Q&A-Inflation surge began well before Russia-Ukraine war; Fed's delay to act now risks inducing "hard landing": Campbell Harvey, Duke University

The U.S. Federal Reserve has been slow to act on inflation concerns, which began well before the Russia-Ukraine conflict began, and now risks inducing a hard landing, **Campbell Harvey, professor of finance at Duke University,** told the Reuters Global Markets Forum on Thursday, April 28.

"Everything points to slower growth, but it is not code red for recession yet," he said.

Additionally, the rising cost of debt servicing would impact Treasury issuances, said Harvey, who has been advocating the Treasury should have been lengthening maturity even more than they did.

Harvey also called decentralized finance (DeFi), which he considers a challenge to the current financial system, a niche currently, and suggested that it be judged by its future potential.

"There are savings and lending projects, tokenization, and also note, there is no Web3 without DeFi," he said.

Following are edited excerpts from the conversation:

Q: How have conditions in bond markets changed since you did your initial research into yield curve inversions?

A: Since my dissertation in 1986, much has changed. The main thing is the size of the market. The size driven by government deficits. It is just much harder for the Federal Reserve to impact long end of the yield curve. Obviously, we didn't have quantitative easing (QE) at the time of my dissertation either.

However, the yield curve signal has been robust, successfully predicting four of the last four recessions - post dissertation - with zero false signals. The size of debt to gross domestic product (GDP) is a big deal. In the 1980s, debt/GDP was about 34%. The Fed could hike and not worry about interest service costs. Now, they need to think about it. Hence, Fed is less independent of Treasury.

Q: How much do you think that's factoring into their current decisions? Or is it a bigger problem down the line?

A: The Fed has been asleep at the wheel. Up until November, inflation was deemed temporary. Now they have to act but they have been slow. They now risk inducing a hard landing. The extent of the distortion in short rates is striking. The Fed moves by 25 basis points or 50 basis points when the real interest rate is -8%. 10 hikes are no big deal. If they had moved earlier, it would have increased the chance of a soft landing. Again, there is a tension. If rates go up, the service cost of federal debt goes up and more money likely printed. The Fed needs to take that into account.

Our situation cannot be blamed on Russia-Ukraine. The inflation surge began well before that conflict - though the conflict has made the situation worse.

Q: As the cost of debt servicing rises, would that potentially impact Treasury issuance?

A: That is correct. Indeed, I have been advocating that the Treasury should have been lengthening maturity even more than they did - even issue consols, or 100-year bonds (perpetual bonds). We have seen this issue in other countries. As debt is at a high level and interest goes up, more debt is issued to pay for the interest. It often does not turn out well.

Q: When do you anticipate rate hikes feeding through significantly to real rates?

A: Yes, the real rate is artificially distorted. Any hike in the nominal rate will increase the real rate -- assuming expected inflation is constant. The short-term real rates are negative. For longer-term, you need to take the term structure of inflation expectations into account -- that term structure of expected inflation is inverted.

Another interesting thing going on is central bank digital currency (CBDC). All of a sudden, we have competitors to fiat currency and the central banks are moving to shore up their local monopolies.

Q: How strong a threat would CBDCs be to fiat currencies, or even the dominance of the dollar?

A: CBDCs are a reaction to the crypto threat. Crypto allows people to transact with alternative -- non-fiat -- value. It could be a gold token, or a token linked to Apple stock or real estate. Essentially, you bypass the fiat. In twenty years, we will look back at fiat inflation as a historical curiosity.

Q: How do you see DeFi expanding from here, and how does it get to a point to compete with traditional finance (TradFi)?

A: I think it is low probability that the United States will adopt a CBDC anytime soon. People don't want the government to see every transaction nor have the ability to 'edit' your balance. DeFi is a challenge to the current financial system.

Q: Are there any particular DeFi projects out there you see as being most promising in terms of broader scale adoption?

A: We are less than 1% into DeFi. It offers to solve a lot of problems. However, it is clunky and niche right now. Don't judge it by the state of DeFi today -- think about what it can do in the future. As for specific projects please look at my book, DeFi and the Future of Finance or my Coursera specialization. Hard to go into a lot of detail here. There are savings and lending projects, tokenization, and also note, there is no Web3 without DeFi. So, the entire growth in Web3 depends on DeFi. There are a large number of opportunities.

Q: Given the amount of QE since the pandemic, does the brief yield curve inversion mean a recession this year or next?

A: A one-day inversion doesn't count as inversion. My theory links to GDP growth, which is measured quarterly. Media focus is on the difference in treasury-bond yields 10-year/2-year. My original model anchors with the 3-month Treasury bill. Theory suggests a short-term anchor. Why abandon 10-year/3-month for 10-year/2-year, when the original model is eight out of eight in predicting recessions with no false signals? Replace when the model is broken, but we have no evidence that it is. That said, I am not dogmatic. My model is a simple model, and I would welcome my model being replaced with a better model if one emerges, but I don't think that's the case yet.

Given the Fed's course, we can reasonably expect a significant flattening as the 3-month Treasury bill will be much more sensitive to Fed hikes than longer-term rates. My research links the slope to real economic growth. Flattenings are bad and inversions are really bad. The Fed's tightening will likely slow down economic activity, which is consistent with the anticipated flattening. There is an extraordinary degree of distortion in interest rates. It makes little sense that the short-term real interest rate is close to minus 8%. Without the distortion, in my opinion, we would have a serious inversion. Everything points to slower growth, but it is not code red for recession yet.

Q: Do you think the pandemic-related reaction has distorted the financial system in a way that central banks will find hard to withdraw easy money for a long time, despite the potential tightening that is expected?

A: Yes, it will be much more difficult to take decisive action. This is not the early 1980s. We had the chance to pay down debt after the financial crisis - yet the government continued to rack up $1 trillion deficits every year. There is less flexibility as a result.