Federal Reserve: All in... they certainly are!

Our Fed preview had a lifespan of roughly three hours, but we seemingly called it right with a 100 basis point rate cut and a formal restart of quantitative easing

Source: Shutterstock

100bp rate cut and US$700bn QE

The Federal Reserve has announced that it is cutting the Fed funds target rate 100bp to 0-0.25% with immediate effect on the basis that Covid-19 is disrupting global economic activity and has significantly affected global financial condition. It has promised to keep rates there "until it is confident that the economy has weathered recent events".

We had expected such an outcome but thought they would wait until the scheduled Wednesday meeting. However, with the news flow on the virus getting worse and the economic disruption set to intensify, the Fed clearly thought it prudent to get out ahead of the market open tomorrow.

The supply crunch in manufacturing, the panic in the financial sector and the collapse in airline travel, hotel stays and leisure activities means we could see a quarterly contraction of the scale reached during the height of the financial crisis, especially with the prospect of some city lockdowns. We are pencilling in an 8% annualised 2Q20 GDP decline relative to the -4.4% figure experienced in 1Q09 and -8.4% in 4Q08.

The Fed has also announced it is formally restarting QE by promising to buy US$500bn of Treasuries and US$200bn of mortgage-backed securities "over coming months". We also expected then to restart QE, but anticipated that they would begin with around US$75bn per month. By giving a more general end-target they have more flexibility to front-load or respond to any market dislocation as necessary.

It is worth noting that the Federal Reserve's balance sheet peaked at US$4.5 trillion in early 2015 – equivalent to around 25% of US GDP. Today the balance sheet is around US$3.8 trillion or 18% of GDP. The Fed would have to expand its balance sheet by around US$1.6 trillion to get us back to a 25% of GDP today, so when you look at it that way the Federal Reserve has more ammunition up its sleeve.

Rounding out the releases, the Fed has also announced in coordination with the ECB, BOE, BOC, BOJ and SNB central banks a "coordinated action to enhance the provision of liquidity via the standing US dollar liquidity swap line arrangements". The purpose being to ease strains in global funding markets that could, if not dealt with, hurt the supply of credit to households and businesses.

> This action in itself is not going to rescue the US economy from recession, but it will help to mitigate the risks from financial tensions that could make the growth and jobs outlook far, far worse. It will also offer breathing room before an anticipated fiscal stimulus and a potential lending scheme provided by the Treasury materialise. That said, only better news on the prognosis for Covid-19 will return us to "normality". Like most, we hope this will be over by the summer, but the Fed cannot take that for granted and consequently this justifies an aggressive response that can always be reversed.

Author

James Knightley
Chief International Economist
james.knightley@ing.com

Disclaimer