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To cut or not to cut?

The dangers of premature easing

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- Hopes are high that 2024 will be a year of substantial policy rate cuts
- A careful examination of history, however, suggests that premature easing may backfire
- On too many occasions, "windfall" declines in inflation have been followed by economic and financial instability

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An immaculate disinflation?

Last year, the US enjoyed the perfect combination of falling inflation and strengthening growth. There were echoes of the late-1990s, when the words "new economy" were on everybody's lips. Back then, the Fed felt able to cut rates – fearing the onset of a recession – yet its forecasts proved wide of the mark. The economy and stock market boomed – and then boom turned to bust. Cutting rates today could threaten a similar upheaval.

Cyclical strength limits rate cutting opportunities

If history is any guide, Fed funds will only be able to fall a long way if unemployment rises significantly and the economy goes into recession. Few forecasters foresee such an outcome. If recessionary conditions don't materialise soon, modest rate cuts today could easily be followed by renewed rate increases tomorrow.

A shift in the transmission mechanism

The (limited) evidence suggests that the many years of zero rates and quantitative easing may have altered household and corporate balance sheets in ways that have reduced the immediate economic sensitivity to changes in policy rates. If so, cutting policy rates too soon may reduce their medium term "bite", allowing demand to reaccelerate and, in turn, encouraging inflation to ratchet higher.

Seduced by external drivers

Our final lesson comes from the second half of the 1980s. Oil prices collapsed in 1986, apparently ushering in a period of sustained low inflation. Central banks slashed rates in the hope of supporting economic growth. Yet, as demand strengthened in 1987, rates had to go back up again. The October 1987 stock market crash led to a partial reversal but Fed funds eventually peaked at nearly 10%. In truth, inflationary pressures were governed more by the state of the domestic economy – including the balance between supply and demand – than by any short-lived "manna from heaven" external developments. The same, ultimately, is true today.

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To cut or not to cut?

- Investors hope policy rates will fall
- Central bankers have also revealed a newly dovish attitude
- Yet history reveals the risks of premature stimulus

An immaculate disinflation?

The US economy performed remarkably well in 2023, at least when compared to economists' fears.

At the beginning of the year, Fed funds had already risen to 3.5% from a pandemic low of 0.1%. Inflation was heading lower but was still far too high. The *Blue Chip* forecasting consensus suggested the US economy would shrink 0.1% in 2023 as a whole. That, apparently, was the cost of defeating inflation. By the summer, Fed funds had risen to a 5.25-5.50% range and, although GDP forecasts had been revised up, the mood regarding future growth prospects was still overwhelmingly gloomy.

Thereafter, however, the news improved rapidly. Inflation ended the year at 3.1% having started the year at 6.3%. Despite the earlier sustained period of monetary tightening, the economy accelerated: in the third quarter, US GDP expanded at an annual rate of 4.9%.

1. The big summer 2023 bond market sell-off reversed course as inflation fell

Source: Macrobond

The good news on inflation triggered both a bond market rally (chart 1) and growing hopes that the Federal Reserve would be cutting policy rates in 2024, even though growth was far more robust than anyone had forecast. Somehow, the Fed had achieved an "immaculate disinflation", in which earlier inflationary excesses had been brought to heel with no cost whatsoever in terms of lost economic output. Some began to talk about the long-term benefits of an AI revolution, most obviously via an increase in productivity growth: if so, perhaps the US economy's speed limit might be higher than before. Others began to wonder whether the US economy was finally emerging from the long shadow caused by the effects of the 2008 Global Financial Crisis and exacerbated by the COVID-19 pandemic.

Either way, with supply apparently rising more rapidly to meet available demand, the inflationary consequences of strong economic growth were less than had previously been feared. Moreover, if the earlier bout of inflation was merely a temporary consequence of either pandemic-related disruptions or Ukraine war-related energy price shocks, there was little need to keep interest rates at levels designed to squeeze inflation out of the system now that inflation was beating a hasty retreat.

