Analytics of US Fed's emergency rate cut

Mr. Vipin Malik, Mentor, Infomerics Ratings

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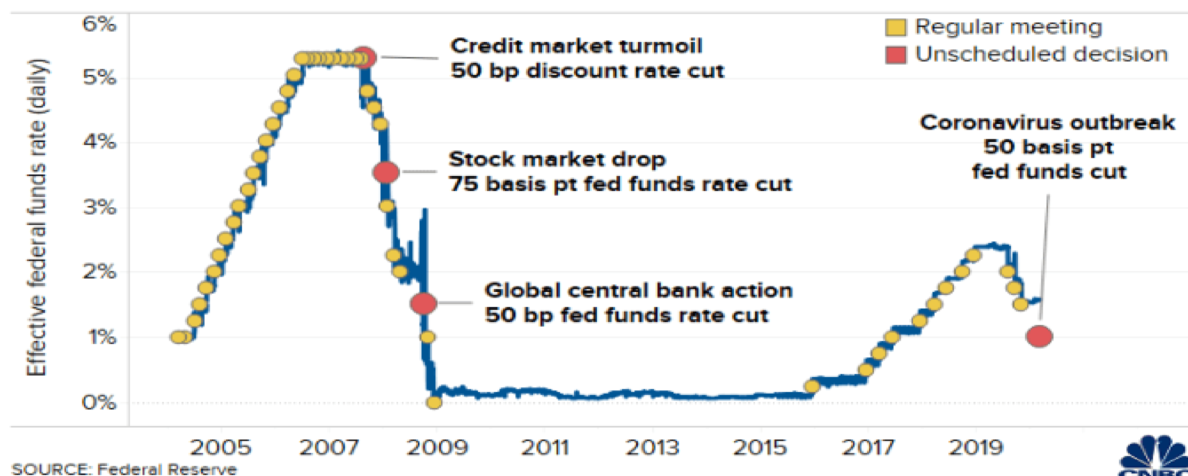
Dr. Manoranjan Sharma, Chief Economist, InfomEerics Ratings.

Most of the world's advanced economies — Britain, Canada, France, Germany, Italy, Japan and the United States — are characterized by very low or negative interest rates. Accordingly, the Fed was perhaps best-placed to make a move in the light of the evolving situation. In an attempt to address the growing economic risk of the coronavirus epidemic and providing President Donald Trump the stimulus sought, the US Federal Reserve unanimously decided on a 50 basis point rate cut to a range of 1.0-1.25. The Fed had reduced the rate three times in 2019 for a total of 75 basis points. In addition to the cut on its benchmark overnight borrowing rate, the Fed also announced a 50 basis point rate cut on the interest it pays on excess bank reserves. The IOER is used as a guardrail for the fed funds rate.

Considered in proper historical and comparative perspective, the US Federal Reserve effected a 50 basis points cut in its first emergency rate cut since the Great Recession in response to the spreading coronavirus. While US economic fundamentals "remain strong", the "coronavirus poses evolving risks to economic activity", the Federal Open Market Committee (FOMC) said. The central bank "is closely monitoring developments and their implications for the economy outlook and will use its tools and act as appropriate to support the economy".



This Fed Policy was entirely in conformity with growing market expectations. Such expectations were clearly reflected in (a) the Group of Seven economies (G7 nations) agreement to "take actions, including fiscal measures where appropriate" and pledge to use "all appropriate tools" to deal with the spreading coronavirus, (b) a massive selloff last week in U.S. equities starkly reflected in the Dow plunging 14% from recent highs (worst week since the 2008 global financial crisis) and (c) heavy pressure from President Donald Trump. Further, on March 2, the Organisation for Economic Cooperation and Development (OECD) slashed its forecasts for global growth in 2020 by 0.5% to 2.4%, and could even reach 1.5% if the coronavirus is sustained and widespread.

Post-policy, the S&P 500 reversed losses and rose by 1.5%, before recording losses again. While theoretically the Fed's move makes it cheaper to access loans that could help companies in difficult times and improve consumer spending, lower rates also make it cheaper for market participants to borrow money for purchasing stocks and other assets.

