US interest rates cut for first time in more than a decade

New rates meant to calm uncertainty over Donald Trump's trade conflicts, analysts say

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The US Federal Reserve has cut interest rates for the first time in more than a decade in an effort to extend the country's historic economic expansion beginning under former President Barack Obama. **(EXTRACT 1)**

The Federal Reserve announced the changes on Wednesday, saying it would lower targets for key federal funds by 0.25 per cent to a range of 2 per cent to 2.25 per cent**.** **(EXTRACT 2)**

However Fed Chair Jerome Powell on Tuesday that said the move might not be the start of a lengthy campaign to shore up the economy against risks including global weakness.

"Let me be clear – it's not the beginning of a long series of rate cuts," Powell said in a news conference after the Fed released its latest policy statement. At the same time, he said, "I didn't say it's just one rate cut."

Mr Powell cited signs of a global slowdown, simmering U.S. trade tensions and a desire to boost too-low inflation in explaining the central bank's decision.

The board was previously considering raising rates in 2019.

U.S. President Donald Trump, who has repeatedly attacked the Fed's policy stance under Powell and demanded that it push through big rate cuts, said on Twitter the Fed chief "let us down" by not telegraphing that an aggressive easing was coming.

It's the first rate cut since December 2008 during the depths of the Great Recession, when the Fed slashed its rate to a record low near zero and kept it there until 2015. **(EXTRACT 3)**

The economy is far healthier now despite risks to what's become the longest expansion on record. **(EXTRACT 4)**

The Fed repeats a pledge to "act as appropriate to sustain the expansion," wording that markets have seen as a signal for possible future rate cuts.

The new rates are also reportedly meant to combat extensive uncertainty caused by Donald Trump's ongoing trade war with China and tariffs threats against several other countries. **(EXTRACT 5)**

Stock indexes fell on Wednesday after the widely-expected announcement.

Some on Wall Street had believed the Fed might act more aggressively in cutting rates by half a percentage point rather than the quarter-point cut it wound up making.

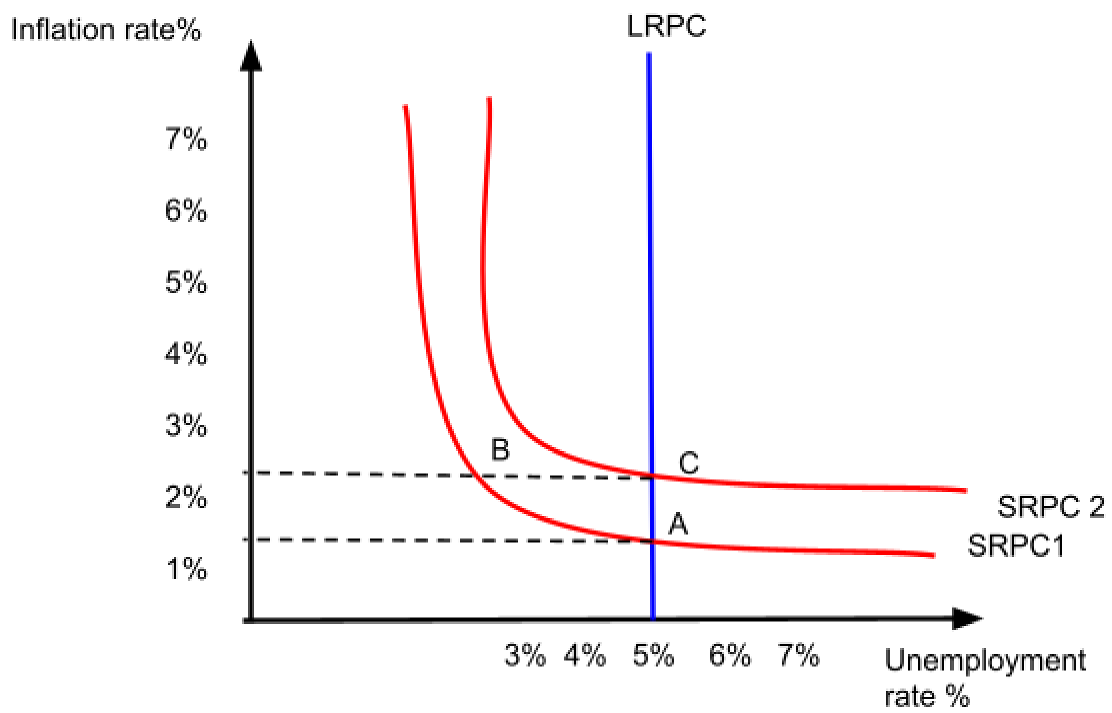
The smaller cut prompted investors to send stocks lower and bond yields higher.

The Fed's repeated vow to "sustain the expansion," was widely-interpreted as a signal for possible future rate cuts.

This article is talking about the US Federal Reserve's decision to cut interest rates in an effort to combat the economic slowdown[1] and how this will affect the country in the long run. It also proposes solutions to the problem and evaluates the risks associated with them.

Interest rates are the cost of borrowing money or the return from saving. Interest rates are raised or lowered to ensure stability and liquidity. In the article, one of the reasons given for the rate cuts is to recover from the recession that it suffered in the year 2008[2]. The US plans to increase aggregate demand and boost a too low inflation. I will be analysing and discussing Trump's demand for cuts bigger than 0.25%[3] and also whether expansionary policy alone as applied by the Federal reserve will be enough to solve the problem.