Four risks with 'premature stimulus'

This paper argues that rate cuts in 2024, while now an established part of the current consensus view, could prove to be premature. It's not so much that rate cuts won't happen. Rather, they may either prove to be very limited or, instead, have to be reversed relatively swiftly. Such monetary easing may eventually end up being regarded as a policy error, the kind of thing that happens in the fog of economic uncertainty.

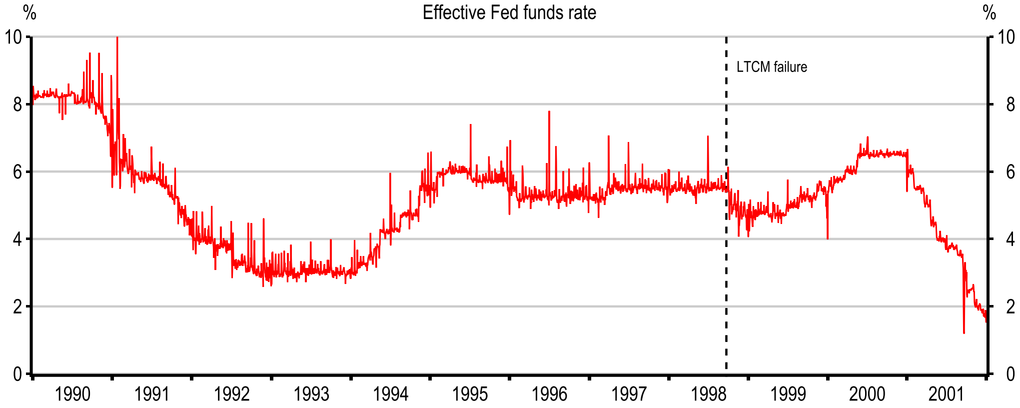
There are four reasons for thinking that what might be called "premature stimulus" might be inappropriate:

1. No distinction is made between the case for lower nominal rates thanks to lower inflation and the case for higher real rates (which, in turn, might require higher nominal rates) thanks to expected AI-related productivity gains (even if they don't fully materialise). There are lessons to be learnt from the late-1990s technology bubble, most obviously linked to the risk of financial instability.
2. Although both headline and core inflation rates have declined, other indicators suggest that inflationary pressures remain: it's not at all obvious that the US economy – or, indeed, other major developed economies – are returning to a pre-pandemic deflationary environment that might allow interest rates continuously to fall. Inflation may be down, but it is not out.
3. Monetary policy has acted usefully to signal the Fed's unwillingness to accommodate second round inflationary effects, but the good work done up until now could be quickly unwound if rate cuts signalled an enthusiasm to accommodate more by way of economic growth when the economy, cyclically, is already looking far more robust than previously forecast, partly thanks to continued fiscal excess.
4. The prolonged commitment to quantitative easing and zero interest rates may have changed the relationship between policy rates and the broader economy in ways that reduce the effectiveness of prior policy tightening if reversed too soon.

Interest rates, growth and inflation: lessons from history

Commentators tend to think that we're either in a rate-increasing or rate-cutting phase of the economic cycle: seen this way, the world is binary. History, however, suggests otherwise. Take, for example, the rate cuts sanctioned by the Federal Reserve in the latter stages of 1998, a blunt response to a sudden bout of financial turbulence that encouraged rate setters to take their eyes off the inflationary ball.

2. Fed funds fell in late-1998, but they were soon going back up again



Source: Macrobond

For much of 1997 and the first three quarters of 1998, the Fed funds rate had been held at 5.5% (chart 2). Then, thanks to the Russian debt default and the associated failure of Long Term Capital Management (LTCM), a hedge fund, severe global financial upheaval threatened. In response, the Federal Reserve acted as a lender of last resort, both in terms of arranging a bailout (or, more accurately, a liquidation of LTCM's hitherto hopelessly illiquid assets) and via three quick 25bp rate cuts, taking the Fed funds rate down to 4.75%.[1]

At the time, rate cuts seemed sensible for both financial stability and economic reasons. First estimates suggested that US GDP growth had slowed to just 1.4% at an annual rate in the second quarter of 1998 (see table 3), following revised gains of 5.5% and 3.0% in the previous quarters (the initial estimates for those quarters, shown in table 3, were 4.3% and 4.2%). It looked, therefore, that the economy was already stalling ahead of what was threatening to be a major financial shock.

