

BOHANON & CUROTT: Action by Fed can have unintended consequences

March 20, 2020 | Cecil Bohanon / Special to IBJ and Nick Curott / Special to IBJ

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ECONOMIC ANALYSIS

On Sunday, March 15, the Federal Reserve lowered its interest rate effectively to zero. It also announced plans to expand its purchase of government bonds, further increasing their prices and depressing their yields. The next morning, the Dow Jones industrial average fell around 9% at the market opening.

In a similar vein, on Tuesday, March 3, the Fed cut rates. The market rallied for about 15 minutes only to end the day down 3%. But wait, shouldn't a rate cut increase the price of shares of common stock?

The price of a company's common stock reflects investor expectations about the company's future earnings and dividends, appropriately discounted. Rate cuts, especially accompanied by a Fed bond buying binge, lower returns on government bonds, an alternative investment to common stocks. This makes the future dividend payouts of common stocks more attractive, leading to an increase in their price.

Of course, this assumes future company earnings and dividends are unaffected by the events that led to the Fed action. And there's the rub!

Our take is that markets responded negatively to both Fed actions in March because the cuts themselves confirmed investors' worst fears about the coronavirus's impact on future profitability of American companies. Investors are thinking: Since the Fed has lowered rates to historic lows, the Fed must know something we don't. And it's bad news. So sell, now!

To echo our column from last week, it is the job of the Fed to provide liquidity to the banking system in times of crisis to forestall bank runs and shutdowns. Low rates also encourage banks to be generous in extending credit to thousands of shops, restaurants and small businesses that suffer from declining cash flow because of the virus. It is our hope that these monetary actions, supplemented with reasonable fiscal measures that target relief to households whose earnings are disrupted by the coronavirus, will avert a deeper economic crisis.

But beware: We are literally *in terra incognita*—uncharted territory. The most recent event similar to today was the Spanish flu pandemic in 1918. There are no living memories of that episode, and the economy was very different then than now. A wise older gentleman in Muncie, now passed on, once told us, “Be very, very suspicious of someone who is too confident in their own predictions.” And so, we admit we really aren’t sure what is next—and suspect you aren’t, either.

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