Interest Rate Hike: Is the U.S. Economy in Trouble?

Two Duke experts examine why interest rates might be cut for the first time since 2008

Keith Lawrence

With the Federal Open Market Committee expected to cut interest rates this week for the first time since 2008, when the country was in a recession, many question whether the U.S. economy is headed toward a downturn.

Sarah Bloom Raskin, a Rubenstein Fellow at Duke, is both a former high-ranking Treasury official and governor of the Federal Reserve Board. She said there are contradicting signals about where the economy now stands.

“Americans may be somewhat confused about why the Federal Open Market Committee is contemplating a rate cut, and why now. After all, unemployment is low, and Fed policymakers have not been raising red flags about the performance of the economy,” said Raskin, who as a Federal Reserve Board governor from 2010-14 helped conduct the nation’s monetary policy and worked to promote financial stability. “Indeed, looking at Fed policymaker projections, most of them did not project that there would be rate cuts until 2020.”

But the committee is signaling a 25 basis point rate cut at a time when Americans have been told the economy is doing pretty well, she noted.
“The rationale being put forth is that the economy could be hurt by the impact of trade tensions and weaker global demand. Even though unemployment is low, the Fed now says that the rate cut should be done to keep a potential downturn from becoming super bad.”

The underlying economic data do not look completely positive, Raskin said. Second quarter GDP came in at 2.1%, down from 3.1% in the first quarter. Inflation has been stubbornly immobile. The Fed aims for a 2% inflation rate, with symmetric moves on both the higher side and lower side of 2%, but inflation has consistently stayed stuck below 2%.

In addition, business investment continues to weaken, and global demand is projected to be weak.

So the overlying question, said Raskin, is whether the rate cut is a “precaution or is it politics? If economic data is looking weak, why is the Fed only now taking this step? And if things are turning bad, is a 25 basis point cut enough?”

Earlier this month, Fuqua finance professor Campbell Harvey said he also saw indications that the U.S. is heading toward a recession, perhaps as early as 2020.

In studying the recessions in the U.S. since the 1960s, he discovered a link between yield curve inversions (rare situations when short-term interest rates exceed long-term rates) and recessions. Before each recession, the yield curve inverted -- including the 2008 global financial crisis.

June 30 of this year marked the day where the yield curve was inverted for a full quarter -- triggering his latest recession forecast.

“There are many different ways to understand why the yield curve is a useful forecasting tool,” Harvey said. “I think the simplest is the following: The safest asset in the world is the U.S. 10-year Treasury bond. When people believe there is increased risk of a crisis or a recession, they shift their assets into this bond. Buying pressure on the 10-year drives prices up, thereby lowering yields.

“The long-term yield can be lowered to such an extent that it ends up below the short-term yield -- an inverted yield curve. So think of the yield curve as an indicator of sentiment about the future of the economy and the risks we face.”

Harvey noted that the GDP, an oft-cited indicator of economic health, “tells us about the past. The unemployment rate is a well-known ‘lagging indicator’ of the business cycle. The yield curve provides a window into the future. When you buy a bond, the cash flows come in the future in the form of interest payments and principal.”
Harvey added that the Fed’s ability to control the yield curve is limited. “Yes, the Fed does have substantial influence over the short-term rate. However, if the Fed cut the short-term rate by 0.25 percent, it does not immediately follow that the yield curve goes from -0.11 percent to +0.14 percent. When the Fed cuts rates, that is usually associated with bad news.”

Beyond the yield curve, Harvey said he tracks other indicators to get a sense of the economy’s direction.

“First, the Duke-CFO survey, which has been going on for 25 years, has an excellent track record. CFOs know the capital spending and employment plans before the plans are executed. Two-thirds of the U.S. CFOs believe a recession will begin in 2020.

“Second, in the policy arena, I focus on anti-growth policies. Currently, both the U.S. trade disputes as well as the specter of Brexit for the UK and EU are anti-trade and anti-growth.

“Finally, I look at the level of uncertainty in the economy. This one is difficult to measure. Our business cycle is 121 months and counting and the longest on record. It is feeling old and many are questioning the robustness of future growth. Additional uncertainty increases risk and decreases the attractiveness of business investment.”

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