3. US GDP growth (%qtr, annualised): initial perception and subsequent reality

Quarter	Forecast (made three quarters earlier)	Initial GDP estimate	Latest GDP estimate
1997Q4	2.4	4.3	3.6
1998Q1	2.1	4.2	4.1
1998Q2	2.4	1.4	3.8
1998Q3	2.3	3.3	5.1
1998Q4	2.5	1.4	6.6
1999Q1	2.3	4.5	3.8
1999Q2	2.1	2.3	3.4
1999Q3	2.1	4.8	5.4
1999Q4	2.4	5.8	6.7

Source: Federal Reserve Bank of Philadelphia Survey of Professional Forecasters

This, however, was a view built on only partial information. Latest official data suggest that growth in the second quarter of 1998 was an annualised 3.8%, more than double the original estimate. We also now know that the third and fourth quarters delivered spectacular annualised GDP increases of, respectively, 5.1% and 6.6%.

At the time, forecasters were understandably – although incorrectly – cautious regarding growth prospects. Most doubted that the US would grow at anything materially beyond 2-2.5% in the second half of 1998 and the first half of 1999[2]. Only later, with the economy booming, did it appear that the Fed's "emergency" rate cuts had inadvertently poured monetary gasoline on a

[1] See, for example, https://www.federalreserve.gov/fomc/minutes/19980929.htm
[2] See https://www.philadelphiafed.org/surveys-and-data/data-files

"new economy" fire associated with rapid asset price gains and huge increases in leverage. By the beginning of 2000, those emergency cuts had been reversed. Six months later, Fed funds had soared to 6.5% (chart 2) and, having previously climbed a financial Everest, the NASDAQ was in freefall.

In hindsight, it's not difficult to explain what went wrong during the NASDAQ bubble. "New economy" hopes meant the expected return on capital was unusually high. Simultaneously, however, inflation was relatively low, at least compared with experiences in the 1970s and 1980s. These twin developments created an ambiguity that undermined the effective conduct of monetary policy. The high expected return on capital argued in favour of high real rates. Low inflation created room for nominal rate cuts in the face of financial upheaval. Those rate cuts, however, left policy rates – as set by the Federal Reserve – too low to secure financial stability: with a low cost of funding but a high expected return, an asset price bubble was created (similar arguments apply to the US in the late-1920s, ahead of the 1929 Wall Street Crash).

The same risks may be materialising today. Activity surprises in the US have, once again, been significantly positive even as inflation has been mostly in retreat. Consider table 4, which shows consensus forecasts for quarterly GDP growth made in February, May, August and November of last year[3]. The initial projections pointed to very little by way of economic growth. The latest published outcomes offer a completely different story, one in which the pace of economic expansion has been an order of magnitude ahead of expectations.

4. Forecasts versus latest reality: US GDP in 2023 and 2024

Quarter	Feb 2023 forecast	May 2023 forecast	August 2023 forecast	November 2023 forecast	Latest reality
2023Q1	0.6	-	-	-	2.2
2023Q2	1.0	1.0	-	-	2.1
2023Q3	-0.1	0.6	1.9	-	4.9
2023Q4	1.2	-0.0	1.2	1.3	-
2024Q1	1.3	1.0	1.1	0.8	-
2024Q2	-	2.5	1.0	1.3	-
2024Q3	-	-	1.3	1.5	-
2024Q4	-	-	-	1.7	-

Source: Federal Reserve Bank of Philadelphia Survey of Professional Forecasters

If, as a result, real rates need to be higher, that can easily be achieved by accepting lower inflation while leaving nominal interest rates unchanged. Cutting nominal rates simply because inflation is lower while taking no account of the pace of economic growth is only asking for trouble, not so much because inflation itself might immediately reaccelerate (although it could) but because the cost of capital – as reflected in the policy rate – would be too low relative to elevated expectations regarding the return on capital, reflected in the creation of renewed asset price bubbles.