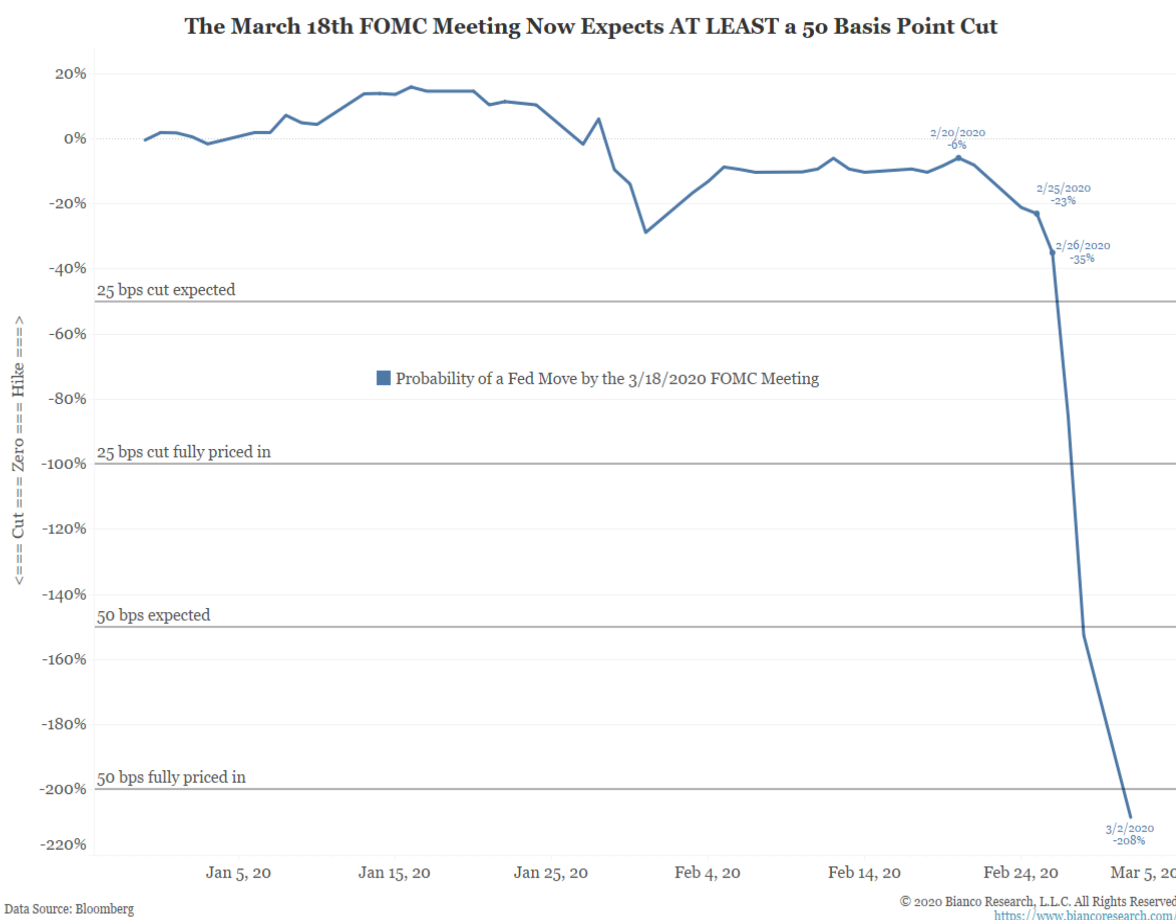
Wall Street banks like JPMorgan Chase and Bank of America used this opportunity to aggressively push the government to further ease regulations. The Bank Policy Institute urged the Federal Reserve to lower capital requirements and alleviate "stress tests" to examine whether a large bank can meet the travails of transition. But this move has been dubbed "transparently opportunistic" by some banking experts.

The Bank Policy Institute (BPI) wants the Federal Reserve to reduce capital requirements and alleviate stress tests designed to effectively meet the challenges of an economic downturn. The BPI asked the central bank to make regulatory changes or implement already planned regulatory changes that "would not reduce safety, soundness or financial stability".

