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Turning in the Context of Recession: Reasons and Effects of the Decline of the Fed's Interest Rate in 2024

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Abstract: On September 18th, 2024, the Federal Reserve announced a 0.5% reduction in benchmark rates, marking its first cut since April 2020. This study aims to investigate the rationale behind this monetary policy decision and evaluate its impacts on the U.S. economy, particularly in the context of an ongoing recession. By examining both domestic and global economic factors, the research identifies decelerating growth and mounting inflationary pressures as key drivers of this policy shift. The methodology integrates a literature review, historical event analysis, and comparisons of policy adjustments over time. The findings reveal that the Federal Reserve's rate cut has a dual effect: on the one hand, it may stimulate investment and consumption to some extent while also helping stabilize financial markets; on the other hand, it poses challenges such as increased inflation and limited room for additional interest rate reductions. Furthermore, these domestic effects also create ripple effects on the global economy, potentially amplifying international economic volatility. Based on the analysis, it can be concluded that while the Federal Reserve's interest rate cut demonstrates short-term benefits in addressing current economic challenges, it also introduces uncertainties that may lead to unintended consequences, both domestically and globally.

Keywords: Federal Reserve, interest rate cut, monetary policy, the Fed's decision

1. Introduction

Because of the leadership of the United States of America in the global financial market, as the central bank of the USA, the Federal Reserve's monetary policy can always influence the world's economic situation. In the last four years, COVID-19, the Russia-Ukraine conflict, and the Israeli-Palestinian conflict brought stress to the financial situation, which forced the Fed to keep increasing the interest rate to limit the rapid inflation caused by the over-inflated level of prices. On September 18th, 2024, the Federal Reserve announced a 0.5% reduction in benchmark rates. The decline in the interest rate of the Fed is viewed as the new cycle of expansionary monetary policy.

This research tries to describe the reason for and effect of the new monetary policy of the Fed and illustrate how it will expand to the world, both the positive part and the negative part. The main research methods include literature review, comparison, and deduction from historical events and policy adjustments. This article may help people to find the context of this interest rate cut of the Fed. It will include the factors that may lead to this decision, the effects that this policy can bring, and how

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it will develop in the short-run future. The main points are the analysis from the historical events and decisions and the reflection of several different markets, such as the gold market and stock market.

2. Functions of the Federal Reserve

2.1. The Mechanism of Federal Reserve Interest Rate Adjustments on the U.S. Economy

As the central bank of the United States of America, the Federal Reserve has several important tools—the interest on reserve balances rate, the overnight reverse repurchase agreement rate, and the discount rate—to adjust its target range for the federal funds rate and keep its monetary policy suitable. To achieve the expansionary monetary policy, the Fed will choose to decline its target range for the federal funds rate. Expansionary monetary policy is typically implemented during periods of economic downturn, characterized by below-target employment levels and inflation rates that fall short of the 2% target [1].

As a result, the expansionary monetary policy can help lower the cost of borrowing money, improve consumption, and decrease the unemployment rate to a normal standard. In an overheating market, the contradictory monetary policy is necessary. In other words, the Fed will curb inflation by reducing excess liquidity in the market, thereby slowing the rate of price increases. This policy can mitigate overheating economic conditions, reduce speculative activities, and ease pressures on labor markets caused by excessively low rates of unemployment.

2.2. Differentiated Impacts of Monetary Policy Adjustments on Key Industries

At first, it is objective that the impact of the changes of the monetary policy is unavoidable for all industries, whether agriculture, finance, or even the governments' different departments. However, industries do not get the impact equally. The following examples show how different monetary policies influence different industries, including the high-tech industry and agriculture.

