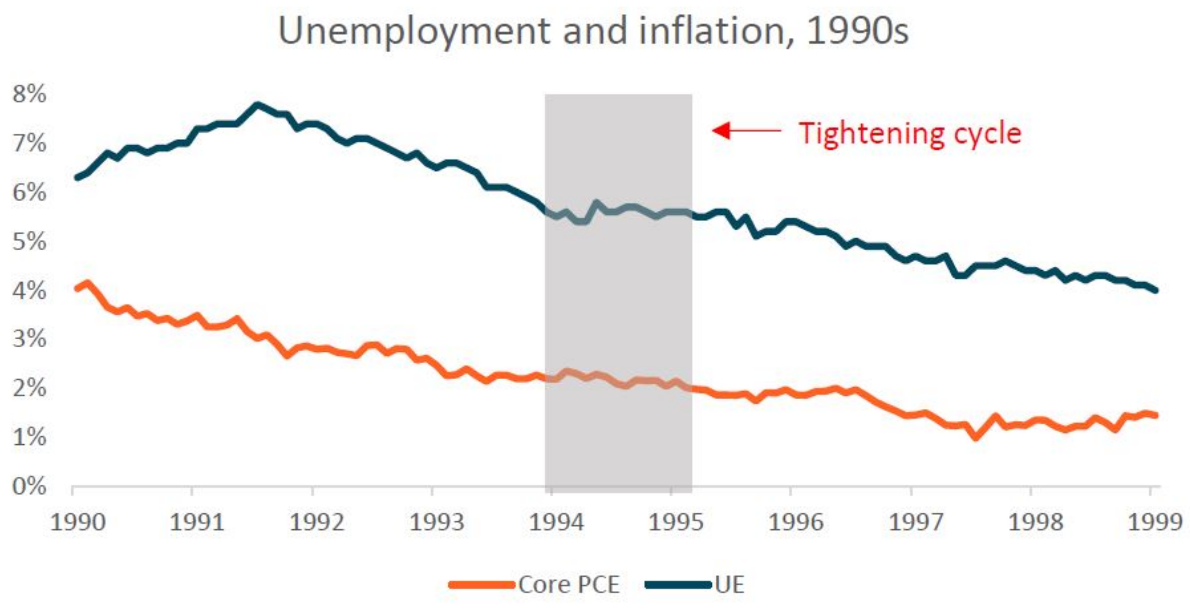
Source: BNY Mellon Markets, Bloomberg

The Fed didn’t initiate the 1994 tightening cycle because of inflation, rather because the labor market was heating up. We can see this in the graph below. The unemployment rate peaked at 7.8% in mid-1990 and had fallen to 5.5% by the time tightening began. It stayed around that level for the duration of the cycle, allowing the Fed to take its foot off the brake a year later. The Fed believed it had successfully cooled the labor market.

In other words, the mid-1990s Fed under then-Chair Alan Greenspan reacted to a quickly tightening labor market, not the inflation rate itself. It was operating under the assumption that low unemployment would lead to rising inflation expectations and, ultimately, to higher inflation. Yet, that didn’t happen. The unemployment rate would end the millennium at just 4% while core inflation was down to 1.5%.

The era of the “great disinflation” was upon us. The economy could indeed display strong growth, stable and low inflation, and relatively high equilibrium rates. By January 2000, the US unemployment rate was 4%, core inflation was 1.5% and the funds rate was 5.5%. The real funds rate, as can be seen above, was still relatively high, at around 3.4%. This was a “high pressure” economy which could operate efficiently without generating inflation or unemployment. Productivity growth over the last three years of the decade was extraordinarily high, averaging nearly 4% per year.

