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

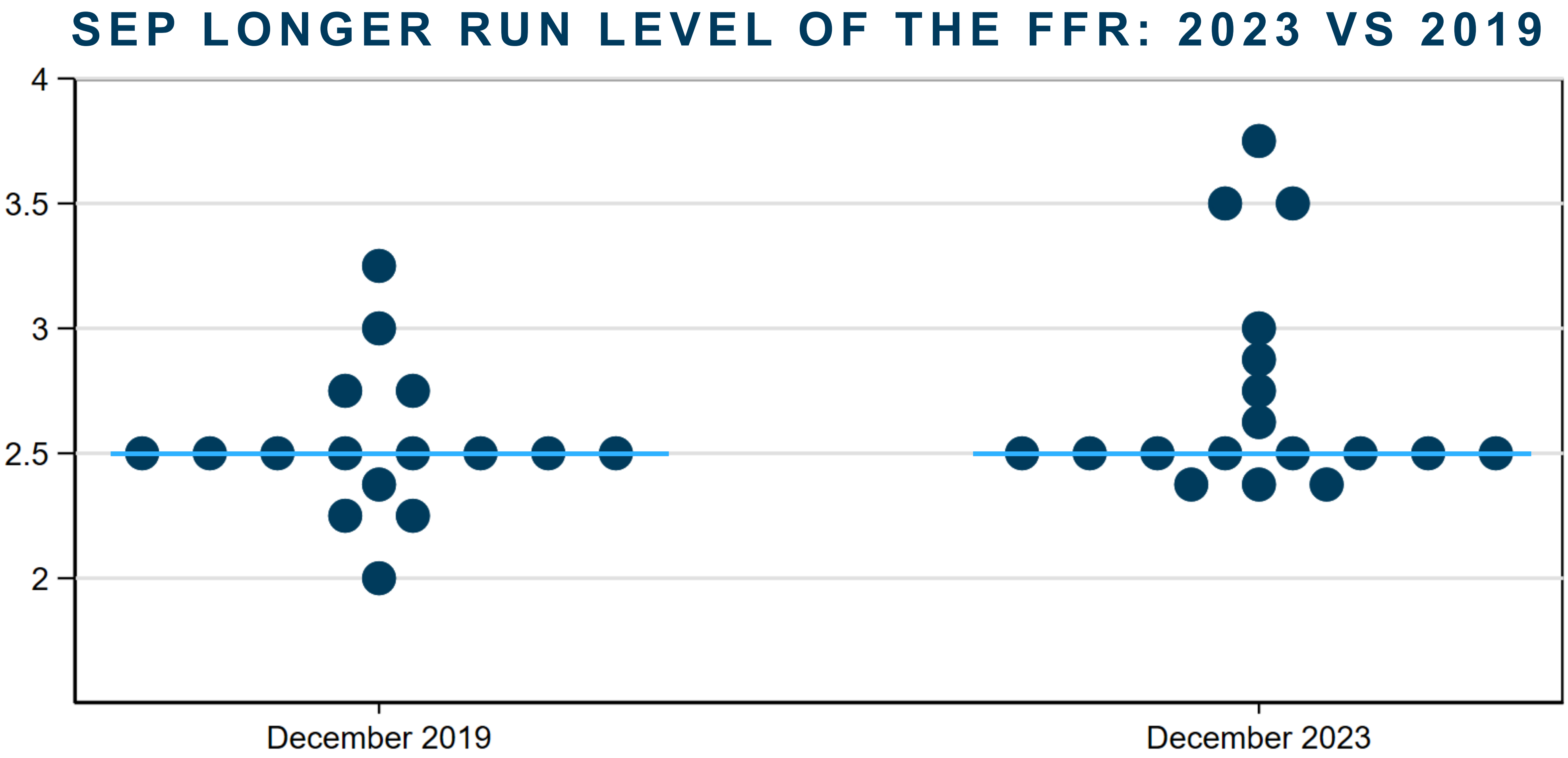
FOMC COMMUNICATION SIGNALED HIGHER INTEREST RATES

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."

FOMC: HIGHER NEUTRAL RATE OF INTEREST?



