

## Into an Easing Cycle

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This week the Federal Reserve followed the European Central Bank and Bank of England in lowering its main rate of interest from 5.25% to 4.75%.

These are the first cuts in interest rates since March 2020 and they effectively announce to the world that the battle with pandemic related supply-side price rises has been won, despite the inflation problem turning out to be less “transient” than initially expected.

Businesses and consumers, who have had to endure the highest interest rates for decades for rather longer than they anticipated, can now look forward to paying rather less for their mortgages, business loans and, perhaps, credit cards.

In effect, consumers' real disposable income has been given a boost by these cuts in interest rates alongside slower price inflation although the outright “price level” remains higher than it was before rates started rising.

The outlook for US interest rates is surprisingly dovish as seen from the perspective of the actual policymakers. More than half of the policy setting committee of the Federal Reserve see US interest rates troughing at 3-3.5% by the end of 2025 and in the longer run settling between 2.5% and 3%. Of course, those estimates are subject to change as the path of realised inflation unfolds but nonetheless current policy settings are supportive for growth and asset prices.

As an aside, it is unlikely that the current Chairman of the Federal Reserve, Jay Powell, will survive a Trump election victory; a 0.5% cut immediately prior to an election is unusual and, despite the policy reasons for the timing, could be used as a reason to curb the independence of the Central Bank should Donald Trump win the 47<sup>th</sup> office of President of the USA.

What distinguishes the Fed from the ECB, and the Bank of England is the “dual mandate.” The US bank is obliged to meet inflation and growth targets, principally expressed as full employment. The mandates of the Bank of England and the European Central Bank are much more one-sided with meeting the 2% inflation rate their only mandated target.

Consequently, there is a bias in European circles to tighter policy that is absent in the US.

Equally some time ago, the US adopted a “flexible inflation target regime” in that the Fed is empowered to take into account years of below target inflation when looking at the future, in effect allowing below trend growth in output to “catch-up.” Thus, the US authorities are much less concerned about hitting a “point” target than the general direction. This is one reason why Powell felt able to lower rates whilst realised inflation is still somewhat above the point target of 2%.

The US regime is much more focused on generating growth than stabilising inflation (important though that is) and one consequence is the gulf in economic performance between the US and the rest of the world this century and particularly since the Covid19 pandemic.

The US seems to have the capacity to “grow” out of its problems, debt for example, that eludes other major economies: Japan has woeful demographics, Germany regards debt, even to create assets, as “sinful” and the UK has removed itself from its major regional market.

It looks increasingly likely that Jay Powell will engineer a “soft landing” i.e. a reduction in inflation to target without inducing a recession. That is a rare feat and should be warmly applauded by consumers, investors and markets.

It is ironic, if polls are any guide, that the only constituency that remains unimpressed is the American voter.

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