For FinTech firms, during the pandemic, the Fed adopted quantitative easing (QE) decisions to face the serious recession. This decision has been proved useful in awakening the investors' confidence and keeping the financial market stable. In this process, compared to most traditional industries, including the banks, the FinTech firms, which are part of the most advanced firms in the world, show more sensitivity to some changes of monetary policy, especially the Quantitative Easing (QE). Compared to many traditional industries, the FinTech firms require high costs in the beginning of their business to attract more consumers to attend. In the next phase, to keep attracting consumers, these FinTech firms have to innovate more and more new products because of the relatively short life cycle of the FinTech products. However, when facing the changes in the interest rate, this industry seems quite "quiet". The reason for this situation may be the main profit mode of the FinTech firms—the financial service, such as data analysis, depending on the technological support and the Internet. This kind of mode is influenced less by the interest rate [2].

Besides, in most counties, agriculture is an important source of jobs and income. What's more, because of the necessity of food, the food price plays a main role in the change of currency. In the few years, the global inflation pushed the increasing of the price of food. In many developing countries, such as India and Thailand, contradictory monetary policies have been implemented to curb food inflation. However, such measures can increase borrowing costs for farmers, reduce investment in agricultural production, and exacerbate rural unemployment. Conversely, the adoption of expansionary monetary policies to stimulate growth could risk reigniting inflationary pressures, creating a delicate balancing act for policymakers. From this perspective, the agriculture and the monetary policy deeply influence each other [3].

As the major income of most developing countries, the low-end manufacturing industry is always the focus and has a strong reflection of the change of the monetary policy. The change of the exchange

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rate is the key. In the international market, the price of a certain good is influenced by the relative value of its country's money. For example, the price of a machine that was produced by China is 20 yuan, and the price in the USA is 4 dollars in the situation that 1 dollar is equal to 5 yuan. But after the Fed increased the interest rate, which let 1 dollar exchange for 7 yuan, the price of the machine in the USA will become about 3 dollars. This will let the demand for the machine increase in the USA's market. In a word, the change of the monetary policy will heavily and directly influence the low-end manufacturing industry, negatively or positively.

3. Drivers of the Federal Reserve's Interest Rate Hikes and their Impacts

3.1. Energy Price Volatility Amid the Russia-Ukraine Conflict

Following the 2008 financial crisis, major central banks in most developed economies implemented significant interest rate cuts, with some eventually reaching the zero lower bound. This kind of monetary policy exhausted the potential ability of the conventional monetary policy to get. In the later phase of longer-term refinancing operations, the European Central Bank failed to get the expected result, which caused the further expansion of the ECB's balance sheet at the end of 2011. After this failure, the European Central Bank turned to deploying quantitative easing (QE) policies, which let the balance sheet contract in 2013 [4].

However, because of some political problems, the war between Russia and Ukraine let the European unstable market have an even greater recession. This war brought two main problems for the European countries: the lack of energy, including oil and natural gas, lead the high price of European products. Before the war, Russia served as the primary supplier of natural gas to most European countries, with significant contributions to oil markets as well. With the beginning of the war, this connection was stopped because of the sanctions against Russia and the break of the "North Stream" natural gas tube, and the supply of some necessary energy for industrial production and daily life declined suddenly. According to basic economics knowledge, the price of the oil will increase with the large decline of its supply.

On March 7, 2022, the WTI crude oil futures price touched $133.460/barrel, and the Brent crude oil futures price reached $139.130/barrel, the highest price since July 2008. To keep the price of oil stable, the Federal Reserve announced the first round of interest rate hikes by 25 basis points, followed by 50 basis points on May 4 and 75 basis points on June 15, July 28, and September 22, respectively [5]. As a result, on September 27, 2022, the WTI crude oil futures price dropped to $76.310 per barrel, and the Brent crude oil futures price dropped to $83.650 per barrel, returning to the level at the beginning of 2022.

3.2. Pandemic-Era Monetary Policies and Post-COVID Inflationary Pressures

The pandemic is one of the biggest public health events in human history. In the United States of America, it caused GDP to collapse at an annual rate of over 30% in the second quarter of 2020. More than 22 million jobs were lost in just the first two months of the crisis, and the unemployment rate rose from a 50-year low of 3.5% in February to a postwar peak of almost 15% in April of 2020. A precipitous decline in aggregate demand pummeled the consumer price level.