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

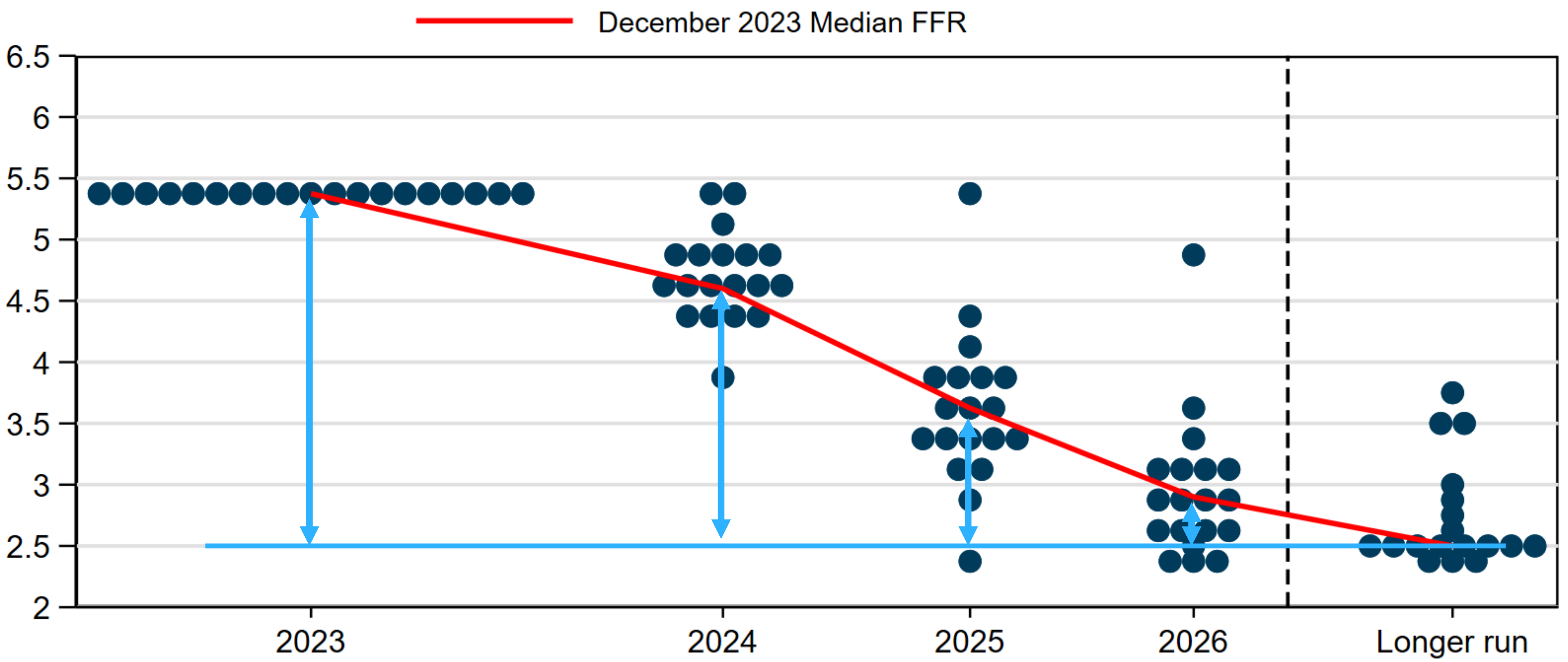
THE NEUTRAL INTEREST RATE: WHAT IS IT?

- 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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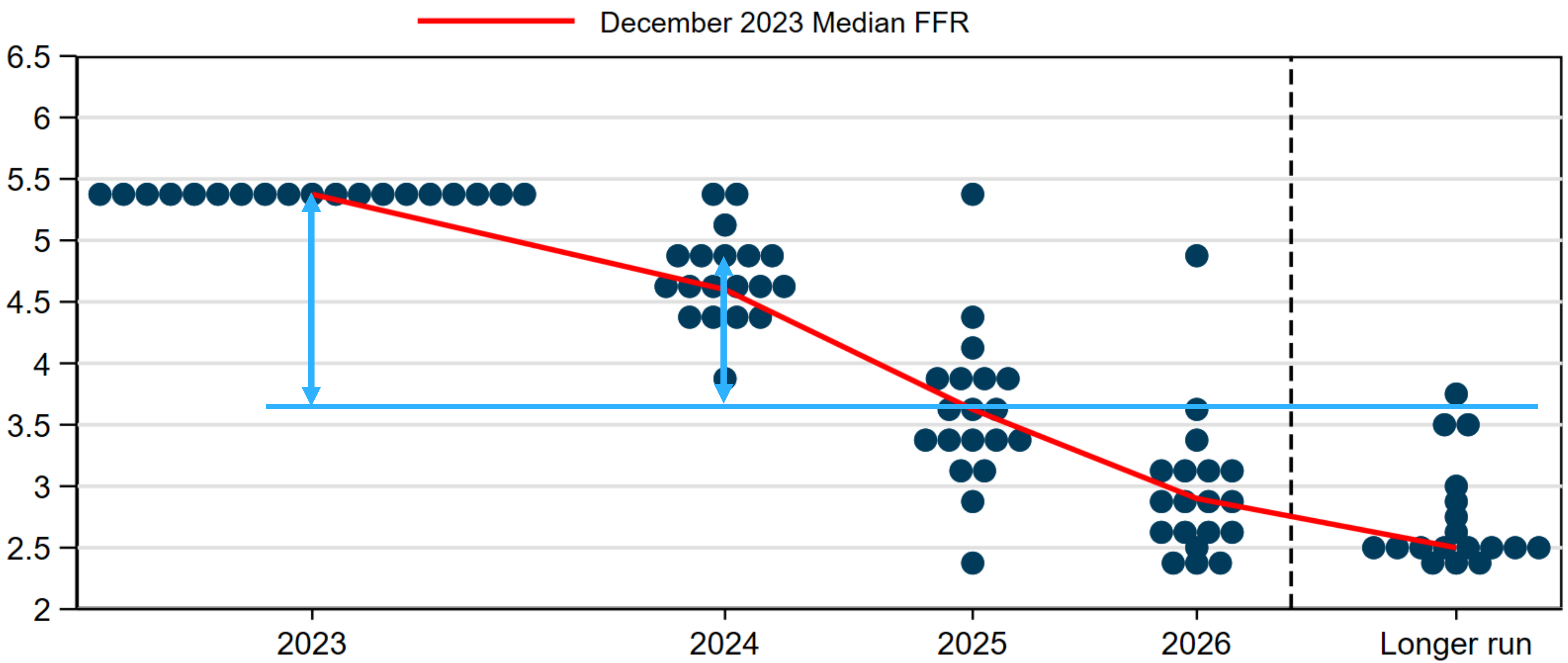