<u>The Relationship between inflation and Unemployment</u>



Due to the recession in the US, monetary policy can be used to stimulate aggregate demand. As unemployment rate decreases from A to B, inflation rate rises. This increase in AD causes inflation and real wages stay the same. When the US realises real wages are the same, they change price expectations and real output returns to its original level. Unemployment remains unchanged, but we have a higher inflation rate. The short-run Phillips curve shifts upwards from SRPC 1 to 2.

[1] Extract 1
[2] Extract 3
[3] Extract 2

The US Federal reserve Expansionary policy

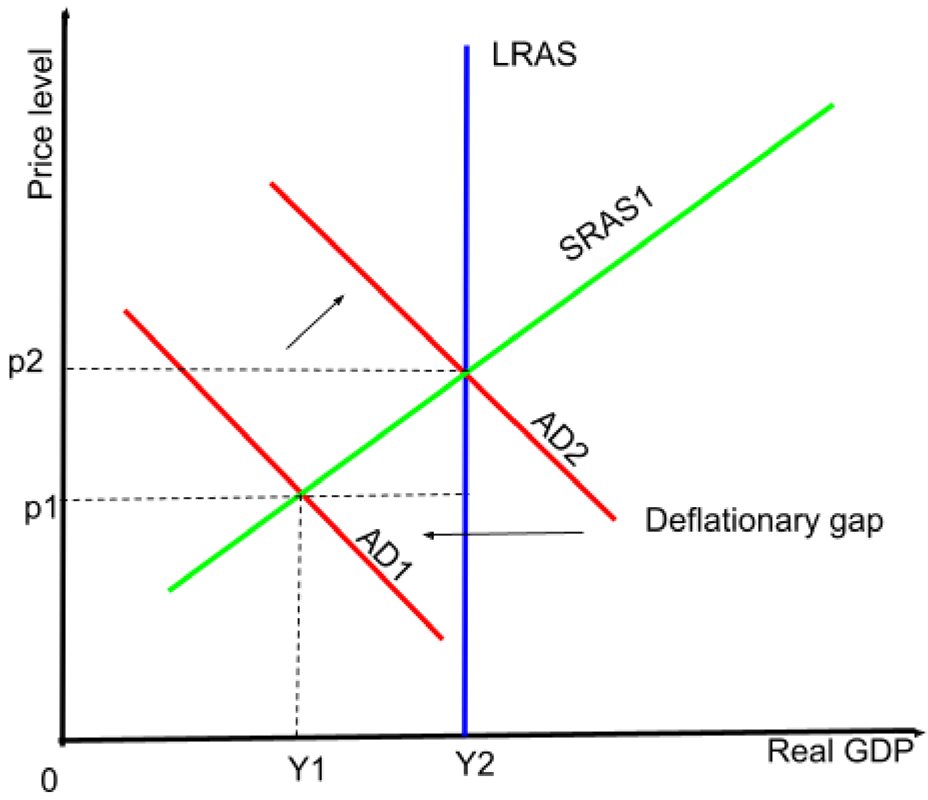


Figure 2

The figure illustrates Expansionary Monetary policy to battle the problem of recession and the 'too low inflation'. Due to the rates being highly cut, Price level increases from P1 to P2 causing an increase in the real GDP moving from Y1 to Y2. This causes Aggregate demand to increase from AD1 to AD2 thereby closing the deflationary gap. This stabilizes the economy making it healthier[4] and hence we can state that it is moving from being in recession to recovery mode in the business cycle. The increase in real GDP leads to an increase in domestic demand. In the long run, an increase in aggregate demand will only be inflationary.

Uncertainty caused by Trump's trade war with China and other countries[5] has affected the US greatly and so to tackle this problem, the federal reserve suggests expansionary monetary policy which involves cutting interest rates. Another reason mentioned in the article as to

[4] Extract 4
[5] Extract 5

why the rates were cut is because the US government wants to sustain the economic growth it has been experiencing for the past few years. Lastly, the country is experiencing a too low inflation or disinflation and plans to boost this. I am now going to evaluate and discuss some of the solutions that can be implemented to solve the issue.

One of the solutions to battle the low economic growth in the country that can be implemented is the central bank pursuing a policy of quantitative easing to increase the money supply and also reduce long-term interest rates. The central bank can use the money created from quantitative easing to buy government bonds from commercial banks. This will (1) increase the monetary base and cash reserves of banks, which should enable higher lending and (2) reduce interest rates on bonds which should help investment. One drawback of this though is that if confidence is very low, then people may not want to invest or spend, despite lower interest rates. A consequence from the rates being cut is that exporting firms with lower interest rates have a cheaper cost of production and this increases their ability to compete in international markets with more attractive cheaper goods which reduces the opportunity cost that arises from the US losing out on trade with China due to the trade war. Another drawback can result from such a situation. In the first place, if there was a credit crunch, banks will be unable to lend funds, therefore although the central banks cuts base rates, it is still difficult to get a loan from the bank, expansionary monetary policy is good because it encourages consumption in the economy and leads to the overall increase in aggregate demand but it is worth noting that some commercial banks may not pass the base rate cut on. This may prove to be a problem for the US which aims to sustain economic growth. A possible solution to this is to tighten up regulations surrounding the base rate by the US government.

Word count: 718