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Fed Thoughts: **What Color is the Fed's Parachute?**

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A dour Federal Reserve (Fed) Chair Jerome Powell has repeatedly taken to the airwaves to emphasize the severity of the ongoing economic contraction, the damaging forces that may affect trend growth for some time, and the Fed’s full-throttle relief efforts. Remember that Chair Powell has been bicycling around the policymaking blocks of Washington DC for much of the past three decades. It appears he is trying to avoid two messaging missteps the Fed made during the 2008-09 recession and the sluggish recovery that followed.

For one, the Fed was (wrongly) accused of supporting the interest of Wall Street over Main Street. Instead, the Fed’s unprecedented policy stimulus at the time—pulling its policy rate to zero, ballooning its balance sheet, and rolling out new lending facilities—was ransom paid to Wall Street to protect Main Street. The shakiness of Wall Street banks that caused a constriction in finance, wider risk spreads and lower equity prices hurt aggregate demand on Main Street, which the Fed’s policies strove to offset. This time around, the Fed is doing the same on a larger scale (an even bigger balance sheet), with a wider scope (nine facilities to date). They are also focusing on retail efforts due to the terrible toll of COVID-19 mitigation efforts on small- and medium-sized businesses. These businesses tend to be more service-centric and vulnerable to lockdowns, typically have thin financial backstops, are shut out of markets and lack assured access to banks. First and foremost on Chair Powell’s list of initiatives is the Main Street Lending Program, which lends to these entities, through banks, in order to slow the bleeding.

For another, market participants fretted after the 2008-09 recession that the Fed would remove its unusual policy stimulus too soon, preventing its effects from reaching longer-lived financial assets. The jerry-rigged solution was to make rate guidance more and more explicit. Chair Powell’s emphasis on the recession and financial crisis’ long shadow underscores that the Fed will remain accommodative for as long as necessary.¹

At the same time, while reassuring that the Fed would carry enough water to meet the current conflagration, Chair Powell downplayed forms of support bruited by his colleagues—formal interest-rate guidance or yield-curve control—and was downright hostile against putting the policy rate into negative territory. This raises three questions about the Fed:

1. What is the basis for its concern about longer-term growth prospects?
2. Why hasn’t it embraced formal interest-rate guidance of one form or another?
3. Why is it so negative about a negative policy rate?

This note explores these questions in order.

Whither Withered Longer-Term Economic Growth?

In a recent speech (mostly repeated a few days later to Congress), Chair Powell warned that “...the scope and speed of this downturn are without modern precedent...” He also spoke about the potential adverse effects on longer-term economic performance:

“A prolonged recession and weak recovery could also discourage business investment and expansion, further limiting the resurgence of jobs as well as the growth of the capital stock and the pace of technological advancement.”

Chair Powell adopted the latter notion much more quickly than his predecessors did during the hesitant recovery ten years ago. This is a shame because it is there in the data. In a [paper](#) presented at the Kansas City Fed’s Jackson Hole Symposium in 2010, my wife Carmen and I looked at the economic outcomes in the decade after the fifteen-worst financial crises of the second half of the 20th century. We updated the paper for [Foreign Affairs](#) in 2018 as the passage of time conveniently provided another set of observations, and reviewed the eleven advanced economies that suffered through the Global Financial Crisis of 2008-09 (the “Systemic Eleven”). The key takeaways shown in the tables below track real GDP per capita after each event. In the median experience, the fifteen economies hardest hit by financial crisis in the second half of the last century took four years to recover their pre-recession level of real GDP per capita.

15 Severe Crises of the 20th Century

Country	Year of Financial Crisis	Peak-to-Trough Decline in Real GDP	Years to Recover
Spain	1977	-0.3%	4
Norway	1987	-0.8%	3
Finland	1991	-5.1%	6
Sweden	1991	-5.6%	4
Japan	1992	-0.4%	3
Indonesia	1997	-14.4%	7
Korea	1997	-6.2%	2
Malaysia	1997	-9.7%	6
Philippines	1997	-3.0%	3
Thailand	1997	-11.9%	5
Argentina	2001	-21.6%	5
Chile	1981	-18.7%	8
Colombia	1998	-6.3%	5
Mexico	1994	-7.7%	3
Turkey	2001	-7.2%	2
	Median	-6.3%	4

Source; Reinhart and Reinhart, 2018

This century has been more dismal as the Global Financial Crisis morphed into a sovereign-debt crisis in Europe (where bank balance sheets deteriorated markedly), the fiscal-policy response was uneven, and monetary policy tested the limits of policy accommodation. The median Systemic Eleven economy took eight years to climb out of its hole, and two countries (Greece and Italy) are still below that horizon.