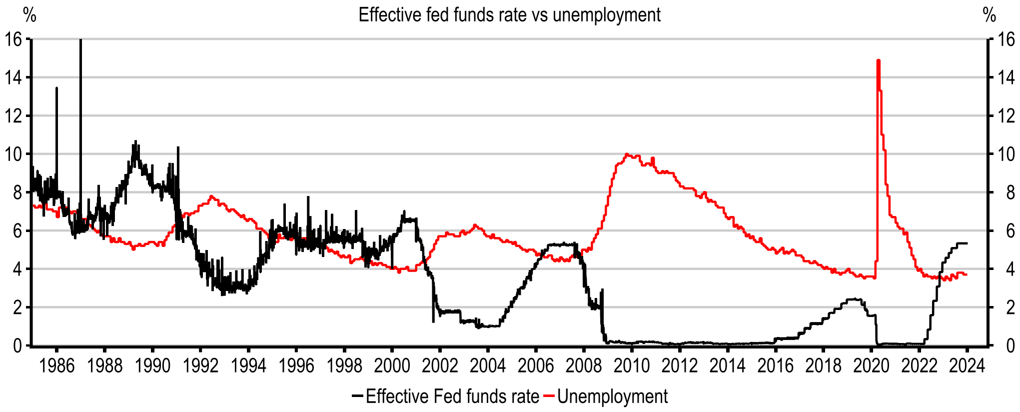
The cyclical case for cutting interest rates is...perhaps not now!

There are various simple rules of thumb that can be applied to monetary policy, at least in an economy that is as cyclical as the US. One is to tether rate decisions to the labour market. Few economies can offer a pattern of "hire and fire" as pronounced as the US. Although the trough for the unemployment rate has varied from cycle to cycle, sustained rate cuts tend to come only when unemployment is beginning to rise. Today, the situation is unclear: in mid-2023, the unemployment rate did rise from a low of 3.4% to 3.9%, consistent with a rate cutting

[3] See https://www.philadelphiafed.org/surveys-and-data/real-time-data-research/spf-q4-2023

environment. Yet the latest readings, for both November and December, showed a renewed reduction to 3.7%. Alongside still low unemployment, US firms continue to complain about a shortage of "quality labour" while, on balance, workers are still able to find jobs relatively easily (although not quite so easily as was the case a few months earlier).

5. Fed funds falls decisively typically only when unemployment is rising decisively



Source: Macrobond

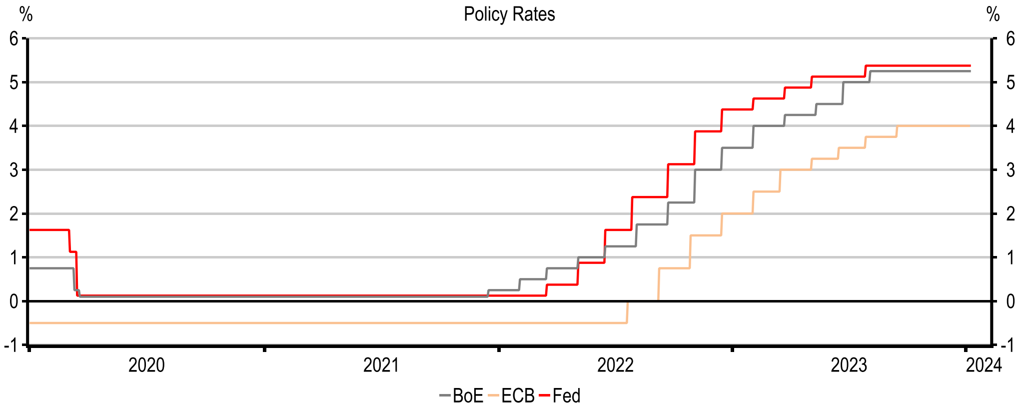
If the economy continues to expand at anything like the pace seen through the first three quarters of 2023, the chances are that the unemployment rate will remain low. Admittedly, it is arithmetically possible to achieve rapid growth through an acceleration in productivity growth with unemployment rising but examples throughout US economic history are, to say the least, few and far between. More likely is an unwarranted increase in labour costs.

