Fed carries out first emergency cut since 2008 in a bid to contain economic fall out from coronavirus

Fed emergency interest rate decision

3rd March 2020

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In a surprise move, the US Federal Reserve cut interest rates by 50 basis points this afternoon as a response to the threat posed by the Coronavirus to the US economy. The target range for the federal funds rate now stands at 1.00% – 1.25%. This was the first emergency cut by the Fed since Lehman Brothers failed in the financial crisis of 2007-08.

The statement issued by the Fed's Federal Open Market Committee stressed that the central bank considers the fundamentals of the US economy to be strong, but that the spread of coronavirus poses 'evolving risks to economic activity'. Currently, there are over 92,000 confirmed cases of coronavirus worldwide. Outside of China, South Korea, Italy and Iran are the countries with the highest caseload. In the US, there are now more than 100 confirmed cases and six deaths linked to the virus. **The number is expected to increase in the coming weeks as tests and diagnostic kits are being made more widely available throughout the US.**

The Fed's rate cut followed a statement by G7 finance ministers and central bank governors released earlier today which confirmed their 'commitment to use all appropriate policy tools to achieve strong, sustainable growth and safeguard against downside risks'. While it is encouraging to hear that international cooperation seems to be on the agenda, no other major central bank has announced any measures so far though the Bank of England might follow suit soon.

The effectiveness of a monetary policy response has been questioned. **The economic effects of coronavirus are essentially three-fold**: first, **a genuine supply shock** as workplaces are shut and both infected and healthy workers stay at home.[1] Secondly, there is **a disruption of supply chains** – many businesses rely on parts produced in other parts of the world and more often than not those components are produced in China. Finally, **avoidance behaviour implies a reduction in aggregate demand** as people stay at home and avoid travelling or going out to restaurants or shops for fear of catching the illness.

None of these points is directly addressed through lower interest rates or more quantitative easing. Indeed, the rate cut could have some unintended consequences and stoke inflation at a time when businesses, who are forced to re-route supply chains or compete for fewer inputs on the market, raise their prices. Arguably, looser financial conditions might help tide over some struggling businesses through cheaper credit**. The main argument for a rate cut, however, is a psychological one – the Fed wants to guard the economy against a broader downturn by injecting confidence via lower interest rates. Whether or not this is sufficient is unclear for now.** The markets for their parts do not seem convinced, with US equities rallying only briefly on the rate cut announcement before diving into the red again.

1: See also our Forecasting Eye released on Monday on the economic impact of a coronavirus lockdown in London

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Kay Neufeld, Head of Macroeconomics

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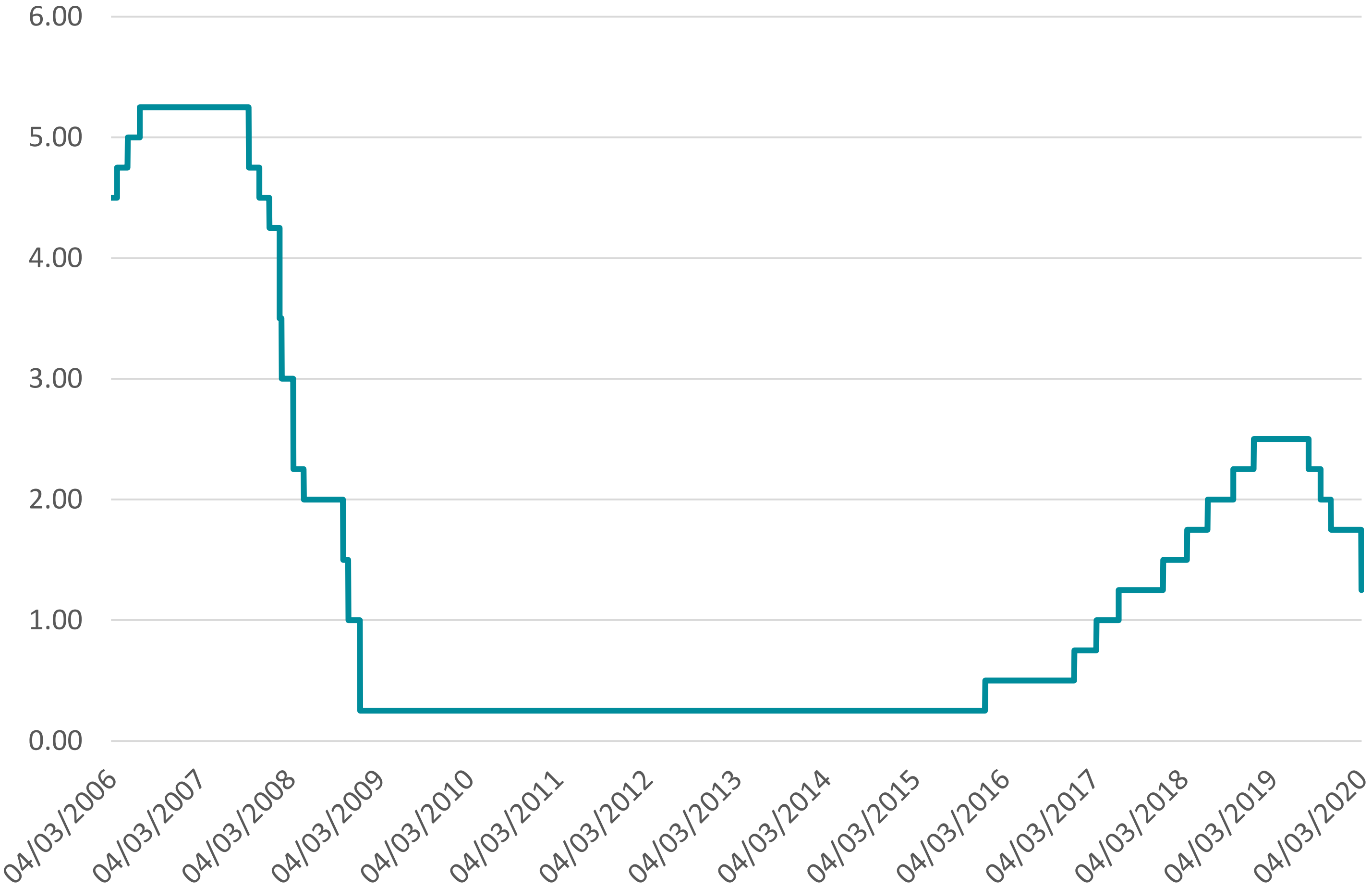
US Federal Funds target range, mid-point



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