FLASH

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The Fed acknowledges that fiscal dominance is here in the US

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The Federal Reserve cut its key interest rate by 25bp this week, as was widely expected by financial markets. However, everything else surrounding this rate cut turned out to be unexpected.

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Hints of dissenting views within the committee, upward revisions to inflation and growth forecasts, and significantly more restrained projections for future rate cuts surprised investors, disrupting equity, bond, and forex markets. The message sent by Jerome Powell and the Fed appeared to be that the US economy has entered a period of fiscal dominance. In a situation of fiscal dominance, monetary policy is driven "passively" by the impact of fiscal policy on inflation, growth, and public debt dynamics. If confirmed next year, this will be a fundamental policy regime change for the United States, with profound implications for the economy and financial markets.

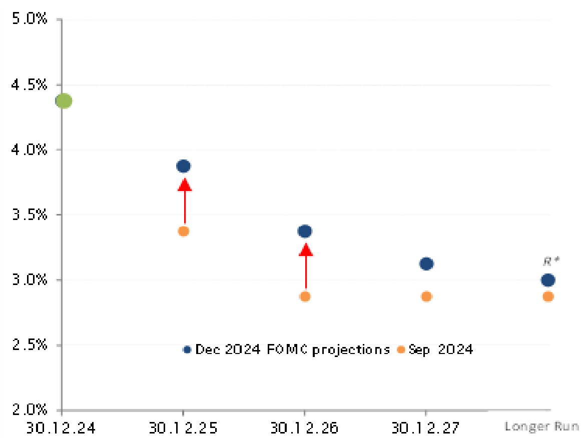
A pivotal monetary policy meeting

The 18 December 18 meeting was supposed to be a "business as usual" FOMC meeting, the last macro event of an otherwise eventful year before investors finally focus on the holiday season. The Fed was expected to seamlessly continue its rate cut cycle, which began in September, while refining its guidance for 2025 in response to stronger recent economic and inflation trends. Instead, it delivered a market-shaking surprise with potentially lasting impacts. The expected 25bp rate cut was the only aspect that unfolded as planned—everything else came as a shock.

Firstly, Fed's Chair Jerome Powell revealed that the decision for the rate cut this time was "a closer call", implying that the decision was not a foregone conclusion contrary to what markets had been expecting. Indeed, one of the twelve voting members of the committee officially dissented and voted for maintaining the rate unchanged, and Jerome Powell's remark suggests that several other members were hesitant in the decision to lower rate this month.

Secondly, the Fed raised its inflation and growth forecasts significantly, signalling that the risks to the outlook had shifted upward. The most spectacular revision was on the inflation side: PCE inflation is now expected to remain above the Fed's 2% target until 2027. The Fed expects inflation to pick up to 2.5% in 2025 after 2.4% in 2024, and to still be at 2.1% in 2026. This persistence of inflationary pressures stands in stark contrast to September's projections, when inflation was projected to slow down to 2.1% next year and settle at 2.0% in 2026. In parallel, Fed's projections now paint a slightly better outlook for growth and employment next year, with projected GDP growth revised up to +2.1% (vs. +2.0% in September) and the projected unemployment rate revised lower to 4.3% (vs. 4.4% in September).

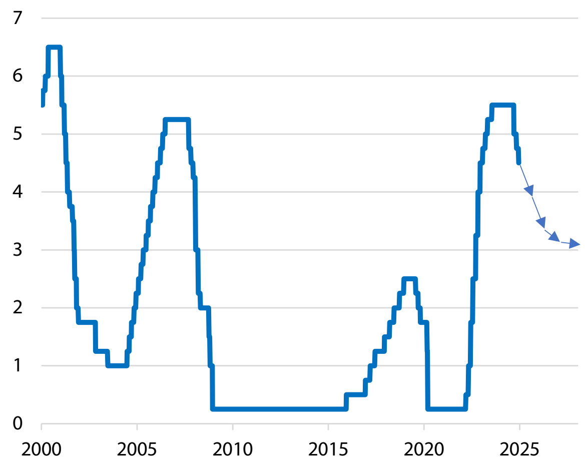
Fed's participants raised their median estimate of future rate levels compared to the September meeting



Source: Bloomberg, Fed

Finally, the update of the infamous Dot Plot, a summary of the Fed Fund rate's estimated path, showed that Fed members were scaling down their expectations of future rate cuts for next year. Only two 25bp rate cuts are now expected by the majority of participants (10), two fewer cuts than three months ago. One member is even expecting no cut at all next year, and three anticipate only one 25bp rate cut. For 2026, two more rate cuts are currently on the line, and the median assessment of the neutral long term rate level was slightly raised to 3%, with a wide range of estimates among members (from 2.375% to 3.875%). Those adjustments point to a rate cut cycle that will be milder than initially contemplated. Rate levels are expected to remain elevated even once the easing cycle is completed, at the highest terminal level of any easing cycle of the past quarter century.