In these circumstances, rate cuts might merely encourage investors to take more by way of risk, happy in the knowledge that a recession didn't materialise as feared in 2023. Doing so when unemployment is already cyclically low, however, may simply lead to a tighter labour market, leading to an inflationary reacceleration. This new strand of inflation, however, would be very much home-grown, and not so easily blamed on "external shocks".

Signals and noise

One version of the "team transitory" argument is that inflation was caused by external shocks alone, with the implication being that, as they fade, inflation itself will simply subside. Certainly, inflation has subsided, but the obvious weakness with the "transitory" argument is that monetary policy had to be tightened significantly in the meantime. Remember that policy rates were close to – and, in some cases, below – zero in the early months of the COVID-19 pandemic yet have, subsequently, risen far more than either economists or investors had expected (chart 6).

6. Central banks have pushed rates up far more than expected



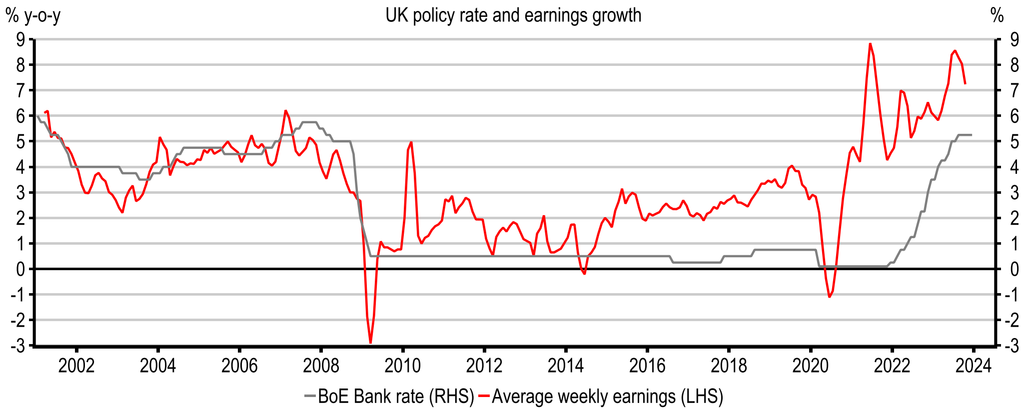
Source: Macrobond

There are those, of course, who might argue that such monetary tightening was, in hindsight, unnecessary, but this is a rather obtuse position to adopt. Central banks are like soccer referees, there to ensure orderly economic play, particularly in the light of unexpected external shocks. Second round inflationary effects stemming from an energy price increase are much more likely in a country where the central bank chooses to leave interest rates unchanged or where there is little by way of fiscal discipline than in a country which raises interest rates promptly (one reason why, following the 1973 oil price shock, UK inflation proved to be far more problematic than its German equivalent).

It equally follows, however, that a central banking “referee” that cuts interest rates in response to falling headline inflation when the economy is either cyclically strong (the US), already showing signs of second round inflationary effects (the UK) or incapacitated on the supply side (parts of the Eurozone) might be acting prematurely. After he stepped down from the Federal Reserve in the late-1970s, Arthur F Burns – the Fed’s Chair through much of the 1970s – admitted as much, saying that the Fed had always been in too much of a hurry to cut interest rates when inflation was heading in the right direction, even if the desired destination had not yet been reached. The result was a gradual ratcheting up of inflationary behaviour, leading to persistent stickiness and lasting economic and social damage.

Put another way, would the Federal Reserve normally cut interest rates with an economy growing considerably more rapidly than expected and a labour market that was unusually tight? Would the Bank of England normally cut interest rates when wage growth was still running at an annual rate far higher than the pace required in order to meet the 2% inflation target (chart 7)? Worse, given the upcoming US presidential election and a likely UK general election before the year is out, might investors begin to question the degree of central bank independence if rate cuts occur against a background where inflation is not yet decisively back to target?

