

Federal Reserve shifts to a more hawkish stance under new Chair Warsh

The outlook for US monetary policy has shifted markedly in recent months. At the beginning of the year, the US economy was on a path of steady growth and moderating inflation, with expectations building around a gradual easing cycle by the Federal Reserve. However, the escalation of the conflict in the Middle East and the resulting surge in energy prices have disrupted this trajectory. As inflationary pressures re-emerged and price growth moved further above the Fed’s 2% target, markets were forced to reassess the outlook.

Following the US-Israeli military campaign against Iran, launched on February 28th, Tehran retaliated by effectively closing the Strait of Hormuz – the waterway through which approximately 20% of the world’s oil and liquefied natural gas (LNG) normally flows. The resulting surge in energy prices pushed US inflation close to 4%, nearly double the 2% target of monetary policy, signalling a renewed phase of price pressures.

that the next move in policy rates will be upward rather than downward. In this article, we analyze the main factors behind this shift and its implications for the outlook of US monetary policy.

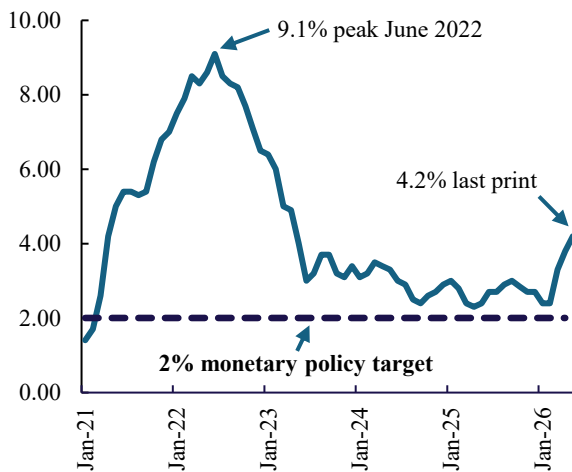
The surge in energy prices following the conflict in the Middle East has altered the trajectory of inflation, reinforcing risks at a time when underlying price pressures were already proving persistent. As a result, consensus forecasts for inflation this year have increased significantly, from around 2.6% prior to the conflict to approximately 3.5% in recent estimates.

While the Federal Reserve operates under its dual mandate of price stability and maximum employment, the latest policy meeting highlighted a clear emphasis on inflation risks. In his first press conference as Chair, Kevin Warsh repeatedly stressed that inflation remains well above the Federal Reserve’s 2% target and placed price stability at the center of the Federal Reserve’s policy agenda. In contrast, labor market conditions received comparatively limited attention, reflecting the view that employment remains broadly resilient. This shift is also evident in the broader Federal Open Market Committee, with policymakers revising upward their inflation projections and moving from anticipating policy rate cuts to signaling a higher likelihood of further policy tightening.

The Federal Reserve’s increasingly hawkish stance reflects not only concerns about current inflation, but also the need to preserve its credibility in delivering price stability. Chair Warsh recognized that inflation has remained above the inflation target for more than five years, underscoring the challenges the institution has faced in restoring price stability. As a result, credibility considerations reinforce the case for maintaining restrictive monetary conditions for longer.

These developments have triggered a sharp repricing of market expectations for policy rates. Earlier this year, investors anticipated a gradual easing cycle as inflation appeared to be moving closer to target. However, the re-emergence of inflationary pressures and the Federal Reserve’s increasingly hawkish tone have altered the outlook. Markets have shifted from pricing multiple rate cuts to policy tightening. This

Consumer Price Inflation
 (% , year-over-year)

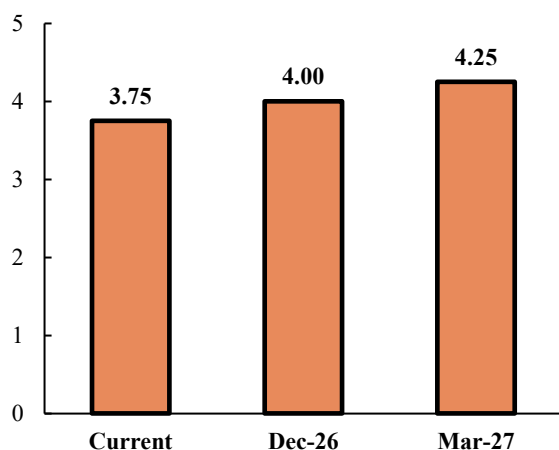


Source: Bureau of Labor Statistics, QNB Economics

At the same time, the appointment of Kevin Warsh as Chair of the Federal Reserve has reinforced the institution’s focus on restoring price stability. His first policy meeting and public remarks suggested a clear emphasis on inflation as the primary challenge facing the US economy, with less attention devoted to labor market risks. This shift has contributed to a renewed tightening bias and increased the likelihood

reflects the growing view that monetary policy may need to remain restrictive for longer than previously expected.

Policy Rate Market Expectations
 (% , upper limit of target range)



Source: Bloomberg, QNB Economics

Taken together, these developments indicate that the Federal Reserve has adopted a renewed tightening bias. While future policy decisions will remain dependent on incoming data, the balance of risks has shifted, with inflation remaining well above target, inflation forecasts moving higher, and policymakers continuing to identify upside risks to the inflation outlook.

As a result, the likelihood of further tightening has increased, and under current conditions the next move in policy rates appears more likely to be upward than downward. Markets are pricing a 25 basis point rate increase by the end of the year, which would raise the benchmark policy rate to 4.00%, while assigning a meaningful probability to an additional rate hike during the first quarter of next year.

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