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The Fed's New Neutral rate

Dr Robert Gay | Fenwick Advisers | 21 March 2016

No one expected the Federal Open Market Committee (FOMC) to change its policy rate from 0.25% to 0.50% this month - yet, this month's meeting still provided plenty of unusual twists that warrant serious thought.

First let's set the stage. By standard metrics, the Federal Reserve already has met, or at least is very close to meeting, its policy objectives of target inflation and full employment. Core inflation as measured by the CPI has exceeded 2% for several months now and unemployment[1] has dropped to 4.9%, which is slightly less than the Fed's staff estimate for full employment of 5% to 5.25%. Indeed, in the press conference following the rate decision, Chair Yellen confirmed that Board members expected unemployment to decline further in the years ahead.

One usually would expect the central bank to assume a 'neutral' policy stance - that is, one that is neither expansionary nor contractionary - when the economy is operating at full employment. Yet, the Fed clearly still is trying to run a highly stimulative policy of negative real interest rates and reinvestment of both interest and principal repayments on its oversized portfolio. In short, the Fed is allowing the economy to run 'hot'. Nonetheless, FOMC members lowered their projections for the trajectory of the fed funds rate by about one-half percentage point over the forecast horizon, which in effect reduced the number of likely incremental rate hikes in 2016 to two instead of four from the previous meeting.

What are they thinking?

One possibility, expressed by Chair Yellen in her press conference after the meeting, is that the recent uptick might be transitory and Board members wanted to wait for convincing evidence that it would continue. That view begs the question of why price pressures would abate if the economy already is at full employment? Inflation typically lags full employment, often by as much as a year or more, but it does not often recede at this stage of the cycle.

Another possibility is that the world economy faces a lot of headwinds that warrant a slow and cautious normalisation of policy. Most commentators have latched onto this rationale. Some think market volatility *per se* has made FOMC members more timid in a throwback to the days of the Greenspan 'put'. I doubt that Ms Yellen thinks in those terms. Rather, 'external considerations' are a legitimate priority for the Fed, albeit a distant fourth priority behind i) safety and soundness of the financial system; ii) price stability; and, iii) full employment, in that order. Since the first three priorities now are satisfied in large part, the Fed is in the extraordinary position of having time to temper its domestic agenda for the greater good of the global economy. A variant on this theme is that risk premiums have

widened somewhat since the first rate hike and hence market pricing has tightened monetary conditions, thereby obviating the need to move more quickly.

These themes have a common thread – namely, an increasingly interrelated global economy no longer allows the Fed to act in isolation. What happens abroad affects the US economy, and financial markets, to a greater extent than ever before and the global outlook is not favorable. In simple terms, the world is awash with excess capacity in industries ranging from commodities and energy to manufacturing and real estate development. That excess capacity combined with a surfeit of debt weighs down prices and growth prospects everywhere, even the semi-autonomous US economy. Global growth slipped to 2.5% in the fourth quarter of 2015 and prospects for 2016 do not look much better. Old norms from the 20th century when an explosion in world population created unprecedented demand simply are irrelevant now that all industrialised nations are faced with aging workforces and burgeoning retirees. The new norm for global growth is well below 3%, a number that used to be associated with technical recessions in the emerging world.

In this context, the March FOMC meeting marks a major milestone – for the first time in my memory, the Fed's fourth priority of 'external conditions' has become sufficiently important to override 'domestic considerations'. In particular, two aspects of the Fed's outlook, both of which are repercussions of the global setting, deserve special notice. First, the staff's estimate of potential output growth has crept lower over the past year and now amounts to only 2% annually. Even that may be optimistic. Recall that just a few years ago, many pundits still thought the US economy still could grow 3% or more without any problem. The great danger in times like now is that central banks do not recognise a major downshift in potential and mistakenly try to reach targets that they cannot achieve. At least the Fed is ahead of the curve in proactively acknowledging this new norm.

To my surprise, the media has not taken any notice of Yellen's other initiative – namely, a discussion of the so-called neutral federal funds rate in her prepared remarks for the post-FOMC press conference:

> "… the Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate. The federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. This expectation is consistent with the view that the neutral nominal federal funds rate – defined as the value of the federal funds rate that would be neither expansionary nor contractionary if the economy was operating near potential – is currently low by historical standards and is likely to rise only gradually over time. The low level of the neutral federal funds rate may be partially attributable to a range of persistent economic headwinds that weigh on aggregate demand, including developments abroad, a subdued pace of household formation and meager productivity growth. There

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> is considerable uncertainty regarding the evolution of the neutral funds rate over time. However, if these headwinds abate, as we expect, the neutral federal funds rate should gradually move higher as well."

She might have added that new financial regulations have tightened financial conditions in such a way as to lower the neutral fed funds rate. FOMC members are far from consensual on this key issue, as can be seen by their extremely disparate forecasts for the long-run funds rate. Chair Yellen does seem to be winning this conceptual battle, which has enormous implications for long-term interest rates. A lower neutral rate translates into lower yields for a longer time. To reinforce that linkage, Chair Yellen also changed the language on asset purchases to say the Fed would continue to maintain the current bloated balance sheet until after fed funds reach its neutral rate. In my view, that could be a long wait.

ENDNOTES

1. Core PCE prices - the Fed's preferred measure of price pressures - rose 0.3% in January to a level 1.7% above a year earlier. That increase is in line with the Fed's target of 1.75% for this index.

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