ARE HIGHER INTEREST RATES HERE TO STAY?

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HIGHER INTEREST IN THE NEWS...

ECONOMY | CENTRAL BANKING | THE OUTLOOK

Why the Era of Historically Low Interest Rates Could Be Over

Higher productivity and increased deficits could raise the ‘neutral’ rate of interest, limiting Fed cuts

By Nick Timiraos Following
Aug. 20, 2023 5:30 am ET

ECONOMY | CENTRAL BANKING

Higher Interest Rates Not Just for Longer, but Maybe Forever

Rate projections suggest many Fed officials see a rising ‘neutral rate’

By Greg Ip Follow
Updated Sept. 21, 2023 12:02 am ET
Greg Ip (WSJ):

“... In their projections and commentary, some officials hint that rates might be higher not just for longer, but forever... the so-called neutral rate, which keeps inflation and unemployment stable over time, has risen.

This matters to any investor, business or household whose plans depend on interest rates over a decade or longer.”
SEP LONGER RUN LEVEL OF THE FFR: 2023 VS 2019

Note: Dots refer to FOMC participants' projections for the FFR. Source: Federal Reserve Board of Governors.
OUTLINE

- Longer-run neutral rate of interest: what it is and why it matters

- Is it higher after the pandemic? No, most likely
THE NEUTRAL INTEREST RATE: WHAT IS IT?

- Longer-run neutral interest rate = level of the FFR so that monetary policy stance is neither expansionary nor contractionary
  - Economy is in balance with inflation at target and full employment

- Median FOMC participants expect the neutral rate for the FFR to be 2.5%
  - 2.0% inflation rate (FOMC inflation target)
  - 0.5% real interest rate
THE NEUTRAL INTEREST RATE: WHY DOES IT MATTER?

IT AFFECTS THE EFFECTIVE STANCE OF FOMC POLICY TO BRING DOWN INFLATION

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● Neutral rate of interest: what it is and why it matters

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NEUTRAL REAL RATE HAS BEEN FALLING FOR DECADES

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NEUTRAL REAL RATE

PERCENT

Several approaches to estimate the neutral interest rate, but consensus that it has been falling since the 1960s

Factors
- Productivity growth
- Demographic transition
- Demand and supply of government debt (safe asset)

Key question: Evolution of these factors going forward
PRODUCTIVITY GROWTH REMAINS WEAK

UTILIZATION ADJUSTED TOTAL FACTOR PRODUCTIVITY

AVERAGE ANNUAL GROWTH, PERCENT

Source: Federal Reserve Bank of San Francisco, Haver Analytics
DEMOGRAPHIC TRANSITION REDUCED NEUTRAL RATE...

LOWER POPULATION GROWTH RATE

PERCENT

HIGHER LIFE EXPECTANCY

YEARS

Source: United Nations World Population Prospects
• Lower population growth reduces the growth rate of the economy, and thus the neutral rate (similarly to lower productivity growth)

• Higher life expectancy increases savings (higher dependency ratios) and reduces the neutral rate
  • Need to finance longer lifespan
  • Older cohort tend to save more (health risks, bequest)

• Demographic transition is a global phenomenon
...and will likely put further downward pressure on...

**Lower Population Growth Rate**
- Percent

**Higher Life Expectancy**
- Years

Source: United Nations World Population Prospects

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**FEDERAL RESERVE BANK OF MINNEAPOLIS**
...GLOBALLY

LOWER POPULATION GROWTH RATE
PERCENT

HIGHER LIFE EXPECTANCY
YEARS

Source: United Nations World Population Prospects
STRONG DEMAND FOR U.S. DEBT REDUCED NEUTRAL RATE

• U.S. public debt is the preferred (global) safe asset
  • Fiscal capacity, financial development, Fed credibility

• Steady increases in (global) demand for U.S. public debt reduced neutral rate
  • Accumulation of reserves by Emerging Market Economies (“Global saving glut”)
  • Changes in financial regulations after the 2008 crisis

• Pandemic increase in U.S. debt may elicit higher interest rates, but effect likely to be small
PANDEMIC INCREASE IN US PUBLIC DEBT IS SMALL

ARE HIGHER INTEREST RATES HERE TO STAY?

**NO, MOST LIKELY**

- Longer-run neutral FFR = 2.5% remains a reasonable assumption

- Argument: Factors that contributed to decline in the neutral interest rate since the 1960s (productivity slowdown, demographic transition) are here to stay

- Uncertainty
  - Will AI result in a new productivity boom?
  - Will fiscal sustainability concerns undermine safe asset status of U.S. debt?
QUESTIONS?