7. UK wages are growing rapidly relative to current interest rate levels

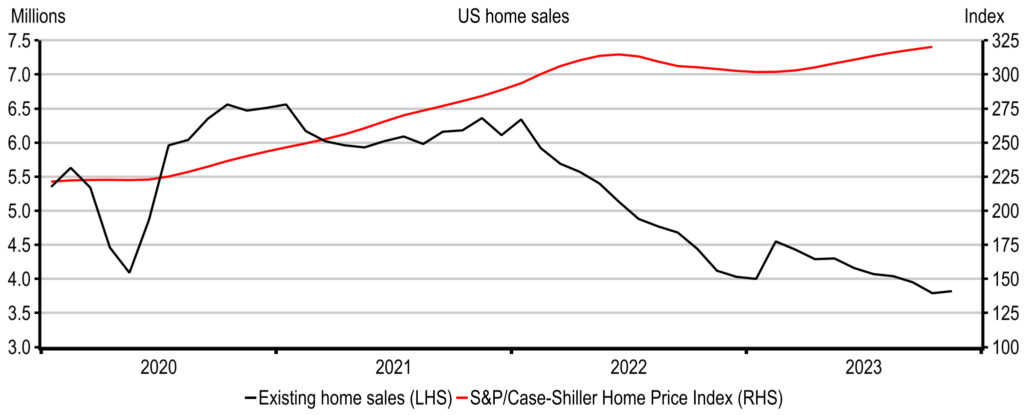


Source: ONS, Macrobond, BoE

Longer lags, greater uncertainties

Much ink has been spilt on the longer lags that now exist between changes in policy rates and their direct impact on economic behaviour[4]. In the UK, higher policy rates in the short term at least may – perversely – boost household financial positions by raising returns on savings even as the impact on mortgage payments – now typically determined by two-, three- or five-year fixed rates as opposed to the overnight rates of yore – is significantly delayed. In the US, meanwhile, there has been a huge increase in what might be described as “home hoarding” by those who might otherwise move but are unwilling to take on new mortgages at significantly higher long term interest rates than before. One result is a housing market offering a mix of low volumes and high prices (chart 8), with many borrowers locked in at rates that are no longer available. Their ability to do so in effect insulates them from the immediate consequences of the Federal Reserve’s monetary actions (chart 9).

8. Home sales have softened, even as prices have risen



Source: Macrobond

[4] See, for example, HSBC Global Economics Quarterlies for 2023 Q4 and 2024 Q1

9. Interest rates may have risen a long way, but US household debt service costs remain very low by past standards

Source: Federal Reserve of St Louis

Across companies, there are important distributional effects stemming from the move towards higher interest rates. Evidence suggests worldwide that the largest companies, typically dependent less on bank lending and more on capital markets, are not immediately affected by higher policy rates – having locked in much lower rates earlier – whereas smaller companies face much greater rollover risk. As the Bank for International Settlements notes, “smaller firms are likely to be subject to significantly larger refinancing pressures than larger ones”. Meanwhile, “in the US, the greater use of corporate bonds [than elsewhere] suggests that immediate debt refinancing needs may be muted and will only grow gradually, peaking in around five years”.[5] Finally, many companies are cash rich and have generated reasonable returns thanks to higher interest rates.[6]

Within the financial system, the consequences are again mixed. Large banks initially do well in an environment of rising policy rates typically because the interest paid on their deposits lags behind the interest charged on their loans. Insurance companies and pension funds do well too because higher interest rates reduce the net present value of their future liabilities. All of that can change, of course, in the event that monetary tightening leads to a severe slowdown or a move into outright recession, triggering a fall in the value of risky assets, a sustained increase in bankruptcies and deleveraging on a growing scale. Even before such cataclysmic developments, however, vulnerabilities may emerge: Silicon Valley Bank’s difficulties were emblematic of a regional US banking model that had expanded rapidly with limited regulatory oversight in an era which seemingly promised low funding costs for evermore, offering parallels with the UK secondary banking crisis of the early-1970s.

