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ECONOMIC TALKING POINTS

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ALERT:

The Federal Reserve Pulled the Fire Alarm— But Didn't Say Why

There is a nagging sense the Fed's emergency 50 basis point rate cut to help support an economy wrestling with the coronavirus is like placing a Band-Aid on an arm to cure a headache. One is hard-pressed to see how precisely this sudden easing in monetary policy could counter fears of getting ill from this pathogen.

True, the Federal Reserve in recent days has come under enormous pressure from both the futures market and the White House to slash rates. President Trump and his key advisers, Larry Kudlow and Steve Mnuchin, were publicly urging Chairman Powell to act quickly.

And so rather than wait another two weeks when the Fed was next scheduled to meet, the central bank stunned everyone by abruptly lowering the overnight benchmark immediately by large half-a-point.

Why would they do so? What was the urgency behind such a grave move? After all, the Fed doesn't have that ammunition left in the first place when it comes to interest rate options.

We had hoped to get some clarity on its motivation during Jay Powell's ad hoc press conference. But something odd occurred. Powell began by telling reporters the economy is in fundamentally sound shape, even pointing to the healthy job numbers and rising income. And then, in response to a reporter's question, he made a fleeting but ominous comment: " We saw a risk to the outlook for the economy and chose to act."

What specifically did he "see" that called for such drastic monetary action? Was it the threat posed by the coronavirus? From an economists' perspective, it is a baffling to see how low rates will buttress an economy facing a non-economic shock, such as a virus.

He did note how this exogenous shock has hurt travel and tourism and disrupted US and international supply chains. But the cure for that is to contain and then eradicate the coronavirus, not easier credit.

Keep in mind rates were already historically low even prior to the outbreak of the coronavirus. This raises the question whether over the last thirty years American's have accepted low interest rates and negligible inflation as the new normal. That would be worrisome since the argument then is that dirt cheap credit must be made even cheaper — or else the new virus will devour the economy. It's a hard sell.

Moreover, by cutting rates now the Fed painted itself into a corner. If the coronavirus ceases to be a threat by summer and the emergency is over, then the FOMC would prefer to reverse those cuts as the economy recovers. But does anyone think they would hike rates in the final months of a contentious presidential campaign?

Nor was President Trump even satisfied with the 50 basis point rate cut. He explicitly urged the Fed to hammer rates down further in order to weaken the dollar— even though Trump himself has consistently threatened punitive actions against all other countries who manipulate their currency.

If the Fed's objective was to calm financial markets and assure Americans there will be ample liquidity in the economy, it certainly didn't work. The rush to curt rates had the perverse effect and only deepened public anxiety. The Dow plunged 786 points that day. So many investors rushed into the safety of treasuries that the ten-year note yield fell below 1% for the first time!

Something was clearly amiss.

There could only be three explanations.

1. Powell genuinely believed lower rates would help the government slay the new virus. We won't bother to flesh this out because it makes little sense.

2. The regional Federal Reserve Banks received alarming news from local businesses of how much damage the coronavirus is already having on their operations. That may have prompted the Fed to act. But this too is hard to believe since the contagion in the US is still very low.

3. The only other explanation is the Fed chairman obtained an advance copy of February's employment report, which is to be released on Friday. Perhaps employers put the brakes on new hiring in light of the uncertainty how this pathogen will impact their business. This explanation has some plausibility, but we won't know until later this week.

In the absence of any fresh data showing the US economy slipping into recession, I suspect the Fed should now be done for the year.

But we have to be vigilant. If the economy were about to slip into a recession, the leading indicators to monitor at this point would by a combination of the following:

1. A sharp increase in the personal savings rate.
2. Sustained drop in retail sales.
3. Persistent fall in the monthly consumer confidence numbers.
4. Jump in applications for unemployment benefits.

Stay tuned!