What the Fed Can Still Do

Joseph E. Gagnon argues that with inflation well below the danger zone, the Federal Reserve should lower one-year and two-year rates to spur the economy.

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics with Joseph Gagnon, senior fellow at the Institute, to talk about the latest economic indicators [as of] July 16 and to discuss whether the Federal Reserve can do anything more about the situation. Thanks, Joe.

Joseph E. Gagnon: Thanks for having me, Steve. Good to be back.

Steve Weisman: What do the latest numbers show, particularly on inflation?

Joseph E. Gagnon: I actually think those [inflation indicators] are the more interesting ones right now. The growth numbers have been a little weaker than expected, but not much. I think all this talk about a double dip seems a bit overstated, but certainly growth isn't as strong as we would have liked. But what's more interesting is that inflation has come in all year lower than people expected, and people have been marking down their forecasts. Actually, this week's numbers were close to what had been forecast, but that's based on forecasts that had come down a lot along the course of the year.

Steve Weisman: What were the important numbers?

Joseph E. Gagnon: The headline CPI [Consumer Price Index] dropped a few tenths this month; a tenth in June and a couple of tenths in May, but most of that was because of gasoline, energy prices. You strip away the food and energy component, it actually rose two-tenths in June, which is the highest it's been for a while, but it's still not a high number. These monthly numbers do move around a bit. Looking at, say, a 6-month average or 12-month average, it's still quite low. It's been less than 1 percent over the past 12 months, and almost only 0.5 percent in the past 6 months at an annual rate, which is pretty low considering that the Fed thinks that 2 percent is sort of the ideal place it would like to be. We have high unemployment. That's probably the biggest reason why inflation is coming down.

Steve Weisman: I should have asked the question the other way. A lot of critics looking at the budget deficit and debt situation are predicting inflation—not now, maybe not imminently, but in the future. They're the ones who want to withdraw the stimulus. What are you most worried about?

Joseph E. Gagnon: People look at budget deficits and the Fed's aggressive actions and say: inflation. Well, if we had had high budget deficits and aggressive monetary policy when the economy was doing fine, then yes, that would be highly inflationary, and we would need to worry about it. But when these actions are actually the result of a weak economy, or a response

to a weak economy, then there's much less reason to worry. In fact, they're very much needed to keep inflation from moving too much in the other direction.

Steve Weisman: So what should the Fed do now? It's lowered rates to near zero in some cases. It's kind of run out of bullets to do that more. But you have some other ideas, and actually you have discussed some here.

Joseph E. Gagnon: One thing I have been recently thinking about is making the Fed's response to the state of the economy a bit more continuously linked to its normal procedures. Normally in the past, when the economy [was] weak, they lowered the short term interest rate that they control. That, as you said, has basically hit zero now, so it seems like we can't do much more. In the past, what they did when they wanted to stimulate the economy more was they jumped into buying longer-term assets—30-year mortgages, 5- and 10-year treasuries. But that was in the context of a financial crisis.

Steve Weisman: That was in the last two years, especially starting in late 2008.

Joseph E. Gagnon: Right. And that was partly a response to a crisis and partly an attempt to calm those particular markets but also an attempt to stimulate the economy. Now that we don't have a financial crisis, but we just have maybe a somewhat weaker economy, it seems to me the way to go is not to do something big and splashy like that, but to do something that's more in line with their normal policy. Their normal policy, as I said, is to raise and lower short-term rates. But when the short-term rate gets to zero, then the obvious next step would be, well, start acting on a one-year rate or a two- year rate and move those interest rates down. And then if you want to ease, you can move rates down at three-year interest rates and four-year interest rates. Normally we know that interest rates tend to be higher when they're longer maturity; so if you want to lock in your mortgage at a long-term rate, you pay more than zero even if the overnight rate is zero. But the Fed can move these longer-term rates down if it wants to act on them; and maybe it should do it more continually, sequentially from zero to one to two to three years. And that's what I think would make more sense. It would be a natural extension of their normal policy, and it would be easy for them to unwind it.

One of the problems with what they did last year was they announced a very large number of very long-term bonds, but they didn't have any particular target for the interest rate. They just announced $1.75 trillion [in] total purchases, and then they were kind of stuck. And it takes time to do that. It phases in for a whole year, it would have been difficult to reverse it, and so they kind of were stuck in a policy that was going to last for a whole year. And that's kind of awkward because if circumstances change, they probably would want to be in a flexible position to change the policy. So if they do this new approach, they can unwind it relatively smoothly and quickly. And they don't have to commit to any particular magnitude or trajectory. They can just say, "Well, for now the two-year Treasury is going to be pegged at zero."

Steve Weisman: What are those rates now, by the way?

Joseph E. Gagnon: They are pretty low already. The three-year Treasury rate is 1 percent, the two-year Treasury rate is about three-fourths of a percent; so that's pretty low. But nevertheless, lowering the three-year Treasury rate from 1 percent to one-fourth of a percent is a 75

basis point cut in the three-year interest rate, which would affect lots of interest rates across the curve. That's a fairly big policy step in the context of their normal actions. So, it's sort of, you know, maybe the right size that is needed now.

Steve Weisman: The minutes of the Federal Open Market Committee that came out indicate some split at the Fed over these issues. What's your reading of how they would react to recommendations?

Joseph E. Gagnon: I think that there indeed is a split. Part of the reason for my recommendation is that I sense there is a lot of reluctance on the Committee to jump in, in a big way the way they did last year. And the kind of thing they did last year really only makes sense if they are going to do it in a big way. So why not have a different approach? They can do more gradually, more continuously, and then they don't have to commit themselves to a major undertaking.

Steve Weisman: And you think—

Joseph E. Gagnon: This might make it easier for them to do it. But within the Committee, I think even that, I think, would face opposition. There clearly are some members who wouldn't even want to do that, who are actually thinking about the other direction. I think they are on hold now because the latest data [are] a little bit weaker. But before, they were certainly already getting ready to go in the opposite direction because they were worried about inflation. But I think the data [are] proving them wrong. And so, the balance of views is definitely shifting more to, "We may need to do more, not less."

Steve Weisman: Joe Gagnon, thank you very much