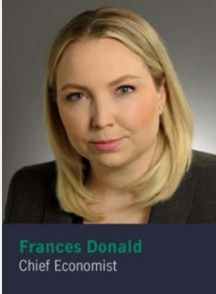

The Fed sent a jolt through the financial markets on Sunday, 15 March, by cutting interest rates by a full percentage point three days before its scheduled rate-setting meeting. While an imminent rate cut had been expected, the timing of the announcement was a surprise. The decision brings the US interest rate back to the level it was during much of the 2008 global financial crisis (0%–0.25%). Our Global Chief Economist and Global Head of Macroeconomic Strategy Frances Donald takes a closer look.

The Fed's historic stimulus package

We've written previously that we believe the US Federal Reserve (Fed) would have to move aggressively before its scheduled March 18 meeting; however, even we hadn't expected this level of action. In our view, the US central bank has thrown just about every tool available at its disposal at the markets and the US economy.

It's important to note that the package Fed Chair Jerome Powell announced on 15 March isn't just about the interest-rate cut, it also includes:

- A new quantitative easing (QE) program worth at least US$700 billion, with US$500 billion allocated to US Treasury purchases and US$200 billion allocated to mortgage-backed securities (MBS). Crucially, in a departure from the Fed's previous normalisation plan, cash from MBS that have matured will now go *back* into MBS purchases rather than into Treasuries. This QE program starts on *Monday, 16 March*.[1]
- Forward guidance returns. The Fed said in its statement that "the Committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals."[1] This is consistent with our forecast that there will be *no interest-rate hikes* in the next five years.
- The Fed's discount rate is cut by an extra 50 basis points (bps) to narrow the spread with the federal funds rate. Banks unable to meet their liquidity needs in the fed funds market will also be able to borrow from the Fed's discount window for as long as 90 days and the Fed also said it will reduce reserve requirement ratios to 0%.
- Using foreign exchange swap lines established in 2008, the Fed and its partner central banks are mobilising existing arrangements to distribute US dollars globally on enhanced terms and with lower costs. Chair Powell noted this was also to prevent financial stresses abroad from permeating the US system.

Has the Fed gone too far? Why is it cutting rates and adding liquidity to this extent?

In our view, there's absolutely a growth component here. It's becoming increasingly clear that we're staring down the barrel of an extremely pronounced growth shock—one that may be short in duration, but painful in terms of depth. There are many market commentators who say that rate cuts at this point won't help growth. I respectfully disagree: They absolutely do, just not to the same degree they have in the past. Mortgage applications during the week ended 6 March rose 55% from the previous week, led by refinancing. This is evidence of lower rates at work. At the margin, it should also help the consumer by lowering some bills, which could translate into slightly higher disposable income.

The more important point here, however, is that **what we're dealing with could be bigger than a coronavirus-created recession—policymakers**

[1] Federal Reserve issues FOMC statement, federalreserve.gov, 15 March 2020.

are acting to steer us away from a potential credit crunch. In our mind, the Fed is clearly trying to prevent a repeat of 2008 and keep us in a 2001 type of recession from which we can bounce back much more quickly. The US Treasury market has seen sizable funding issues in the past week and has been displaying signs of stress. As Chair Powell noted during the Fed's press conference, the Treasury market is typically the most liquid, and any sign of stress is therefore concerning and could translate into broader market dysfunction. He also noted that he felt it was important that the Fed "support market functioning."[2]

What's next? Is the Fed "out of bullets"?

Of course not. The Fed may be out of *rate cuts*, but it's not out of tools. We're expecting more action from the Fed in the weeks ahead.

- We expect the Fed to introduce a **commercial paper backstop** to support the corporate credit markets.
- We expect target **yield curve control**, as the Bank of Japan has done. While it's impossible to know if the Fed would choose to target the 10-year yield curve or another maturity, we believe it's likely that it will try to engineer steepening of the yield curve.
- It's also possible that **the Fed could seek approval from Congress to allow it to purchase credit and equities** (also like the Bank of Japan). Although Chair Powell deflected this question in Sunday's press conference, we don't think it's out of the scope of possibilities this year.
- One measure that **we don't believe the Fed will pursue is negative interest rates**. Or at least, not during this cycle. Chair Powell noted during Sunday's press conference that "… we do not see negative policy rates as likely to be an appropriate policy response here in the United States."[2]

Ultimately, we believe that the Fed's package won't be able to prevent a recession if that's where the US economy is headed—and it probably is. However, this package will likely support credit channels and enable the healthy functioning of the US Treasury market, thereby preventing severe financial contagion from taking place. That said, overall visibility remains limited. Hopefully, the fog will clear soon.

[2] "FOMC Press Conference Call," 15 March 2020.

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