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MARMORE

FIRST TAKE

U.S. Fed rate cut by 50 bps due to Coronavirus threat

Was the Fed being proactive or did they press the panic button too soon?

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HIGHLIGHTS

- The U.S. Federal Reserve announced an emergency rate cut of 50 bps on March 3, 2020 citing the threat of novel coronavirus affecting economic growth in the near term. The announcement was made after an unscheduled meeting, which took place ahead of their scheduled monthly meeting on March 17-18. As things stand, Fed's benchmark funds rate are now in a range between 1%-1.25%. The U.S. Fed had earlier slashed the rate thrice in 2019, reducing it by 75 basis points in total. The Central Banks of UAE, Saudi Arabia, Qatar and Bahrain followed suit by effecting cuts of 50 bps in their respective policy rates. Central Bank of Kuwait reduced its discount rates by 25 bps from 2.75% to 2.50%.

- The unscheduled rate cut by the U.S. Fed was the first such instance since December 2008, where policy action has been initiated away from a scheduled meeting. The move comes after days of volatility in financial markets and the meeting of G7 finance ministers and central bank governors, where they pledged to use all appropriate policy tools to maintain the economic health of the advanced world. In the announcement, U.S. Fed Chair Jerome Powell said that while the economic fundamentals of the U.S remain strong, the action to cut rates was in response to the downside risks from the Coronavirus.

- The decision polarized opinions among several economists and analysts. While some stated that the U.S. Fed took a proactive decision to get ahead of a potential crisis, others felt that this was a strong negative signal from the central bank. Outgoing Bank of England governor Mark Carney stated that there is likely to be a large economic shock due to Coronavirus. He added that monetary policy would not have a material impact due to several central banks having limited room for action, with interest rates close to zero or negative. Further cuts would be self-defeating for European banks whose profitability is already weak. Some analysts even expect the U.S Fed to go all the way to zero interest rate.

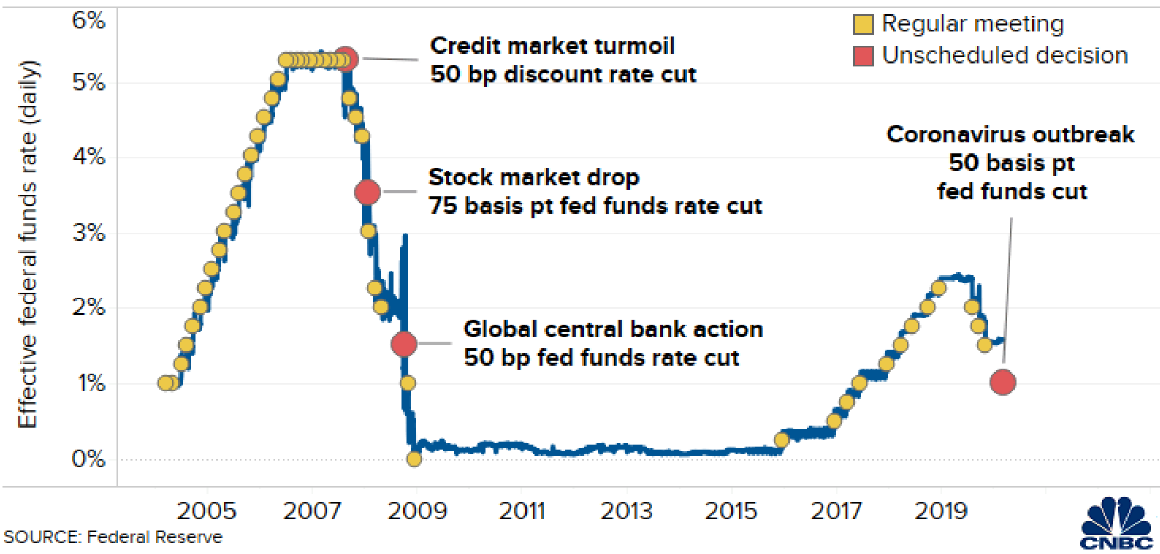
- Consequently, the 10-year Treasury bond yield dropped below 1% for the first time in history, as investors grew increasingly worried about the economic impact of novel coronavirus outbreak. Although the yields have been lower since the turn of the year, the volatility in the markets accelerated the fall in yields to record lows. Reacting to the move, the U.S. stock market initially showed gains before diving sharply into negative territory, suggesting that investor concerns were not appeased by the U.S. Fed's move. The U.S. dollar hovered near five-month lows versus the yen, while Gold extended its gains.

- With the U.S. election campaign going strong, Donald Trump, who has made the strength of the U.S. economy and financial markets as key factors for his bid for re-election, has been vocal for the Fed to cut interest rates in recent days. The Reserve Bank of Australia was the first among major central banks to react, reducing policy rates by 25 bps. With the rates in other developed nations/regions like U.K., Japan and the Eurozone being lower than that of the U.S., the move by the Fed will present a challenge for other Central Banks who would be expected to follow. For instance, the European Central Bank would have to send rates further into negative territory if they choose to follow the U.S. Fed.

- Whilst the merits of timing of the move remain muddled, it has certainly raised a few key questions. With the U.S. economic fundamentals not being largely alarming yet, many perceive the Fed's action as financial markets dictating the hand of the Central Bank. The effectiveness of monetary policy as a suitable counter to the economic fallout of a potential pandemic is debatable as well. What remains in the future is yet to be seen, but recent signs suggest that the U.S. Fed is focused on preventing a recession in the near term at all costs.

Appendix

Figure 1: U.S. Fed Rate movement over the years



Source: CNBC, U.S. Federal Reserve

Figure 2: 10-year U.S. Treasury yield (in %)

Source: CNN, Refinitiv

Disclaimer

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