In light of the anticipated effects of COVID-19 on economic activity and on risks to the outlook, at two unscheduled meetings on March 3 and March 15, 2020, the Federal Open Market Committee (FOMC) declined the target range for the federal funds rate by a total of 1.5 percentage points, bringing it to the effective lower bound target range of 0 to 0.25%. What's more, to keep the financial market stable, the FOMC decided to spend at least 500 billion dollars and 200 billion dollars on purchasing Treasury securities and MBS of some financial organizations on 15 March, 2020. Later,

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in the meeting in June, the FOMC finally decided to purchase at least $80 billion of Treasury securities and at least $40 billion of agency MBS per month [6].

These monetary policies actually slow down the recession caused by COVID-19, but the radical expansionary monetary policy brought serious inflation to the USA.

As figure 1 shows, the inflation rate had a sudden increase in 2021 and kept in the relatively high level in 2022. In the next two years, the inflation rate gradually went back to the suitable level. After the problem from the pandemic was solved partly, the prior task for the Fed is limiting the high inflation.

In conclusion, these two factors influence the Fed a lot in deciding to increase its interest rate.

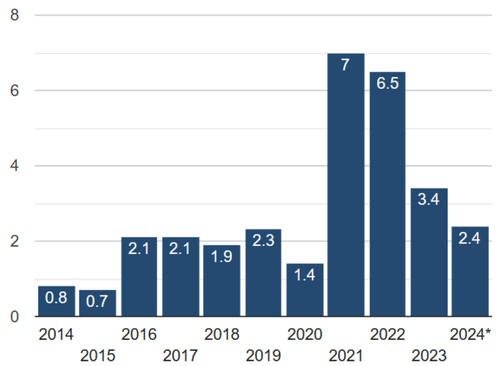

Figure 1: The rate of inflation in the USA during 2014-2024

4. Factors behind the Federal Reserve's Recent Interest Rate Cuts

In the last part, the basic factors that led to the final decision of cutting the interest rate were discussed. This phase will continue to research the key that let the Fed choose to announce the interest rate cut at this time. At a press conference to discuss the rate cut, Fed Chair Jerome Powell said the decision to ease more aggressively was based partly on the central bank's confidence that inflation will soon reach policymakers' goal of a 2% annual rate, as well as cooling employment. Powell added that the labor market remains solid, though not as hot as it was during the pandemic, when labor shortages drove up wages and some businesses found it difficult to find new workers [7]. Powell's words indicate that the Fed's current focus has shifted toward stabilizing the labor market and encouraging economic growth, as inflation has shown signs of steady decline and approaches the 2% target.

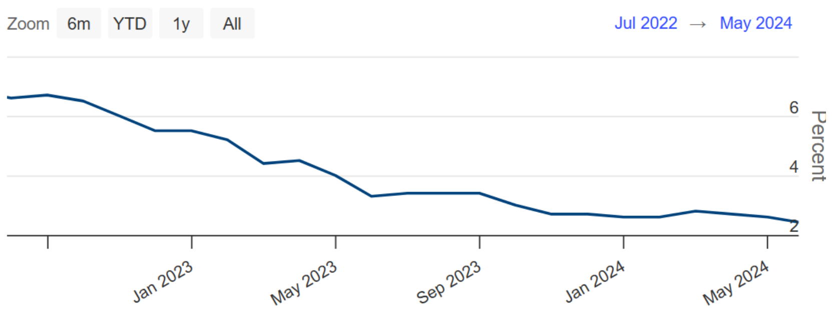

Figure 2: The trend of the change of the inflation rate in the USA [8]

Figure 2 shows that the inflation rate decreased steadily from July 2022 to May 2024. It shows that the rate of inflation is keeping decreasing, and the trend of the decline will continue. It proves that the constrictive monetary policy the Fed set before was meaningful and useful to get the goal—controlling the rate of inflation around 2%.

