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Trump Wants to Cut Interest Rates. Powell Should Do It Anyway.

The chairman made the case last year for easing if the yield curve inverts—as it did in March.

By Donald L. Luskin

It's time for the Federal Reserve to cut interest rates. Not because the economy is falling apart, and not because the president is demanding it—but because it's the right thing to do, based on a compelling policy vision put forth last year by Chairman Jerome Powell.

Last July, in his first semiannual testimony before Congress, Mr. Powell was asked by Sen. Patrick Toomey (R., Pa.) what he thought of the narrowing yield curve. Mr. Powell answered: "If you raise short-term rates higher than long-term rates, then maybe your policy's tighter than you think, or it's tight anyway."

Alarmingly, that's no longer an "if." The yield of the benchmark 10-year Treasury note fell below the effective fed-funds rate more than two months ago, on March 25. As of this writing, the 10-year yield at 2.07% is below even the floor of the Fed's target range for the fed-funds rate, 2.25% to 2.5%. At this point, a rate cut of 25 basis points would still leave the 10-year yield within the target range. Today it would take two cuts to uninvert the curve. So if Mr. Powell is going to be true to his own prescription, then surely he must acknowledge now that "policy's tighter than you think."

The wisdom of the policy view Mr. Powell articulated to the Senate is that it relies on the collective sagacity of markets to send the Fed policy signals. Mr. Powell, not an economist by training, has spoken forcefully against the Fed's overreliance on quantitative models designed to capture unobservable abstractions such as the neutral interest rate, which the quants call "r-star," or the natural unemployment rate, "u-star." In a speech last year, he warned against the policy hazard of "navigating by the stars."

Mr. Powell's concern with the inverted yield curve goes deeper than economic theory. As a practical matter, the basic business model for banks is to fund themselves at the short-term fed-funds rate, then make long-term loans to borrowers at what is normally a higher long-term rate. When the long-term lending rate is below the short-term funding rate, lending becomes a losing proposition for banks—so they stop doing it. That's why an inverted yield curve may not only predict a recession but cause one.

Worries about excessive inflation shouldn't currently be a binding constraint on a possible rate cut. The Fed's preferred measure—the price index of personal-consumption expenditures, excluding food and energy—has increased at only 1.6% over the past year, far below the Fed's target of 2%. What's more, it's decelerating. So far in 2019 it has increased at an annual rate of only 1.4%.

President Trump provocatively tweeted—right in the middle of the most recent Federal Open Market Committee meeting—that inflation is “wonderfully low.” Ben Bernanke, if he were still chairman, would probably see it as dangerously low, verging on deflation. Either way, there is self-evidently no upside threat. If there were, we can be sure that the 10-year yield would be rising, not falling.

Fed officials have insisted that low inflation is “transitory.” But inflation has met or exceeded the Fed’s target in only six out of the past 124 months. It’s time to stop ignoring other evidence—such as today’s inverted yield curve—that points to the need for a rate cut.

A cut now doesn’t have to imply a whole new easing cycle. It need not spook markets by signaling that the Fed has lost confidence in the economy. It could just be an adjustment of the type former Fed Chairman Alan Greenspan made successfully as the “maestro” of the long 1990s expansion. Such an adjustment now would build market confidence, because it would show the Fed responsibly reacting to an important signal from markets.

And in this case it could also help rehabilitate Mr. Powell’s reputation with markets, which have become understandably skeptical about him. To put it charitably, he has given mixed signals during his tenure—such as his flip-flop from December’s declaration that the Fed’s balance sheet is “on automatic pilot” to today’s new regime of completely restructuring it.

So markets would have three good reasons to applaud a rate cut. First, there’s no risk of inflation, so why should Fed policy be any tighter than it has to be? Second, as Mr. Powell explained to Mr. Toomey, the market is signaling strongly that the Fed is too tight now. And third, a cut would show that Mr. Powell can lay out an original and compelling market-based policy vision, and then execute on it faithfully.

Let’s not get distracted by the president’s tweets urging a rate cut. By Mr. Powell’s own statements, it’s the right thing to do now. So do it.

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