That last observation, in turn, suggests that the monetary transmission of old can no longer be trusted. Interest rates were at rock bottom from the 2008 Global Financial Crisis through to the early years of the COVID-19 pandemic. Quantitative easing contributed – intentionally – to significantly lower borrowing costs further out on the yield curve. Many households and companies extended the maturity of their debts, effectively reducing their immediate exposure to future policy rate increases. Meanwhile, the low cost of borrowing contributed to a “hunt for yield” threatening fault lines within the financial system. Whether those fault lines prove to be large enough to trigger an upheaval equivalent to that seen during the global financial crisis is, however, another matter. Still, localised turbulence may divert attention away from appropriate economic management at the macroeconomic level (as the Silicon Valley Bank failure in early 2023 threatened to do, and as the LTCM crisis actually did).

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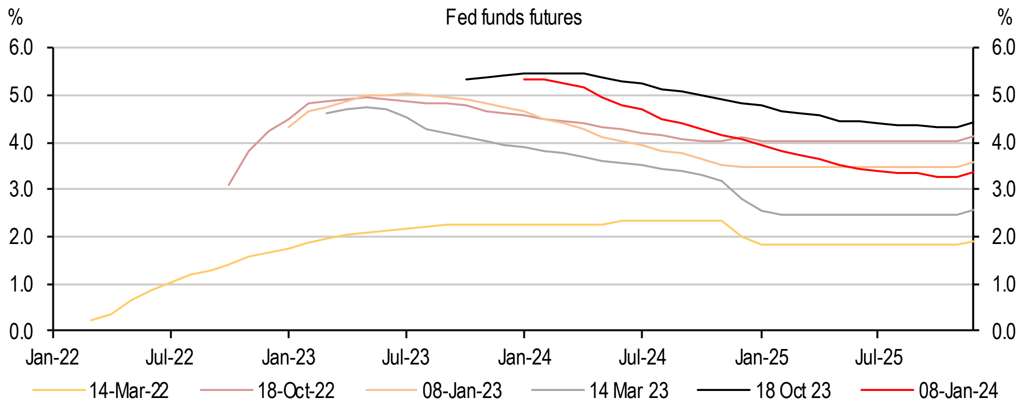
[5] See BIS Quarterly Review, December 2023
[6] See Hare, C., and Balboni, F., Counting the cost (of capital), HSBC Global Research, September 2023

Put another way, cutting interest rates early in response to supply-led declines in inflation alone may not be consistent with longer-term price stability objectives. This is particularly so for the US where, as mentioned earlier, the full impact on debt financing of higher interest rates might only be felt in, say, five years. To the extent that the US has emerged from the pandemic with an unemployment rate lower and growth rate higher than expected, it may be that the near-term reduction in inflation is more of a false dawn than before. By cutting interest rates at a time of considerable cyclical strength, egged on by fiscal stimulus on a scale hitherto unimaginable, the risk is that the mistakes of Arthur F Burns in the 1970s – most obviously declaring victory over inflation prematurely – could end up being repeated.

An alternative to the consensus

Chart 10 shows how investors have constantly revised their views regarding the outlook for monetary policy in the US. Rates are always, apparently, close to the peak, irrespective of where the peak happens to be (chart 10). That, in turn, suggests that investors have no clear handle on what, precisely, is driving monetary policy prospects. Uncertainties over inflation, the economic cycle and the longer-term fiscal outlook have doubtless increased, but investors are mostly hoping for a return to “business as usual”, with inflation returning to target in a year or two and a soft landing for the economy (earlier in 2023, after the failure of Silicon Valley Bank, rate cuts hopes were even greater, triggered by recessionary fears which later eased). It’s easier that way.

10. The futures are most definitely uncertain



Source: Bloomberg

Unless, however, clear evidence emerges that we really are at the end of the latest US economic upswing sooner rather than later – with a sustained increase in unemployment consistent with recessionary conditions – it’s difficult to see why the idea of “business as usual” makes sense. To see why, consider a simple thought experiment.

The Federal Reserve decides to cut interest rates in line with current market expectations, even though the stock market boomed in late-2023, the unemployment rate is close to a 55-year low, wage growth continues to run at above 4% and service sector inflation is still sufficiently elevated to suggest that overall inflation may remain above, rather than below, target.

