What can past cycles of interest rate cuts tell us about future monetary policy?

JIROU SUGIE
ECONOMIC RESEARCH OFFICE

MUFG Bank, Ltd.
A member of MUFG, a global financial group

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At the Federal Open Market Committee (FOMC) meeting held on 18th and 19th June, the Federal Reserve Board (FRB) revised its monetary policy stance from “the Committee will be patient as it determines what future adjustments … may be appropriate” at the start of the year to “the Committee will closely monitor the implications of incoming information … and will act as appropriate”, due to increased uncertainties and muted inflation pressures. In addition, all seventeen FRB members predicted that the federal funds rate would be maintained at current levels or would be raised in their quarterly assessment for the federal funds rate published in March. However, this changed this time around in June when eight members – almost half – projected interest rates will be lowered this year. While it could be argued that this large split by eight members from the assessment that the FF rate will remain the same is an anomaly, it is clear that there is movement towards a rate cut compared with the FOMC meeting in May.

The behaviour of economic indicators, such as stock prices, production and employment, at the start of a cycle of rate cuts reveals stock prices (S&P500) were at a very high (or record high) level in the majority of cases over the past 30 years (Chart 1). Therefore, it does not appear that the FRB uses a large shift in stock prices as a marker for the start of its rate cuts. In contrast, a notable deceleration in the growth of production and employment indicators can be seen before the start of interest rate cuts. Currently, the sluggish growth of production invites a rate cut and the high stock prices are also indicative of an upcoming rate cut, but employment indicators do not show a need for the FRB to lower interest rates right now.

As mentioned earlier, this shift towards a rate cut is likely due to FOMC members strengthening their stance of emphasising the “uncertainties about this outlook” in their Statement, brought about mainly by the worsening of trade friction between the US and China. In other words, as long as there are no developments which dispel this uncertainty (e.g. significant progress in US-China trade negotiations resulting in the abolition of tariffs and a swift recovery of production), the FRB will cut interest rates. Although it is difficult to predict the outcome of the meeting between US and Chinese leaders at the G20 summit in Osaka, it is fairly unlikely that they will reach a bold agreement based on the severity of their conflict. There are also no signs of acceleration in the inflation rate, so it is likely that the FRB will lower interest rates sooner or later.

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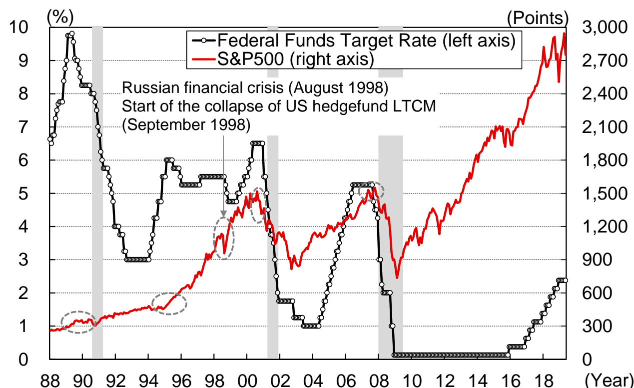
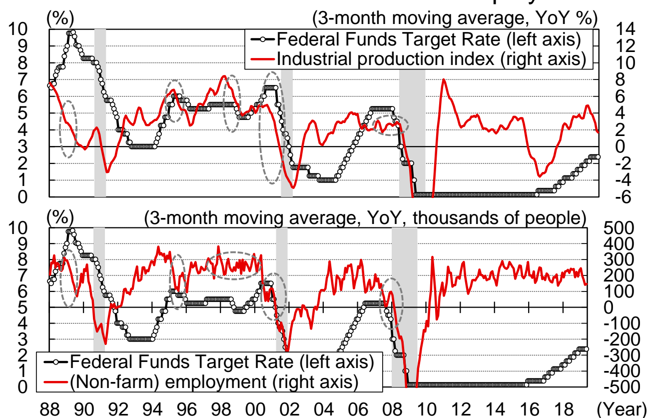
Chart 1: The Federal Funds Target Rate, S&P500, Industrial Production Index and Non-Farm Employment





Note: 1. From December 2008 onwards, "FF target rate" is the median of the target rate range
2. Shaded areas denote periods of economic recession

Source: FRB, US Department of Labor, Bloomberg, MUFG Bank Economic Research Office

Translation by Elizabeth Foster

For further details, please contact the Economic Research Office, MUFG Bank

Managing Director, Rei Tsuruta Tel: +81-(0)3-3240-3204

Written by Jirou Sugie <jirou_sugie@mufg.jp>

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