The Daily Dish

The Fed Blinks

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Eakinomics: The Fed Blinks

As was widely expected, the Federal Open Market Committee (FOMC) lowered its target for the federal funds rate by one-quarter of a percentage point to a range of 2 to 2-1/4 percent. In explaining this decision, the FOMC was impenetrably opaque: “This action supports the Committee’s view that sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee’s symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook remain. As the Committee contemplates the future path of the target range for the federal funds rate, it will continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective.” In other words, there is some uncertainty (when is there not?), but this action and all future actions will be consistent with our objectives. Thanks for that.

In his news conference, Chairman Powell pointed to inflation running below the Fed’s target, some softness in recent data, and the uncertainties stemming from the trade wars of President Trump. Inflation is running below the Fed’s target, but inflation expectations show no signs of moving toward deflation. And it is true that manufacturing, housing, and business investment have been weaker in the first half of 2019. But all sectors never run in lockstep, and overall the economy is in good shape. Chairman Powell acknowledged as much and emphasized that this was not the start of a lengthy rate-cutting cycle.

Which brings us to the president. Some will conclude that he browbeat the Fed into this action with his ceaseless finger-pointing at the Fed as the problem with growth. Now, the Fed may not have reacted directly to the president, but on average it pays too much attention to short-run movements in financial markets. The president similarly pays enormous attention to the stock market as an economic indicator and seemingly goes on the trade war offensive when the market is strong, but backs off when it retreats. Given the stock market as the common link, one way or another, the president is seemingly driving the Fed.

What’s the substantive problem with this decision? In addition to diminishing the Fed’s credibility, this move runs the risk of inflating an equity-market bubble that far outweighs the costs of inflation at 1.5 percent instead of 2 percent. With the household sector — 70 percent of the economy — on firm footing, any recession risk would have to emerge from the financial sector, and dropping the federal funds rate has the potential to exacerbate those risks.