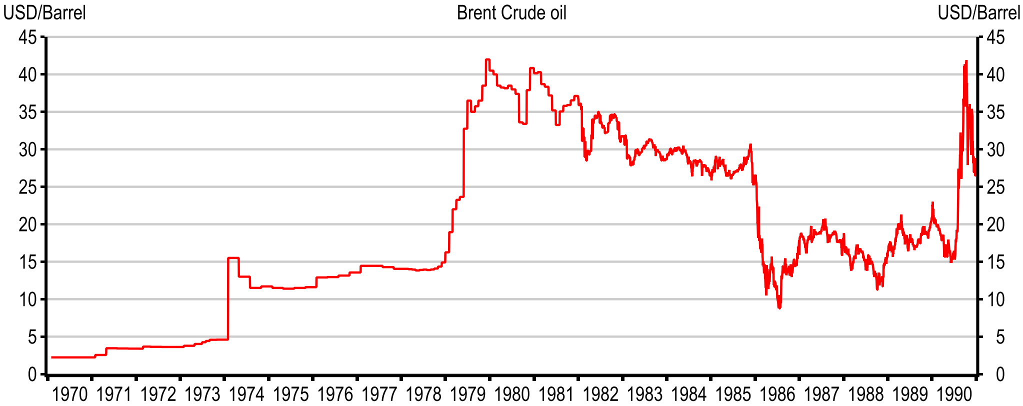
What then happens? The chances are that the stock market booms, leverage returns, demand swells, GDP growth comes in higher than expected, unemployment falls and wage growth picks up. Perhaps productivity growth accelerates in the near term – as it did in the late-1990s – preventing inflation from immediately reaccelerating. That, however, only leads to an even bigger surge in the stock market and, with it, a further increase in leverage.[7]

Eventually, the Federal Reserve would be forced to return to its earlier tightening stance. The "supply-side" improvement in inflationary conditions would have proved to be temporary. With prices pressures rebuilding, the Fed would have no alternative other than reverse course.

Admittedly, the Federal Reserve may not choose to follow the futures market. After all, it hasn't done so in the past. Perhaps ongoing economic strength will encourage investors to dampen their optimism regarding rate cuts in 2024.

And if the economy remains robust? A final lesson comes from the mid-1980s. Oil prices had been drifting lower in the first half of that decade, following their almost tripling in the light of the 1979 Iranian Revolution. In 1986, however, they collapsed, dropping from USD30/b to below USD10/b (chart 11). The rate on Fed funds that year dropped from over 8% to under 6%. The economy was booming and the stock market was surging. Meanwhile, the US dollar was falling, a welcome development initially but eventually a major source of tension between the US and Germany.

11. Windfall inflation gains can lead to policy errors



Source: Refinitiv Datastream, Macrobond

Realising that the "supply-side" reduction in inflation and the corresponding fall in interest rates had done nothing to tame demand at home, the Fed reversed course in 1987, pushing Fed funds back over 7%: higher rates, in turn, contributed to the October 1987 stock market crash. In response, rates fell again. The crash, however, did nothing to slow economic growth or to keep a lid on inflation. Eventually, the Fed funds rate rose to a peak of nearly 10%.

The lesson from this episode is simple. External shocks alone should not govern domestic inflationary outcomes. In the same way that the rapid rise in commodity prices stemming from the COVID-19 pandemic and Russia's invasion of Ukraine overstated underlying inflationary pressures, the subsequent commodity price reversal may now be contributing to an understatement of those pressures. Cutting interest rates simply because inflation has dropped may seem like a sensible thing to do – and, in an election year, may be politically expedient – but history suggests that such actions can backfire, either because of subsequent unsustainable asset price bubbles or, more simply, because inflation dares to revive.

[7] For a detailed discussion of some of these issues, see King, S., We Need to Talk About Inflation: 14 Urgent Lessons from the Last 2000 Years (Yale University Press, 2023)

Disclosure appendix

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