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Interest Rate Change as a Cause Will Become a Consequence

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The Federal Reserve in Washington on May 2, 2023. The Fed's annual inflation target of 2 percent has been exceeded since the beginning of 2021. (Win McNamee/Getty Images)

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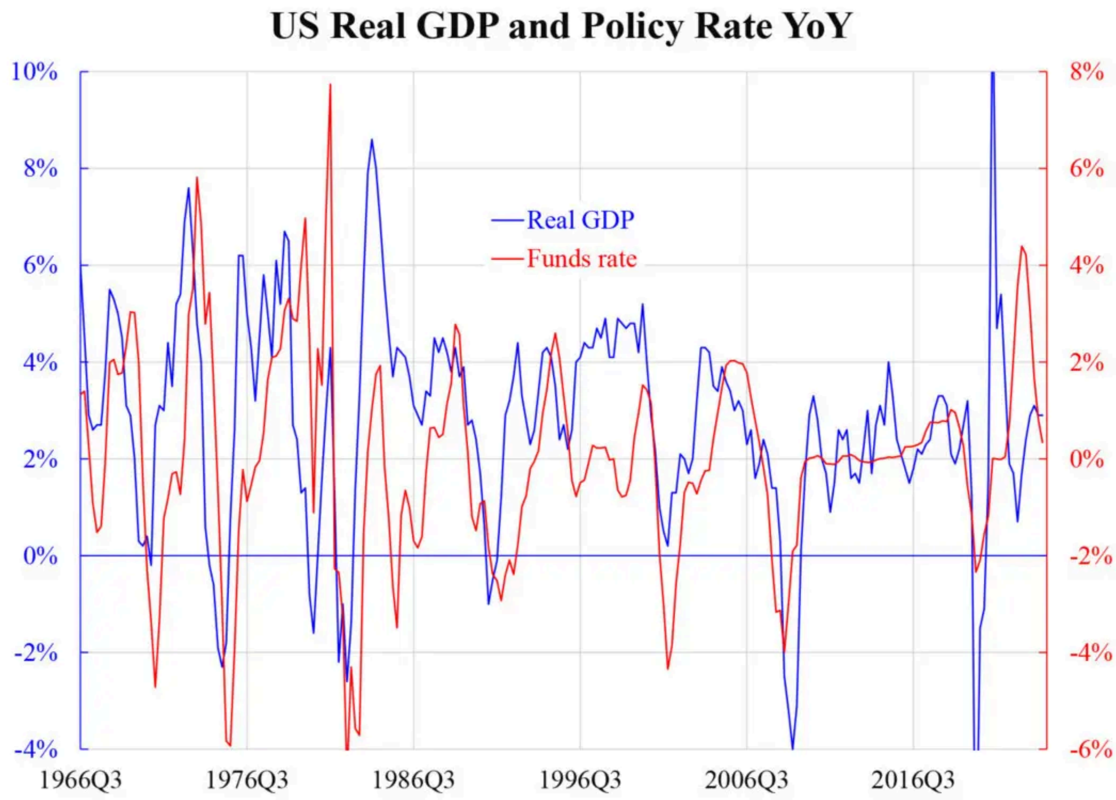
Commentary

While the U.S. presidential election is the focus and former President Trump's trade is the theme, what really moves the market seems to be the interest rate change. Central banks are already cutting or planning to cut rates soon. The very first intuitive gut feeling is that this will do good to both the market and the economy. However, a series of countercyclical interest rate cuts as a cycle, whether pre-emptive or under pressure, signals something wrong. The traditional wisdom says to sell when the Fed begins a cut cycle. This has been true over the past three decades.

There is, in fact, a subtle bilateral causality between the economy and interest rate. Rate cut boosts the economy via the intertemporal channels. Interest rate is nothing but the relative price between now and the future. Cutting the rate means cheaper now yet more expensive in the future, thus withdrawing more economic activities (be they consumption, investment, or anything else) from the future to now. However, this kind of substitution effect could be mild and slow. Empirically, it takes a year or two to transmit the impact of interest rate change to the economy.

On the other hand, countercyclical policy ideology guides a central bank to cut rates when there are signs of an economic downturn. Nevertheless, such a downturn is not linear but stepwise. That says, signs are usually unclear when growth of real activities is merely weakening. Yet as the imbalance happens the economy "steps down" like collapsing. The scenario of soft-landing or goldilocks is highly unlikely though not impossible. Currently the weakening signs like unemployment rising and inflation falling are clear, what remains unclear is how bad it will be.



(Law Ka-chung)

Back to the bilateral causality issue. To evaluate which side of causality is stronger, we can see whether the economy and interest rate are positively or negatively related. The attached chart compares the two, showing that in most of history, the correlation has been positive. That says it is more likely that real GDP growth change is the cause, while interest rate change is the consequence.

Although the Fed generally hikes rates as the economy booms, it cuts rates as it busts; there are some periods exhibiting low correlation, which might signal the causality is bilateral. Recently the two are obviously negatively correlated, signally the impact of interest rate change on the overall economy. But this is not a good signal to us because this means the higher and longer the interest rate is economic growth will be lower for longer! However, causality flow from interest rate to the economy is usually short-dated, as history shows.

As the economic downturn becomes obvious, the Fed will be forced to react accordingly, and we will soon see. Rate cuts in a downturn will not be just once or twice but a cycle. As the market is not fully pricing this in, it has not fully priced in the economic downturn ahead. As it materializes, they will claim this as a black swan—that we all now know.

Views expressed in this article are opinions of the author and do not necessarily reflect the views of The Epoch Times.

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Law Ka-chung is a commentator on global macroeconomics and markets. He has been writing numerous newspaper and magazine columns and talking about markets on various TV, radio, and online channels in Hong Kong since 2005. He covers all types of economics and finance topics in the United States, Europe, and Asia, ranging from macroeconomic theories to market outlook for equities, currencies, rates, yields, and commodities. He has been the chief economist and strategist at a Hong Kong branch of the fifth-largest Chinese bank for more than 12 years. He has a Ph.D. in Economics, MSc in Mathematics, and MSc in Astrophysics.

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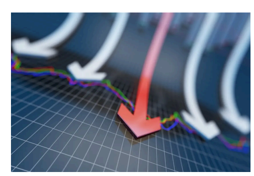

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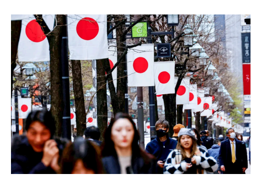

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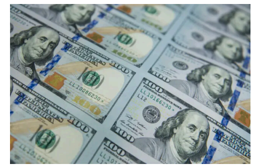

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