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U.S. ECONOMY

Federal Reserve Cuts Rates by Half Percentage Point to Combat Virus Fear

Central bank lowers federal-funds rate range to 1% to 1.25% in its first between-meeting move since the financial crisis

By Nick Timiraos

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WASHINGTON—The Federal Reserve executed an emergency half-percentage-point rate cut and markets slid, reflecting fears the coronavirus epidemic is raising recession risks for the U.S. and global economies.

The Fed reduced the federal-funds rate to a range between 1% and 1.25% in the first rate change in between scheduled Fed policy meetings since the 2008 financial crisis. Stock markets fell anyway. Major market indexes declined around 3% and the yield on the benchmark 10-year U.S. Treasury dipped below 1% for the first time as investors sought havens.

The central bank has typically reserved such moves for times when the economic outlook has quickly darkened, as in early 2001 and early 2008, when the U.S. economy was heading into recession.

Recession risks have risen enough to "warrant a Federal Reserve shock-and-awe approach," said Tiffany Wilding, an economist at Pacific Investment Management Co.

The market's moves Tuesday showed the extent to which investors worry the central bank can't on its own prevent a dropoff in confidence and spending without a commanding response from public-health authorities and other government agencies.

The rate cut was approved unanimously by the Fed's rate-setting committee, which met by videoconference on Monday night. In a statement, officials held out the prospect of additional stimulus by pledging to "act as appropriate" to support the economy.

Fed officials moved to prevent a pullback in credit availability to households and businesses that could amplify any slowdown in U.S. growth, especially if steps to mitigate the spread of the virus—school and business closures, canceled public events and social behavior broadly speaking—curtail spending and depress hiring.

“The virus and measures being taken to contain it will weigh on economic activity here and abroad for some time,” Fed Chairman Jerome Powell said at a hastily arranged news conference on Tuesday.

The Fed’s response shows how policy makers are bracing for greater economic distress from a contagious, flulike virus than seemed possible just a week ago.

In China, where nearly 3,000 people have died since the initial outbreak there, steps to contain its spread prompted steep declines in production. The coronavirus has infected more than 10,000 people outside China since an initial outbreak there.

The epidemic roiled global financial markets last week amid signs containment efforts were jeopardized by new clusters in Italy, Iran and South Korea. Stocks posted their largest weekly losses since the 2008 financial crisis. Commodity prices tumbled, signaling a hit to global demand, and long-term U.S. government-bond yields reached record lows, reflecting lower growth expectations and investors seeking havens.

“The concern was that by the time they got to the meeting, things could have spiraled far enough that they would have a much bigger problem,” said William English, a former senior Fed economist who now teaches at Yale University, referring to the Fed’s scheduled March 17-18 policy meeting.

Positive test results for infections in the U.S. last weekend further raised the prospect of changes to behaviors that could lead to a drop in consumer spending, especially travel, tourism and entertainment.

Even if any shock is temporary, there are big unknowns over how long it will last and how deep output might decline. While an interest-rate cut won’t address the cause of the downturn, Mr. Powell said he hoped it could soften damage to spending and confidence, stem financial-market disruptions and speed a recovery once any epidemic is under control.

“A rate cut will not reduce the rate of infection. It won’t fix a broken supply chain. We get that,” Mr. Powell said. “But we do believe that our action will provide a meaningful boost to the economy.”

When the Fed cut rates three times last year, officials characterized those moves as an insurance policy against the risk of a global slowdown amplified by the U.S.-China trade war. Because the source of the latest shock isn’t primarily economic, it could be more difficult for interest-rate policy to buoy consumer spending and confidence.

“Finance didn’t start this thing. It’s not the Asian debt crisis. It’s not a currency crisis, a mortgage crisis. It’s not from Fed policy being too tight,” said Steven Blitz, chief U.S. economist at research firm TS Lombard.

Mr. Blitz said it was reasonable to expect a short but swift downturn that would reverse by the summer, once the impact of the virus fades. But he added it was difficult to tell if other fissures in the economy might now surface after an 11-year rally in the stock market accompanied by a corporate-lending boom, all underwritten by lower interest rates.

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“The risk is that whenever any recession takes hold, a different reality can emerge from what caused it once unaccounted-for excesses underlying the U.S. economy are laid bare,” he said.

A separate risk is that the Fed’s response won’t be effective without a robust response by public-health authorities that maintains confidence in the nation’s ability to contain or mitigate the spread of illness.

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Even then, steps to limit outbreaks could lead to changes in social behavior that temporarily depresses spending and curtails hiring. That could lead weak businesses to fail and distressed households to fall behind on monthly payments.

“Right now the public health response is the most important. How effective are they treating people?” said Claudia Sahm, a former Fed economist who is now economic-policy director at the Washington Center for Equitable Growth, a liberal think tank. “The Fed is not going to be the lead policy lever.”

President Trump in recent days called on the Fed to cut rates and said he was disappointed the central bank didn’t do more on Tuesday, repeating his longstanding preference for U.S. borrowing costs to be lower than other advanced economies, including those with negative rates.

Mr. English said while he was confident the Fed wasn’t being swayed by political pressure, there is a risk that the central bank’s credibility suffers because not everyone will see it that way.

One silver lining of Mr. Trump's criticism, was that it "was so unreasonable," said Mr. English. "If he was making a reasonable argument, you would worry he was moving the needle."

After Tuesday's cut, investors expected the Fed would lower rates again in the coming weeks, including at the March meeting.

Fed officials repeatedly said last year it would be important to act aggressively at the first sign of a downturn in spending or hiring because they have less room to counteract a recession by cutting rates.

Fed officials are likely to look for evidence that businesses not directly affected by the virus are seeing a weakening of demand as they plot their next move. "Are households and businesses hunkering down to see how this goes? If they see that, the Fed would provide more accommodation," said Mr. English.

Economists at Goldman Sachs see the U.S. avoiding a recession for now but have downgraded the U.S. growth forecast to an annualized rate of 0.9% in the first quarter and 0% in the second quarter.

Michael Feroli, chief U.S. economist at JPMorgan Chase, said Monday he saw a 50% chance the Fed would cut rates this year to zero, up from a 33% chance last week.

The Fed's action came after central banks in Australia and Malaysia cut rates and finance ministers and central-bank governors from the Group of Seven countries said they stand ready to cooperate. The Bank of Canada is expected to cut rates at its policy meeting Wednesday.

The Fed's rate cuts could be important for global growth, too, because with rates at negative levels in Europe and Japan, foreign central bankers have fewer tools to spur growth in their economies unless they grow more comfortable pushing rates deeper into negative territory.

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