



## Negative real interest rates

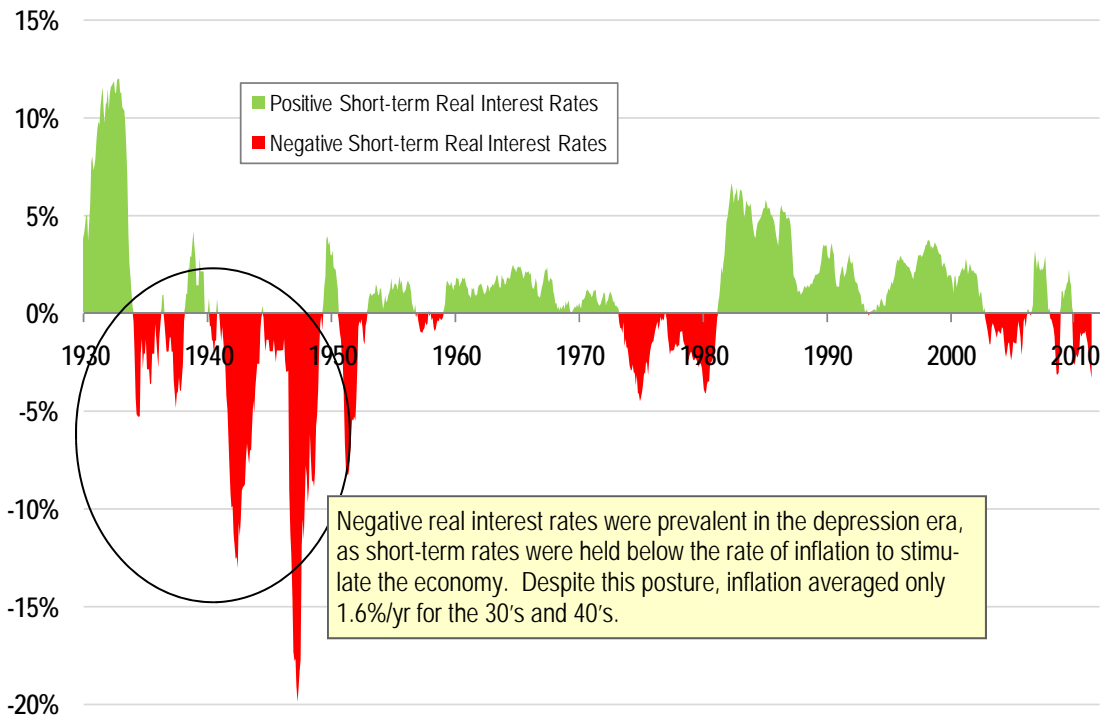
Several market commentators (Bill Gross the most prominent), have criticized the Federal reserve for holding the Fed funds rate (0.25%) below that of the inflation rate (headline inflation over the last year is 3.6%), making short-term *real* interest rates negative. Putting aside the fact that the high 3.6% rate is a short-term phenomenon due to a commodity price spike, the commentators' thinking is that savers are unfairly losing money with inflation more than eating the return from short-term t-bills (note: t-bills have a similar rate as the Fed determined Fed Funds rate) and that these negative rates are overly stimulative and will create serious inflation in the future. The implication is that negative real interest rates are unprecedented and unstable.

Both are false. Over the last 80 years, real interest rates have been negative 39% of the time, hardly a rarity (see chart below). This is not by accident, or a mistake. The useful Taylor rule formula to approximate Fed policy conceptually states that the Fed funds rate *should be* below inflation when the unemployment gap (unemployment rate, now 9.2%, minus the natural employment rate, approx 5%) exceeds half the inflation rate plus one (using the default Bloomberg Taylor configuration). It sounds complicated but the simple take-away is that the Fed funds rate should be lower than inflation when unemployment is very high to help compensate for the economic weakness that joblessness represents. This is the situation now as it was in the Great Depression era.

We contend that the severity of this credit bubble/de-leveraging/balance sheet recession will justify the Fed holding short-term rates at 0.25% for several years. Positive real short-term interest rates should not be expected unless the U.S. enters outright deflation.

### Short-term real interest rates

Average 1month t-bill yield (prior year) minus headline CPI (YoY%, prior year)  
1930 to present



Data Sources: Bloomberg and Global Financial Data