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THE OUTLOOK

Case for Cutting Rates Can Be Found in Close Calls of the 1990s

Fed officials at their meeting this week are set to weigh whether trade tensions and a recent hiring slowdown might warrant action

Then-Chairman of the Federal Reserve Alan Greenspan, right, talks to former Treasury Secretary Robert Rubin during a committee hearing in January 1995. By the summer of that year, Fed officials worried the economy might be slowing too much, and cut rates in July and December 1995. PHOTO: PAUL J. RICHARDS/AGENCE FRANCE-PRESSE/GETTY IMAGES

By Nick Timiraos

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The Federal Reserve usually cuts interest rates because bad things are happening. Sometimes, though, it cuts rates because the risk of bad things has gone up—like taking out an insurance policy.

That's how some analysts characterize the current case for cutting rates, and they cite 1995 as the parallel. Back then, the Fed lowered rates in time to prevent an economic slowdown from turning into a recession.

Fed officials are set to consider at their meeting Tuesday and Wednesday whether a worsening of trade tensions since their April 30-May 1 meeting and the recent slowdown in hiring and industrial activity might warrant similar insurance, if not this week, then later this summer.

Over the 12 months that ended in February 1995, the Fed doubled its policy rate in hopes of achieving a so-called “soft landing,” when growth ebbs just enough to contain price pressures while allowing the economy to keep expanding. The Fed lifted rates four times last year with the same aim.

By the summer of 1995, Fed officials worried the economy might be slowing too much. “We ought to be taking out some insurance against recession,” said Fed Vice Chairman Alan Blinder at the central bank’s July 1995 policy meeting, according to the transcript. The Fed cut rates at that meeting, and again in December 1995 and January 1996.

The July 1995 example stands out because the Fed lowered rates even though stock markets were rallying. Stocks have climbed in recent weeks on the hopes of easier Fed policy.

While concerns around a sharper-than-anticipated slowdown were broadly shared at that 1995 meeting, “no one thought the probability of a recession was better than 50/50,” said then-Fed Chairman Alan Greenspan, according to the transcript. He justified the rate cut in part by pointing to inflation that “is being held down by events in the rest of the world,” something that could also be happening now.

The analogy isn’t perfect. Most Fed officials back then had concluded softer inflation pressures meant their benchmark federal-funds rate—then at 6%— was high enough to deliberately slow growth. Today, with the rate in a range between 2.25% and 2.5%, most officials don’t share that view.

Rate cuts in 1995 “started from a level in which the funds rate was clearly restrictive,” said Donald Kohn, a senior Fed economist in 1995, in a recent interview. “That’s an important difference between now and where we were in 1995.”

Economic weakness also was more evident in the data then than it is today, when the picture is more mixed.

The mid-1990s episode is proof that “the Fed never cuts for free,” said Roberto Perli, an analyst at research firm Cornerstone Macro. “You need a reason for it, and most of the time there is something really nasty happening.”

To justify a rate cut in the current environment, Mr. Blinder said in a recent interview, officials should need to see either more evidence of a substantial growth slowdown or conclude that the so-called neutral interest rate—the level that neither spurs nor slows growth—is lower than they thought. That would imply rates could be curbing growth more than they anticipated.

Some observers think the recent hiring slowdown might offer such evidence. The Fed's rate increases last year were aimed at slowing job growth to a more sustainable rate that would avoid hotter price pressures. But the tepid May gains raise the question of whether the pace will weaken further.

The Fed's challenge is complicated today because officials face two very different scenarios. In the first, trade tensions with China and other countries ease, leaving less urgency to reduce rates. In the other, these frictions worsen and the economic outlook deteriorates, calling for lower rates.

While the Fed can try to cushion a modest weakening in demand, it isn't all-powerful. It can't undo "the real economic harm caused by trade protection and extreme uncertainty that is shaking globally integrated production chains," said Krishna Guha, vice chairman of Evercore ISI.

If it looks like the worrisome scenario is unfolding, the Fed will have greater incentives to cut rates sooner rather than later because they are already very low, leaving less room to cut them to stimulate growth in a downturn.

> "The cost of insurance goes up after an accident," said Laura Rosner, senior economist at advisory firm MacroPolicy Perspectives.

The Fed took out insurance again in 1998 to prevent a potential market meltdown stemming from the Russian debt default. They reversed the cuts in 1999 after averting catastrophe.

The examples from the 1990s are both reassuring and distressing. They show the Fed can make a preemptive strike to sustain an economic expansion, but it hasn't since repeated the trick.

Fed officials this week will have to balance the appeal of such insurance with the risk it scares investors into thinking the central bank sees something more ominous in the economy.

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