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Figure 3 shows the rate of unemployment from Jul 2022 to Sep 2024. Compared to the rate of inflation, the rate of unemployment is relatively high since about Sep 2023. What's more, the trend of the graph is upward, which indicates that this data will keep increasing. However, the rate of inflation actually did not drop to an expectable number yet. A 0.5% cut of the target range for the federal funds rate is quite large and radical, and this makes people worry about whether such monetary policy will make the financial market fluctuate heavily and cause some panic. Fortunately, until this article, some data that can reflect the financial market developed as people expected. For example, the price of gold keeps the trend of growth in general, and the price of gold has increased to 2777.8 dollars per ounce. The Nasdaq index also showed a steady upward trend, with about a 1.51% improvement. These facts show the new monetary policy has had some achievement. On 7,Nov, 2024, the Fed announced the further policy—a 0.25% cut of the interest rate. Later, the Fed may choose different policy depending on the reflection from the labor market and the rate of inflation.

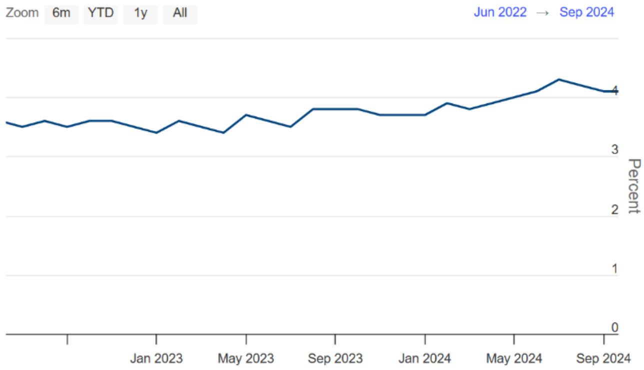

Figure 3: The trend of the change of the rate of unemployment in the USA [8]

5. Worldwide Responses to the Fed's Monetary Policy Shifts

Based on the local situation, the central banks of different countries and areas always have different choices to face the huge change led by the Fed. The European countries choose to reduce their interest rate earlier than the Fed. The European Central Bank has chosen to decrease its rate from 12 Jun, 2024. It is quite understandable for this situation because the recession in Europe caused by the Russia-Ukraine conflict, the terrible climate, and the lack of energy heavily broke its market and largely expanded its debt. For most countries, the Fed's further decision is the key for their decision. China's central bank has maintained a relatively stable RMB-to-USD exchange rate through targeted interventions, despite pressures from a slowing real estate sector and external financial uncertainties. Further decisions of the Chinese Central Bank are unclear; they may depend on the further action of the Fed.

6. Conclusion

During the pandemic, to face the biggest recession after the Great Depression, the Fed chose to decrease its interest rate. Once the interest rate had dropped to zero. On the one hand, the decisive policy adjustment was actually meaningful and suitable for slowing down the rapid recession; however, on the other hand, the overexpansionary monetary policy led to heavy inflation. As a result, the Fed started to raise the interest rate to limit this situation. Four years later, with the stable inflation rate and the weak labor market, the Fed chose to have a 0.5% cut of the target range for the federal funds rate on 18 Sep, 2024. This was viewed as the beginning of a new cycle of expansionary monetary policy. Many economists predict that the Fed will set a new interest rate cut soon. In fact, after about 2 months, the further decline of interest rates had been announced. However, the radical

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interest rate cut policy was beyond many economists' prediction. Since the inflation rate isn't back to 2% yet, the over-radical policy may let the inflation rate become unstable. The main reason for the Fed to make such a decision is the gradually increasing rate of unemployment, which has exceeded the rate of inflation. Even though the increasing price of gold and the rise of the Nasdaq index express that the Fed's policy is useful and fits the expectation, after the interest rate cut was announced for the second time, these two indices declined. The Fed should provide the market and investors with more confidence to make sure the USA's economy has a soft landing.

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