Systemic Eleven of the 21st Century

Country	Year of Financial Crisis	Peak-to-Trough Decline in Real GDP	Years to Recover
Iceland	2007	-9.2%	9
Ireland	2007	-10.5%	7
United Kingdom	2007	-6.1%	8
United States	2007	-4.8%	6
France	2008	-3.8%	7
Germany	2008	-5.2%	3
Greece	2008	-26.3%	--
Italy	2008	-11.9%	--
Netherlands	2008	-4.3%	8
Portugal	2008	-7.0%	9
Spain	2008	-10.6%	9
Median		-7.0%	8

Source; Reinhart and Reinhart, 2018

The Federal Open Market Committee (FOMC) listed the potential mechanisms impairing long-term economic performance in its most recent minutes, repeated here (at length):

“One of these risks was that workers who lose employment as a result of the pandemic may experience a loss of skills, lose access to adequate childcare or eldercare, or become discouraged and exit the labor force. The longer-term behavior of firms could be affected as well—for instance, if necessary but costly transmission-mitigation strategies lowered firms’ productivity; if business investment shifted down permanently; if many firms need to adjust their business models in the aftermath of the pandemic; or if business closures, particularly those of small firms, became widespread. A few participants noted that higher levels of government indebtedness, which would be exacerbated by fiscal expenditures that were necessary to combat the economic effects of the pandemic, could put downward pressure on growth in aggregate potential output.”

Add to this list that investors remain skittish toward risk taking after a severe economic and market correction. Chair Powell is preparing us for the worst, in part to ward off disappointment if it eventuates. This helps to answer the next question.

Why Hasn’t the Fed Embraced Interest-Rate Guidance?

Policy-rate guidance comes in two flavors, as described by Bernanke and Reinhart in 2004. A central bank can make an explicit promise to hold the policy rate at its current level until at least a certain date. This *unconditional commitment* was first used by the Fed in 2003 with the assertion it would not change the policy rate for a “considerable period.” While somewhat vague, market participants understood the policy rate would hold at its current level at least until the next FOMC meeting and would not be changed until those words were taken out of the policy statement (note that this happened above the zero bound).

A *conditional commitment* links future policy changes to some future observable outcome. This first appeared in the central bank toolkit in 2001 when the Bank of Japan (BOJ) asserted it would maintain ample liquidity until the core CPI's rate of change became zero or higher on a sustained basis. A more recent example, formally embraced by the FOMC from 2012 to 2014, was the “Evans Rule” (from Charles Evans, president of the Federal Reserve Bank of Chicago) that the rate would be kept low until the unemployment rate fell below 6½ percent and inflation was projected to be ½ percentage point higher in a year or so. Both served to reassure market participants that tightening was a distant event.

A more extreme form of guidance is a commitment to cap some market yield, or yield-curve control. This typically stems from a frustration with quantitative easing leading to a switch in emphasis from quantities to prices. If open-market purchases of government securities do not get sufficient traction to lower yields, the central bank can stand willing to acquire as many as necessary to keep yields at or below set levels.

The Fed was there in the 1940s, as part of the war effort. The Treasury directed the Fed to cap yields, at times up to seven points along the term structure. It worked, but it lasted long past the war rationale to March 1951, evidence that policy interventions linger. In modern times, the BOJ, having bought securities in massive volume, promised to cap the ten-year Japanese government bond yield at around zero.

When it was a decision of the central bank, interest-rate guidance or yield-curve control was the answer to a problem—that investors expected a too-abrupt reversal in policy accommodation. The central bank answer was to re-anchor those expectations with a promise of brute-force purchases.

Is This in the Fed's Future?

