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ECONOMY

Fed Eyes Another Rate Cut, Weighs When to Stop

Officials face questions over whether and how strongly to signal pause in cuts after October meeting if economic data hold steady

Fed Chairman Jerome Powell has repeatedly highlighted episodes in 1995 and 1998 when the central bank cut interest rates three times and avoided a recession. PHOTO: DANIEL BRENNER/BLOOMBERG NEWS

By Nick Timiraos

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Federal Reserve officials are heading into their meeting in two weeks likely to cut interest rates while debating whether they have done enough for now to vaccinate the economy against growing risks of a sharper slowdown.

Officials began these discussions last month, when they cut their benchmark rate to a range between 1.75% and 2%.

Now they are deliberating whether to call timeout on the current sequence of rate cuts, how much time they need to assess the effect of those moves and how to communicate their plans.

In recent public statements and interviews, officials have held the door open to cutting interest rates for a third time in as many months, though they have argued less forcefully for another

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reduction than they did before their moves in July and September.

They framed those reductions as a policy recalibration to cushion the economy against a global manufacturing swoon amplified by the U.S.-China trade war rather than the start of an open-ended stimulus effort to combat a deepening downturn.

Investors in interest-rate futures markets have maintained strong expectations of a cut at the October meeting—a 90% probability as of Friday, according to CME Group—in part because Fed officials have done little to dispel those expectations.

"Our policy actions have been very helpful to keeping the economy on track and to manage some of the risks we were facing," New York Fed President John Williams told reporters after a speech Thursday. "Looking forward, I think we just have to take this same approach, this meeting-by-meeting approach."

Fed Vice Chairman Richard Clarida echoed those views in public remarks Friday, delivering the last word from the central bank's inner circle before the Fed's customary premeeting quiet period begins Saturday.

If officials conclude they should signal a possible timeout from rate cuts, Fed Chairman Jerome Powell could disappoint investors who have come to expect additional central-bank support.

"The risk is that even a balanced message that avoids sending a clear 'we are done' message results in a selloff" in short-term bonds, sending interest rates up and stock prices down, said Jan Hatzius, chief economist at Goldman Sachs, in a report last week.

The Fed usually cuts interest rates because bad things are happening in the economy, but sometimes it has cut rates because the risk of troubling developments has gone up—similar to taking out an insurance policy.

The challenge is judging how much insurance is needed. "You don't know how long you have to buy it, how much more you have to buy," said Vincent Reinhart, a former senior Fed economist who is now chief economist at Mellon.

Mr. Powell has repeatedly highlighted episodes in 1995 and 1998 when the Fed cut interest rates three times and avoided a recession. "The Fed cut, and then cut again, and then cut a third time," he said last week. "The economy took that accommodation on board and gathered steam again, and the expansion continued. So that's the spirit in which we're doing this."

Dallas Fed President Robert Kaplan said Friday he hoped the current sequence of rate cuts would be "modest, limited and restrained" and not the start of a "full-fledged rate-cutting cycle."

With another reduction in October, officials could then see whether this broad scenario unfolds, allowing them to stop cutting rates. Or if it doesn't, they could reduce rates further.

"This is a fluid situation," said Mr. Kaplan, who described himself as agnostic on a rate cut this month. "This is a fragile time where this could break either way."

One issue facing Fed officials is how to signal in their postmeeting statement that the threshold for additional reductions would require stronger evidence of deterioration.

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One way Fed officials have in the past signaled a possible timeout from rate cuts was to highlight the accumulation of recent stimulus, though plans to take a breather from cutting rates don't always work out.

In October 2007, for example, Fed officials followed a half-point cut in September with another quarter-point cut. They discouraged expectations of future cuts in their postmeeting statement, but the economy slid into recession one month later, triggering a more aggressive round of rate reductions.

Since last month's Fed meeting, geopolitical risks have neither receded nor intensified. The U.S. and China are attempting to reach a trade truce ahead of a world leader summit in Chile next month. Britain and the European Union agreed Thursday to new terms for the U.K.'s exit from the bloc, which still requires approval from U.K.'s Parliament.

Meantime, surveys and other economic data have hinted that weakness in the hard-hit manufacturing sector isn't lifting and might be spreading to other parts of the U.S. economy. But the September employment report showed little obvious sign of a collapse in hiring.

While global manufacturing activity is slumping, Mr. Clarida said Friday that he didn't see any evidence of shocks or slowdowns "spilling into the consumer."

Chicago Fed President Charles Evans said Wednesday he saw some risk that the economy will have difficulty navigating uncertainties or shocks. "There is an argument for more accommodation now to provide some further risk-management buffer against these potential events," said Mr. Evans.

One positive development for the Fed is that market-determined interest rates, which tumbled in July and August, have firmed up in recent weeks. As a result, long-term interest rates have risen back above short-term interest rates. In recent months, long-term rates have dipped below short-term rates, a phenomenon known as an inverted yield curve that has often preceded recessions by a year or two and that some officials had cited as a reason for additional rate cuts.

Increases in interest-sensitive spending, particularly in the housing sector, suggest the Fed's rate cuts are providing some boost to the economy, and officials have said it will take time to reap the full benefit of additional stimulus.

Lower mortgage rates, for example, are supporting home sales, which in turn could propel spending at home-improvement retailers.

—Michael S. Derby contributed to this article.

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