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# With war in Ukraine, Fed's game plan for rate hikes faces new challenges

The invasion has already rippled through the U.S. economy and upended the Fed's moves to cool down inflation

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By Rachel Siegel

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When the Federal Reserve raises interest rates this week, policymakers will have spent months fine-tuning the best moment to begin cooling off an overheated economy, which by many measures had nearly recovered from the once-in-a-lifetime kind of recession caused by the global pandemic.

Yet all that planning to tackle inflation, now at 40-year highs, has been unexpectedly upended in just a few weeks, with the war in Ukraine now rippling through the U.S. economy through record-high gas prices. At the same time, new waves of global supply chain problems that have already taken hold in Ukraine and Russia could also start appearing in China, where a new covid surge has just started to halt production at major manufacturing hubs.

The Federal Reserve is poised to start putting the breaks on an economy that some experts now say could be in danger of faltering anew. Goldman Sachs analysts have forecast that the economic fallout of Russia's war will pull back on economic growth and raise the risk of the United States entering a recession.

There's a lot of new uncertainty, and the economic consequences depend on how long the geopolitical turmoil continues and the ability for policymakers to buffer against surging energy price hikes that are already seeping into the economy. But for the central bank, what is certain is that the next phase of Fed policymaking will have just as thin a playbook as the one that came before it.

"It's really been a series of negative shocks, that are completely outside of their control, that have complicated their job," said Stephanie Aaronson, director of the Economic Studies program at the Brookings Institution who spent nearly two decades at the Fed.

The initial plan was for the Fed to moderately raise interest rates by 25 basis points at the conclusion of its policy meeting Wednesday. Investors are counting on as many as six more gradual interest rate hikes to ease skyrocketing inflation, up markedly from the three included in the Fed's most recent projections.

But that game plan, now set against the backdrop of Russia's war in Ukraine, could end up being either not aggressive enough if inflation hits double digits in coming months, experts say, or too aggressive if consumer spending starts to drastically dampen on its own and inflation turns around.

"The war and its spillover effects substantially intensify the conundrum the Fed already faced about how aggressively to tighten [policy]," said Eswar Prasad, an economist at Cornell University. "It's a tough call."

After navigating a global pandemic for two years, the Fed and households across America have been handed a whole new kind of economic problem in the past few weeks.

Economists at Goldman Sachs and JPMorgan Chase last week downgraded their forecasts for gross domestic product, a measure of goods and services in the economy, with Goldman analysts putting the risk that United States enters a recession during the next year at about 20 percent to 35 percent. Policymakers at the Fed and White House had hoped that monthly inflation readings would start to tick down by now. But the war's strain on global energy markets only promises to push prices higher.

Higher fuel costs are pushing airlines to cut back on their routes. Small businesses, from concert venues to landscapers, are raising prices to make up for rising gas and transportation costs. Food prices are expected to keep climbing if the conflict continues through Europe's key planting season this spring. The interruption of Russian oil shipments, including the import ban the White House announced last week, threatens one of the largest supply disruptions since World War II.

Already, early looks at consumer sentiment has fallen in March to its lowest level since 2011, according to survey data released Friday from the University of Michigan, as incomes took a beating by rising fuel prices. Consumers said they held very negative prospects for the economy, apart from the job market.

Also, major world powers can't seem to get past the pandemic, a problem which could threaten global supply chains anew in coming months. In China, a surge in covid cases has prompted lockdowns in the manufacturing hubs of Shenzhen and Changchun, dealing a new blow to electronics and car factories that have been repeatedly paused. Foxconn Technology Group, a critical supplier for Apple, said it's stopping production, and it's unclear when the lockdowns would be lifted.

The Fed's tools are limited; raising or lowering interest rates cannot heal supply chains, boost oil supply or sanction Russian President Vladimir Putin's closest confidants. Monetary policy also isn't meant to respond to short-term blips in the economy, like an energy shock. It is intended to see through the turbulence and assess what's happening in the economy over the long haul.

Testifying before Congress earlier this month, Federal Reserve Chair Jerome H. Powell underscored the need to be "nimble" and left the door open for the Fed to move more aggressively if inflation doesn't fall as interest rates rise, supply chains heal and congressional aid from last year fades away.

"We will proceed, but we will proceed carefully as we learn more about the implications of the Ukraine war for the economy," Powell told lawmakers.

But Fed experts say that kind of patience can be hard to justify now. Prices rose 7.9 percent in February, with the biggest drivers coming from gasoline, shelter and food. Inflation has seeped into every corner of the economy, gutting the Fed's message from much of last year that inflation would be temporary and limited to pandemic-affected sectors.

Last month, hotels, furniture, chicken and new cars and trucks all saw their largest annual price increases on record. The February inflation report doesn't even capture the strain on energy markets from the war in Ukraine — and already showed the gasoline index rising 6.6 percent compared with 2021.

As a result, the Fed has come under growing criticism, especially from Republicans, who say the central bank should have intervened with aggressive rate hikes months ago.

"I've warned that it could be extremely difficult to put the inflation genie back in the bottle," Sen. Patrick J. Toomey (R-Pa.) told Powell during a Senate Banking Committee hearing earlier this month. "Well, the genie is out, and the Fed is behind the curve. We must act with urgency to get inflation under control."

Such high inflation has some economists questioning whether the invasion of Ukraine should change the Fed's calculus at all. Adam S. Posen, president of the Peterson Institute for International Economics, said for the Fed, the war doesn't change a fundamental need to start acting and plow ahead to catch up with inflation.

"We know we have to go north. We don't know if we need to go north 400 miles or 700 miles, but we have to go," Posen said. "Four-hundred miles is a long way, and 700 miles is rather a long way, so we should go pretty fast."

But there are risks of going too fast. If the Fed raises rates too abruptly, that could cause a recession. Now the Fed has to balance cooling down the economy, while also factoring in the hazards an energy shock could have for the broader recovery, and for people's own pocketbooks.

Fed watchers and the markets will closely scrutinize how Powell describes the path ahead at a news conference Wednesday. "Uncertainty" is likely to be a major theme, one that accounts for the tumult in Ukraine and shields the Fed from committing to a schedule of rate hikes.

But that may only work as an explanation for so long.

"The Fed may end up seeing its hand forced," Prasad said. "I don't think it quite has the luxury of being able to wait for how things play out because they're at the fine edge of inflation taking off to an extent that it becomes much harder to corral in the future."

By Rachel Siegel

Rachel Siegel is an economics reporter covering the Federal Reserve. She previously covered breaking news for the Post's financial section and local politics for the Post's Metro desk. Before joining the Post in June 2017, Rachel contributed to The Marshall Project and The Dallas Morning News.

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