Monetary theorists, with a few governors and many Reserve Bank presidents counted among that tribe, prefer to work with closed models describing behavior across all possibilities. Nothing does this better than a rule about the policy rate. Thus, there is a strong pull toward closure among many FOMC participants. A promise, say, to not raise the fed funds target when the unemployment rate is in double digits and the pursuit of a 2 percent inflation goal goes in that direction. If the risk-free term structure looks too steep to support economic activity, it could be tilted down by the announcement of an interest-rate cap. Indeed, the experience of considerable healing in the investment grade corporate market by the announcement of a new facility, well before actual purchases, might lead some to believe that yield-curve control can be gotten on the cheap.

This theory, however, is confronted by a deep practical reality that is probably more evocative to Chair Powell: Don't fix something unless it is broken. By stressing the prolonged and pronounced pain the economy still has to go through, he has already convinced investors that policy will be accommodative for some time to come. How else can the current ten-year Treasury yield at 5/8 percent be explained?

In addition, an academic prescription often comes with side effects. For one, the same helpful participants offering rough guidance will now want to perfect the project later, moving from round numbers to fractions to decimal points. For another, policy rules often are retained past their sell-by date, as witnessed by yield-curve control extending after World War II. If guidance strengthens the transmission of monetary policy at the zero bound, why stop it when the time comes to raise rates? The rate guidance provided by the “dot” chart of the Summary of Economic Projections may have seemed like a good idea in 2012, but it has mostly been a millstone around the necks of Fed chairs since. It is instructive that Chair Powell did not let this crisis go to waste and promptly ditched it. A chair eliminating precedential rate guidance is unlikely to put on a newly fashioned straightjacket. Lastly, market functioning may be impaired as the central bank takes one side of all transactions. At a minimum, investor expectations shift from being about the economy to being about the policy rule.

Never say never. Interest-rate guidance and yield-curve control are last resorts for central bankers who believe that market participants do not understand or trust what the central bankers are saying. This is why they are described as credibility mechanisms: a rule that reduces the message to one sentence is more difficult to violate than a vague assertion. If the Fed believes that the incorrect market expectation of a premature policy reversal is suppressing the prices of capital assets and cannot be talked out of markets, Chair Powell would reluctantly embrace some rule. He would probably do so with as much affection as he showed for the “dot” plot.

Why is the Fed so Negative About a Negative Policy Rate?

Pulling the interest rate on reserves into negative territory taxes them, as depositories have to pay the central bank for the privilege of holding balances. Unlike other taxes, there is no way to evade the tax and erode its base because reserves are kept within a closed system. The amount of reserves outstanding—a liability of the Federal Reserve—is entirely determined by Fed decisions about the stock of assets it holds.²

Intermediaries must pass this tax along to its clients or owners in the form of:

1. Lower deposit rates
2. Higher loan rates, or
3. Fewer profits

The first mechanism looms importantly in Fed thinking, sparking the fear that lower deposit rates invite flight from banks given the myriad investment alternatives available to their customers. Such disintermediation poses problems for those left and those leaving. For the banks that are left, disintermediation requires them to find other, more expensive, funding sources or shrink their balance sheets. Since the stock of reserves is fixed for the banking system as a whole, balance-sheet shrinkage involves running off earning assets, including loans. Obviously, loan constriction goes in the wrong direction of the Fed’s economic objectives, a problem already exacerbated by increased bank risk aversion amid an ongoing deterioration in loan books.

For those leaving, the more attractive return on alternative assets may involve additional risk, either by extending maturities or assuming credit exposure, and do not offer the protection of federal deposit insurance. Such distinctions may not be appreciated by all retail investors. Of course, rather than pay for depositing at a bank, households and firms can opt to hold currency. If the Fed keeps its stock of assets unchanged, an increase in one of its liabilities, banknotes, will lead to a drain of another, reserves. (Mechanically, the Fed deducts reserves from a bank to pay for the currency it provides). If the Fed keeps the level of reserves fixed, it will have to offset the drain of an expanding stock currency by acquiring more assets through open-market purchases. The sums are not trivial and there is some evidence that this substitution is ongoing in our zero-rate world. Currency in circulation stands at \$1.8 trillion, up \$80 billion from the start of 2020. This is a striking pickup, suggestive of hoarding. It comes at a time of general lockdowns when paper notes are an infection risk, involve person-to-person transfer, and much of economic activity has shifted online.