Based on the latest estimates, this rate cut cycle will be the shallowest of the past quarter-century



Source: Fed

Fiscal dominance prevails

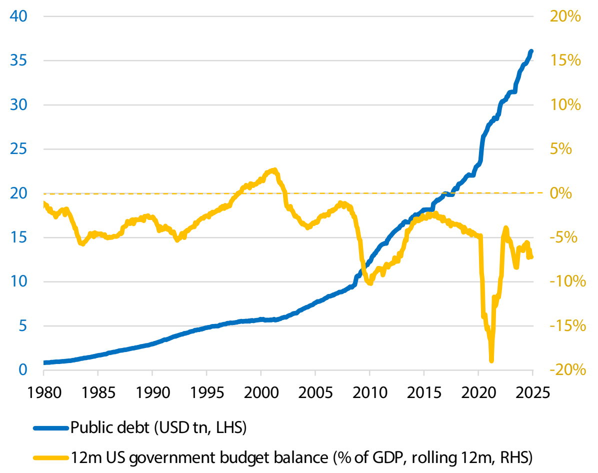
Beyond the technical and uncertain adjustments to interest rate trajectories, the Fed's message hints at a deeper shift: the US economy may be transitioning from decades of monetary dominance to an era of fiscal dominance, following decades of monetary dominance and a bout of exceptional policies triggered by the Covid pandemic.

With a new administration just weeks away and after years of unprecedented public deficits, fiscal policy still seems to be the main force driving the US economy, even as the pandemic's effects have largely faded.

The proof of this is the remarkable resistance of activity growth in the past two years, when virtually all models and economists predicted that the sharp monetary policy tightening would cause a recession. The 525bp rate hike cycle in 18 months should indeed have caused a recession in the US if fiscal policy remained passive and neutral. Passive and neutral it was not, as the series of fiscal stimulus measures during the Covid pandemic, along with the so-called Inflation Reduction Act of 2022, boosted activity and employment, driving inflationary pressures and more than counteracting the effects of rising interest rates.

While the economic policy response to the shock of the Covid pandemic was both exceptional and warranted due to the emergency of the situation, the fact that fiscal policy support has extended through the past couple of years reveals a shift in attitude toward public deficits. Fiscal policy support is becoming a permanent feature of the US economic policy mix, even as economic conditions have normalised, and no new external shock has hit the economy. The immediate consequences are persistently high public deficits and surging public debt, with a direct upward impact on inflationary pressures and interest rates. The fact that fiscal policy is poised to remain on this course under the next administration likely drove the Fed's revisions to its growth, inflation, and rate outlook announced this week.

Wide public deficits are leading to a surge in US public debt



Source: Bank Syz, US Treasury, BEA

Such situations are what economists call "fiscal dominance": when fiscal action, deficit, and debt levels force the central bank to react in ways that it otherwise would not, and when a country's debt and deficit are so high that monetary policy no longer is an effective instrument for controlling inflationary pressures. This is currently the case in the United States, where restrictive monetary policy with positive real rates is not sufficient to bring down inflation toward the 2% level. As a result, the Fed is forced to adjust its approach and trim its initial plan of rapidly cutting rates to bring back monetary policy to what it sees as a neutral level.

Following this week's revisions to the growth and inflation outlook, and with the prospect of persistently wide public deficits and ever surging public debt, the question arises of whether the Fed should even cut rates at all next year. As fiscal policy has become dominant and is now the key driver of inflation and debt dynamics, monetary policy is indeed relegated to a passive role of setting interest rates in response to the fiscal stance. The higher the fiscal support, the higher inflation will remain, the more public debt will rise. In this context, the central bank's main task is no longer to ensure that its policy favour sustainable economic growth conditions. In simpler terms, the goal is to keep interest rates high enough to prevent inflation from spiralling out of control and to sustain investor demand for the growing supply of public debt. This seems to be the position the Fed is in today.

A fundamental change for Fed's monetary policy

Therefore, the Fed's "hawkish rate cut" of this week must be examined in the light of the profound impact that the US fiscal policy has on the economic policy mix. Uncertainties around the outlook for public deficits under the coming Donald Trump administration are high. Most economic measures of Donald Trump's agenda will likely lead to persistently elevated public deficits, including tax cuts across the board. Effectively, the stated intent to aggressively cut into government spendings under Elon Musk's leadership could balance the impact of those measures on the federal budget and contribute to lower public deficits, but the size and scope of those spending cuts remain unknown at this stage.

In the meantime, a government shutdown is looming as disagreement on fiscal policy divides Republicans and Democrats in the Congress, but also creates dissensions within the Republican party itself. As a result, despite a majority in both Chambers in the new Congress that will begin its term on 3 January, there is still uncertainty around the US fiscal outlook. However, the past few years have set a new dynamic in motion, in which the dependency of the US economy on fiscal policy and the surge in public debt change the way that the Fed conducts its monetary policy. This week, the Fed seemingly acknowledged this situation, and investors should take notice. If this situation of fiscal dominance continues, the drivers of monetary policy will change, and the framework that has prevailed in the past decades for setting and analysing US monetary policy will no longer be valid.

For further information

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