Q & A on Interest Rates and the Federal Reserve

Q1: How big a concern at this time is deflation?

A1: The drop in inflation (as measured by changes in the CPI) is raising concerns about deflation. This is likely temporary and mostly a reflection of weaker demand as activity has come to a halt. While the yearly change in the core CPI (1.4%) has dropped to its lowest level in nine years, the yearly change in the median CPI (2.7%) is only at a 15-month low. The median CPI was developed by the Cleveland Federal Reserve and has been a better guide for future inflation trends than the core CPI (which was developed in the 1970’s when it was politically expedient to exclude food and energy from inflation calculations). There continues to be more inflation beneath the surface than is widely acknowledged and I don’t believe deflation is a big concern right now.

Q2: Are negative interest rates likely in the US?

A2: On a real basis (rates minus inflation) interest rates in the US are already negative. Much of the current discussion of negative interest rates focuses more on the Federal Reserve possibly following the path of the ECB and actually setting a nominal rate that is below zero. Fed Chair Powell said today that there is little appetite for going this route at the Fed, the evidence of its effectiveness is mixed, and it can lead to operational difficulties in the financial sector. The Fed would rather lean on other tools in its kit and do what it can to avoid taking rates into negative territory. To date, no central bank that has taken its policy rate into negative territory has been able to move it back to positive territory.

Q3: What other tools are available for the Federal Reserve?

A3: Two come to mind: Explicit forward guidance about how long rates will remain low and yield curve control. While the Fed may not want to push short-term rates lower, it can commit to keeping them low for an extended period of time. If market-based yields begin to rise and steepen the yield curve, the Fed could buy intermediate- and long-term bonds with the aim of lowering those yields and flattening the yield curve.

Q4: Are there limits to what the Fed can do to support the economy?

A4: The Fed is doing what it can to provide liquidity to the economy in its role as lender of last resort, but there are limits to what the Fed may do. The Fed can address liquidity issues but it cannot address matters of solvency (that is the domain of fiscal policy). As Fed Chair Powell made clear, the longer economic weakness persists, the more likely it is that liquidity issues become solvency issues. The duration of economic weakness increases the risk of long-term scarring that can weigh on the economy’s potential.

Bottom line: Fed Chair Powell’s somber assessment of the near-term challenges facing the U.S. economy contributed to broad-based selling pressure in stocks. While the path forward may be rockier than some have hoped, the Fed remains committed to assertively and creatively providing liquidity where it is needed. The Fed will do what it can to minimize the duration of the economic weakness and help support a return to growth.
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