An influential strand of academic work suggests the differences between banks stem not from their liabilities (deposits), for which there are many close substitutes, but their assets (loans). Banks have processes in place to evaluate credit and a retail presence that touches households and firms that do not necessarily have market access because of the low value of their needs. As a result, banks may have some market power in setting lending rates. If so, mechanism (2) will be at work and a deposit tax on banks will be passed through to increased loan rates,

which will be counterproductive to providing economic stimulus. Especially hard hit would be small- and medium-sized firms that are already reeling from the pandemic shutdowns. There is some evidence from Sweden that the Riksbank's first forays into negative territory produced higher loan rates. Of note, when Chair Powell talks about the evidence regarding negative rates from the foreign experience, he speaks diplomatically about "mixed results," but an adverse effect on the lending channel is the dark consequence he must fear.

In principle, banks could choose to let a deposit tax eat into its profits, presumably if they want to protect customer relationships. However, while there are many banks in the US, the system as a whole is very concentrated and the firms at the top are liable to equity holders. Lower corporate profits or, even more significantly a cut in dividend payouts, would hit their share values hard, probably inclining bank management to weigh investor as well as customer relations. This is an awkward part of the conversation for Fed officials, who are often accused of protecting the profits and share values of banks, especially big ones. Unfortunately for those officials, it is mostly an unsaid truth representing their market means to a macroeconomic end. A healthy and profitable banking system supports economic activity, especially the most vulnerable parts of the economy. Indeed, the signature new facility of the Fed and the Treasury, the Main Street Lending Program, essentially relies on banks to be the retail agents of the government. If bank profits and share values were not important to the Fed, why have officials been thus far reluctant to ban dividend payments and share buybacks as has been done by their European counterparts?³

An unstated objective of a negative deposit rate is to close the gap between US money market rates and those in Europe and Japan so as to foster US dollar depreciation. There are two problems on this front. In periods of crisis, it is hard to engineer depreciation of the safe-haven currency, especially when economic strains are showing the seams in the Euro area construction and Japan is pressing the limits of stimulus. Also, Fed officials appreciate that US dollar depreciation essentially "borrows" some of the aggregate demand of our trading partners by making US goods and services more competitive on the world market. As of now, the major economies are mostly riding through an even worse economic downturn than our own, so they do not have much to share.

The hostility to going negative is sufficiently entrenched that Fed officials never voice the one advantage that the US has relative to its trading partners. A significant fraction of reserves, more than one-third at the end of 2019, are held by foreign banking offices in the US. Moreover, the share rises at a time of stress when dollar liquidity is at a premium. The Fed's swap lines with nine central banks, now tapped to the tune of \$446 billion, are essentially round-tripped. The Fed provides dollars to its colleague central banks that in turn lend them to their commercial banks to deposit back at Federal Reserve banks. By taxing those deposits, the Fed could profit on both legs of these transactions.

But, once again, never say never. If pressed by extreme economic circumstances, beyond the lower bound of our forecast, the Fed would go negative on its deposit rate so as to establish it is willing to do whatever it takes to support activity. It would swallow the negatives to emblazon a positive. It would not do so because of political pressure, and it would be an effort of last resort.

That does not mean that market interest rates could not go negative, as they have at times at home and in many foreign jurisdictions. Market participants already put some (misplaced) weight on the Fed going into negative territory, and most term premiums are already there. An amplification of these preexisting conditions could put a minus sign in front of some Treasury yields.

One Last Thought

The answer to the question posed in the title, "what color is the Fed's parachute?" is green, as in Fed greenbacks.

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Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

- ¹ An unfair, but informative, comparison is that the ten-year Treasury yield averaged 2.58 percent during the Fed's first visit to the zero-lower bound of its policy rate and then 2.11 percent from there to when Chair Powell's term started. In the most recent foray at zero, the ten-year Treasury has averaged 0.69 percent.
- ² Note that the Fed Board reduced the reserve requirement on net transactions accounts to zero percent, effective March 26th. The reserves that the Fed pumps into the banking system get held, far in excess of those needed to satisfy reserve requirements and to support deposit creation.
- ³ This is a bone of contention within the Fed. The latest FOMC minutes repeated that some participants want to ban dividend increases and share buybacks. There are prominent outside critics, too. Kristalina Georgieva, managing director of the International Monetary Fund, recently published an op-ed urging such a ban.

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