Falling Inflation & Unemployment In The Decade

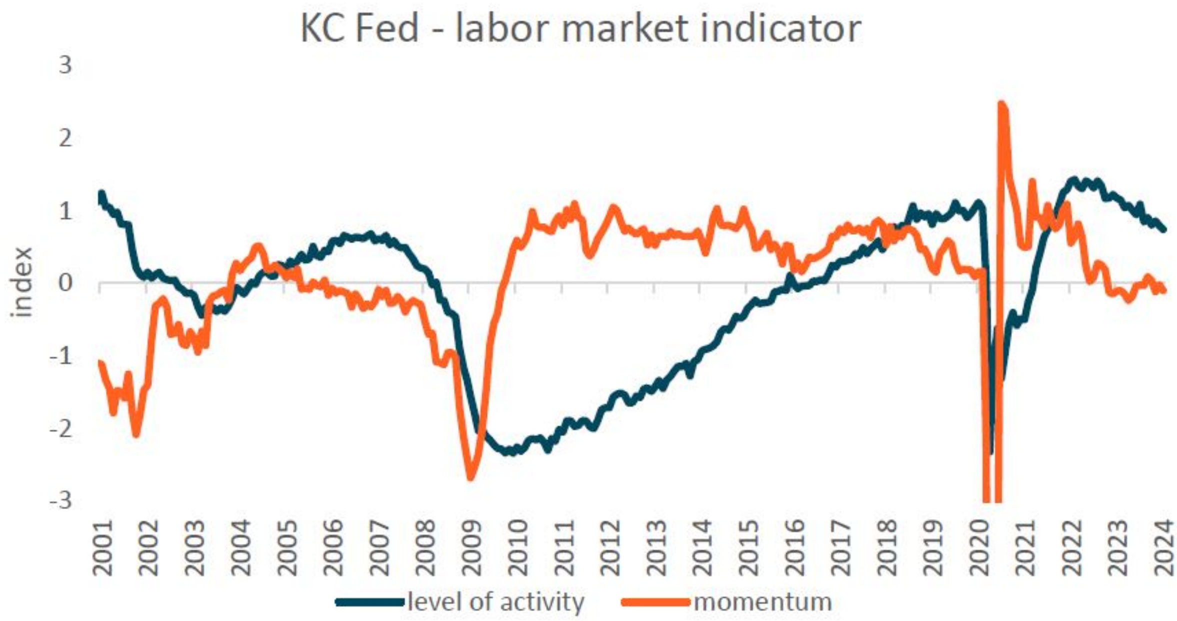


Source: BNY Mellon Markets, Bloomberg

We think comparing and contrasting the current environment to the mid-90s era can be instructive. Tight labor markets may seem to be an obvious commonality, but we would argue that the labor market is actually on its way to equilibrium. The chart below shows the Kansas City Fed's labor market activity indicator, which summarizes two dozen economic data series describing the strength of the labor market and extracts a common trend. From this analysis, the KC Fed publishes a "level" indicator which describes current labor market's overall strength. Also published is a "momentum" indicator, which can be thought of as a rate of change in labor market strength. (More on the KC Fed's LMCI here).

Note that the blue line, illustrating the strength of the labor market, has been recently declining steadily after a period or above-normal strength. The orange line, which depicts the concept of the rate of change of labor market activity, has been falling as well and is now hovering around zero, indicating it's currently normal, or average. We think that on the whole, the labor market is indeed coming into balance, and is unlikely to reaccelerate in the near future. This should give comfort to the Fed that there is receding risk of labor tightness leading to an undesirable return to accelerating inflation.

Loosening Labor Market Still In The Cards

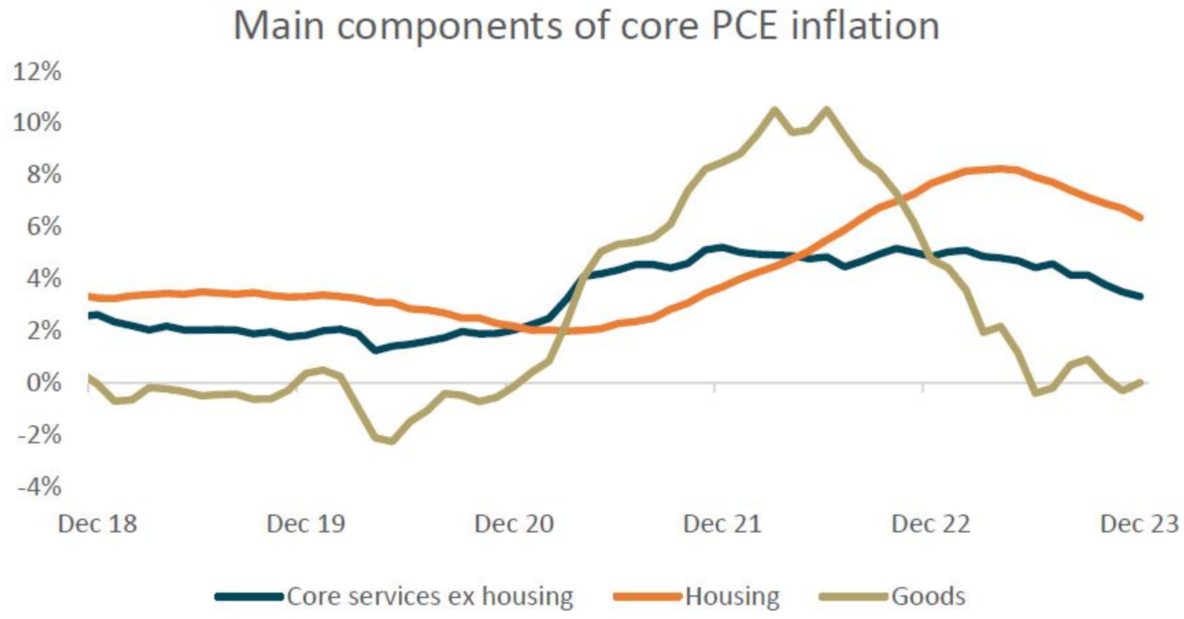


Source: BNY Mellon Markets, Federal Reserve Bank of Kansas City

The chart below shows the three main components of inflation – housing, goods, and core services ex-housing. All three are trending downward. Housing is still quite elevated but following Main Street indices of rental prices, which have fallen over the last year. Goods inflation is essentially zero. The so-called “supercore” is finally and slowly continuing to trend downward but is still higher than comfortable and therefore one of the key indicators that needs to show further relief. A data-dependent Fed will certainly have its eyes focused here.

When the Fed cuts, we think it will be because inflation data have given it the “greater confidence” necessary to do so. It’s possible that the market is right and we are wrong and rate cuts will have to wait until such confidence is gained. As of now, we maintain our view of a May cut. But we also think that the rate cuts won’t be quick in succession or very deep. We target a terminal rate in the upcoming cutting cycle of closer to 3%, or even 3.5%, given that we expect to have another “high pressure” economy which requires higher rates in equilibrium, including higher real rates than those to which we have become accustomed.

We Still Believe In Disinflation



Source: BNY Mellon Markets, Bureau of Economic Analysis

Please direct questions or comments to: iFlow@BNYMellon.com

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