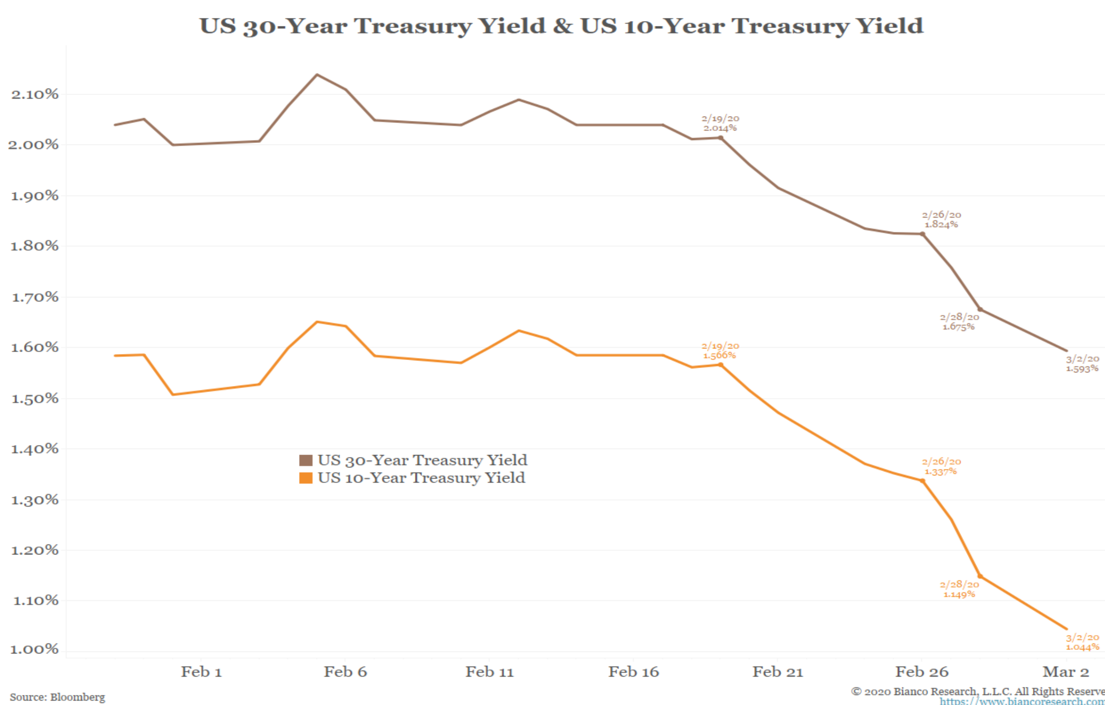
The death toll from COVID-19 has exceeded 3,000 people, and the virus has infected over 90,000 other people, mostly in China. Against this backdrop, a new study from the Brookings Institution highlights several dire projections for the outbreak's hit to US economic growth. While the estimates differ in their extent of gravity, even the softest estimate sees GDP growth tumbling 2%, or $420 billion, from their baseline necessitating "monetary, fiscal, and health policy responses" in afflicted countries.

Despite the central bank aid, Warwick McKibbin and Roshen Fernando expect the global epidemic to reduce US growth through the year. Their study projects seven scenarios for the coronavirus' contagion. The first three assume the epidemic remains in China, though breakouts in Iran, Italy, South Korea, and Japan have turned the outbreak global. The next three scenarios consider pandemics with differing degrees of severity. A final scenario considers the toll from a mild and annually recurring pandemic.

Brookings has done well to stress that the crisis transcends a demand management problem to a multi-faceted crisis requiring "monetary, fiscal, and health policy responses". In the ultimate analysis, there is no substitute to greater investment in healthcare systems and timely and effective global cooperation. In this world of inter-dependencies and inter-linkages, the world has become increasingly integrated and the impulses get quickly transmitted from one part of the world to the other. It is likely that more cuts could be occur and the Fed could even go to zero by the end of the year.



It has, however, to be realised that the coronavirus fears may have triggered market panic but the rapid escalation of global debt could wreak heavy financial damage post-crisis. The underlying supply and demand problems require coordinated and concerted measures with a sense of urgency to boost the domestic economies.



This analysis clearly brings out that the fault-lines caused by the coronavirus are clearly real and worrisome. But it has also to be realised that in the past, the world effectively met epidemics, such as, Sars in 2003 (mortality rate of 10%, affected 26 countries), Swine Flu in 2009 (mortality rate of 4.5%, affected 57 million) and Ebola in 2014 (mortality rate of 25%, killed11, 310 people). In comparison to all these epidemics, the coronavirus in 2020 had a mortality rate of 2% and killed 3,052 people in 78 days. But why is the world so scared of the coronavirus? In 2003 (during Sars), there was no Facebook, no WhatsApp; in 2009 (during Swine Flu), Facebook had just 150 million users; in 2014 (Ebola), WhatsApp had just 450 million users but in 2020, during the coronavirus, WhatsApp had 2 billion users and Facebook had just 1.69 billion users. Hence, the social media has also played a role in hyping this development. To be sure, there is a need for us to be cautious in India but there is no reason to be alarmed.

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