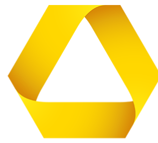

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Economic Briefing

What is behind the Fed's big move?

23 September 2024

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Last Wednesday, the Fed initiated its rate cutting cycle with a big 50 basis points move. It is now clearer what motivated it to do so.

The Fed started big,...

At its meeting last week, the Fed began its cycle of interest rate cuts with a major step of 50 basis points (see our **briefing**). This is all the more remarkable given that Fed Chairman Jerome Powell cannot see anything in the economy that points to an increased likelihood of a downturn, as he noted in **the press conference** after the meeting.

...because it sensed to be rather late ...

The decision to take this big step is partly explained by the fact that if the employment report for July had been received a few days earlier, interest rates would probably have been cut in July: the Fed meeting was on July 30-31, and the July employment report was published on August 2. It showed a 0.2 percentage point increase in the unemployment rate to 4.3% and a disappointing +114k jobs gain. Thus, the Fed wanted to take a big step to possibly make up for lost time.

... and ran the risk of falling back behind the ideal of 2019

However, the overall economic environment at the time of last week's FOMC meeting appears more important. Fed Chairman Powell repeatedly referred to 2019, the year before the coronavirus pandemic and the peak of the last business cycle. The economic data in 2019 apparently comes close to the optimum from the Fed's point of view. The unemployment rate in 2019 was 3.7% on average, employment was still growing by almost 170,000 per month, and there was no significant inflationary pressure (Table 1).

The current data situation is somewhat less favorable: at 4.2%, the average unemployment rate in the last three months was higher than in 2019, while the job gain of 116 thousand was noticeably lower. The number of job openings has fallen in recent months and, at 1.2 (still a very good figure), is at the 2019 level. However, core inflation is still elevated and, at 2.6%, above the Fed's target.

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Table 1 - "Ideal year" 2019 and current situation

Payrolls: average gains in the most recent 3 months in thousands. Core inflation: PCE deflator excl. food/energy, annual rate of change in %. For 2019: Annual averages; for 2024: 3 months up to August (payrolls), other data up to July

	Unemployment rate	Job openings/unemp.	Nonfarm payrolls	Core inflation
2019	3.7	1.2	165.7	1.6
last 3 months	4.2	1.2	116.3	2.6

Source: BLS, BEA, Commerzbank Research

Recalibration of monetary policy…

Overall, the labor market is now less tight than in 2019 and is therefore no longer a source of significant inflationary pressure, as Jerome Powell explained in his prepared statement at the beginning of the press conference. Although economic growth in the third quarter is still robust at an estimated just under 3%, the Fed apparently believes that now is the right time to “recalibrate” monetary policy.

… with an eye on the neutral interest rate

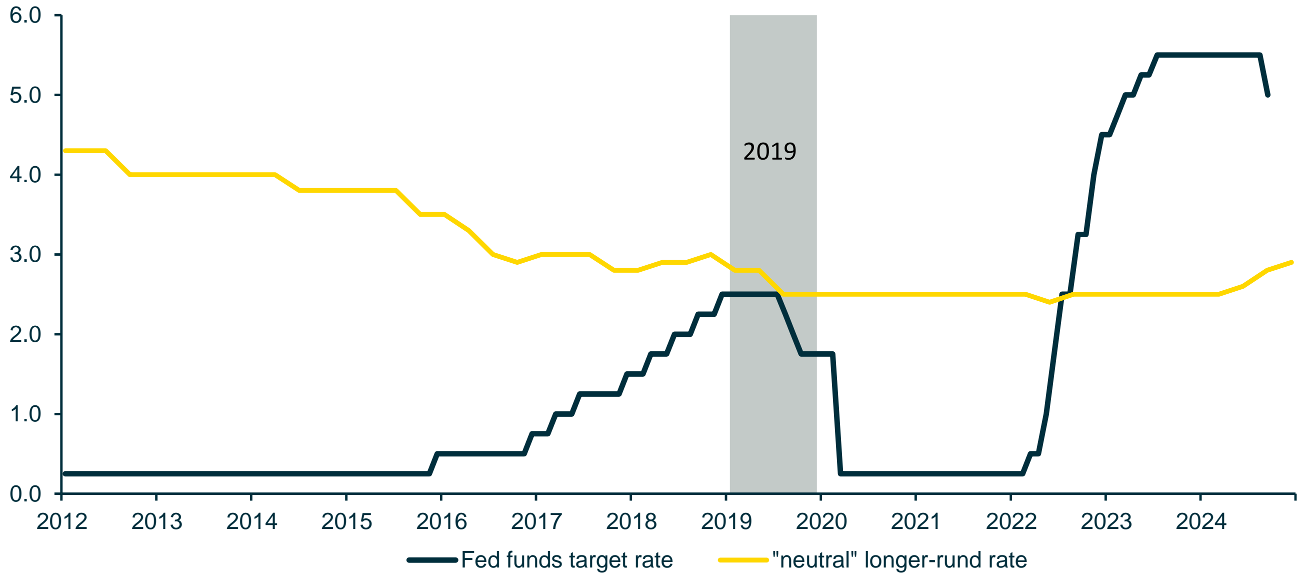
Another important factor in the 50 basis point cut was probably that key rates were very significantly above the level that the Fed considers appropriate in the long term. For several years, Fed leaders have set this level at around 3% (Figure 1). Here, too, a comparison of the current situation with 2019 is instructive: at that time, the key interest rate was close to the “neutral” value.

A restrictive policy was certainly necessary to combat the excessive inflation of recent years, and thus a key interest rate well above the longer-term neutral value. Now that the inflation wave has been broken, the goal is to reduce the key interest rate in an appropriate time frame towards the 3% level. This should also safeguard the second part of the Fed's mandate, maximum employment. The risk that the Fed will lower interest rates too quickly, which could lead to a resurgence in inflation, is apparently seen as low. After all, despite the recent cut and even in view of further easing on the horizon, the key interest rate is still so high that a resurgence in inflation is unlikely from the Fed's perspective.

From the current perspective, the Fed wants to lower interest rates to 3.4% next year (corresponding to a fed funds target range of 3.25% to 3.50%). This would be close to the neutral level. Much depends on whether inflation has actually been defeated. Only then will it be possible to speak of a successful soft landing.

Chart 1 - The Fed saw itself too far above the "neutral" level

Fed funds target rate (upper bound of target range) and median estimate of FOMC meeting participants of appropriate longer-run rate



Source: Fed, Commerzbank Research

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In accordance with ESMA MAR requirements this report was completed 23/9/2024 13:50 CEST and disseminated 23/9/2024 13:50 CEST.

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