THE FEDERAL RESERVE WILL RESIST DROPPING INTEREST RATES BELOW ZERO

By Scott Colbert, CFA®

The futures market for Treasury bonds in March and just recently an obscure Fed Fund Futures market pointed toward the possibility of negative interest rates here in the USA. Market participants, whipped into a negative rate flurry this past week, almost forced the Federal Reserve (Fed) to respond. Their clear message: "Not if they can help it."

Why all the fuss? Both the Bank of Japan and European Central Bank have implemented negative-rate policies in the years since the "Great Recession" in an effort to keep afloat their sluggish economies and combat deflationary pressures. And last week, for the first time ever, a little used forward market for overnight bank lending dipped barely into negative territory.

But the effectiveness of negative rate policy (the Fed lending money to banks at less than zero interest and charging banks fees that wanted to hold cash) remains the subject of debate in global central banking circles.

Critics point to the fact that it does not seem to have helped either Japan's or Europe's economy. We know it's clearly hurt the health of their banking systems. And it penalizes savers, who earn no money, and might even get charged to hold cash as well. Indeed, at least six of the 12 presidents of the Fed's regional banks have downplayed the idea recently.

So why doesn't the Fed rule out this negative rate policy in its entirety?

One word. *Deflation.*

The Fed attempts to stimulate the economy in a downturn by lowering the cost of short-term bank borrowing, this time nearly to zero. In turn those lower rates get passed along to other borrowers who might refinance or issue debt at ultra-low rates as well to help keep their businesses and households afloat. Maybe it will even spur some investment in a new building or allow you to buy a new car. And to nudge longer-term interest rates downward, the Fed has also printed money to buy longer Treasury bonds, mortgage debt, and even some riskier assets once again to help lower borrowing rates, stimulate the economy and perhaps conjure up some inflation.

But ultimately the Fed does not control inflation. While we've grown used to at least some inflation in our lives, the Consumer Price Index[1] was -.8% last month, and if deflationary pressures continue to exist, even a zero-borrowing rate becomes unattractive if asset values are falling. Thus, the potential for negative interest rates if deflation were to take hold remains.

So bottom line is the Fed is loath to throw away an old rusty golf club it has in its bag (think two-iron) if it might potentially need it someday. But for the time being, they want to avoid using it at all costs by keeping that inflationary ball on a positive trajectory, moving forward, down the middle of the fairway.

[1] Bureau of Labor Statistics

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ABOUT THE AUTHOR

SCOTT M. COLBERT, CFA®

Executive Vice President, Chief Economist and Director of Fixed Income Management

Scott is the chief economist and director of fixed income management with Commerce Trust Company. He joined Commerce in 1993 and has investment responsibilities for over $19 billion in fixed income assets. Scott directly manages the Commerce Short-Term Government and the flagship Commerce Bond strategies. Scott received his Bachelor of Science degree in nuclear engineering from the University of Cincinnati in 1986 and received his Master of Business Administration from Xavier University in 1988. He has been both a director and president of the Chartered Financial Analyst Society of St. Louis.