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OUTLINE

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

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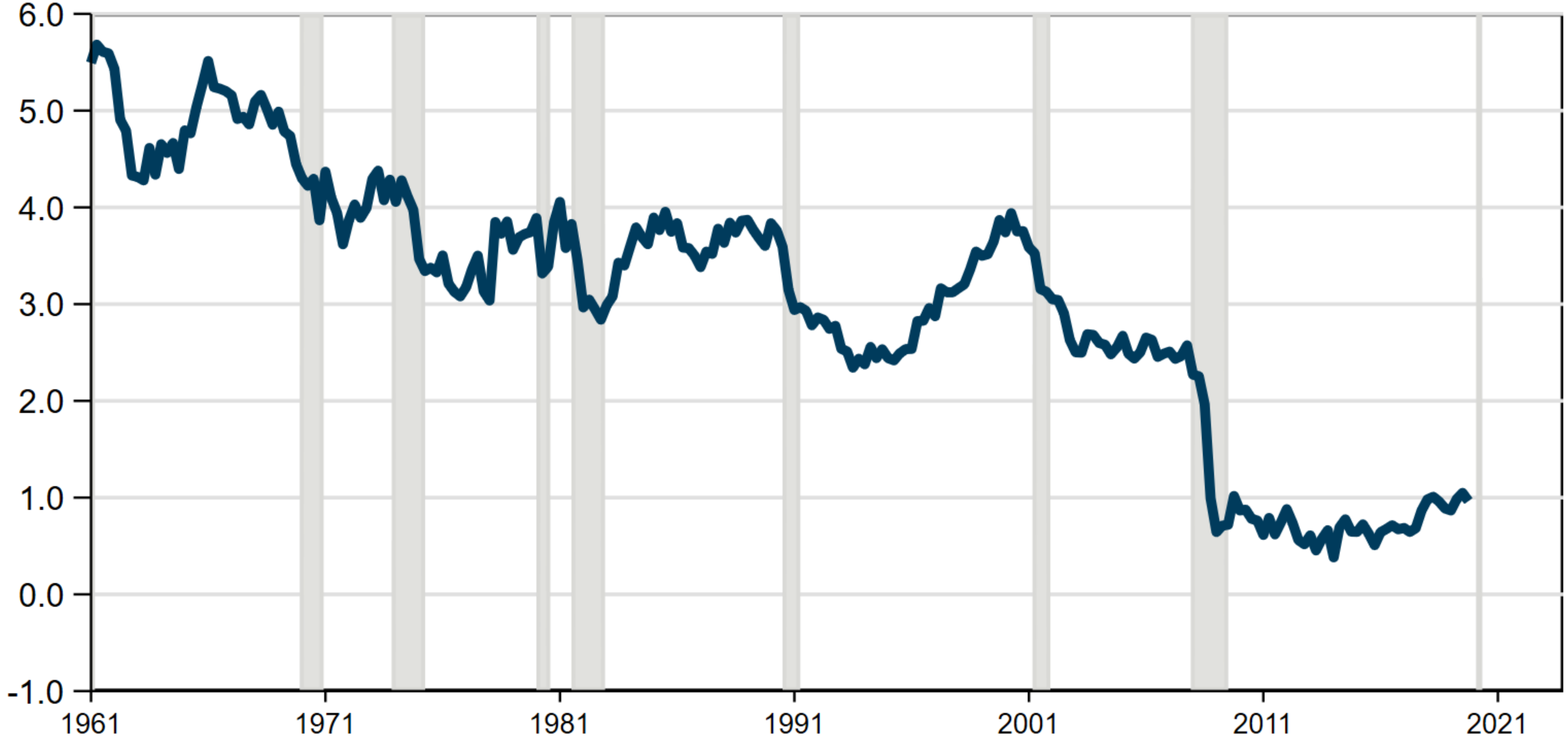
NEUTRAL REAL RATE HAS BEEN FALLING FOR DECADES

NEUTRAL REAL RATE

PERCENT



Source: Holston-Laubach-Williams (2017) updated by the Federal Reserve Bank of New York.

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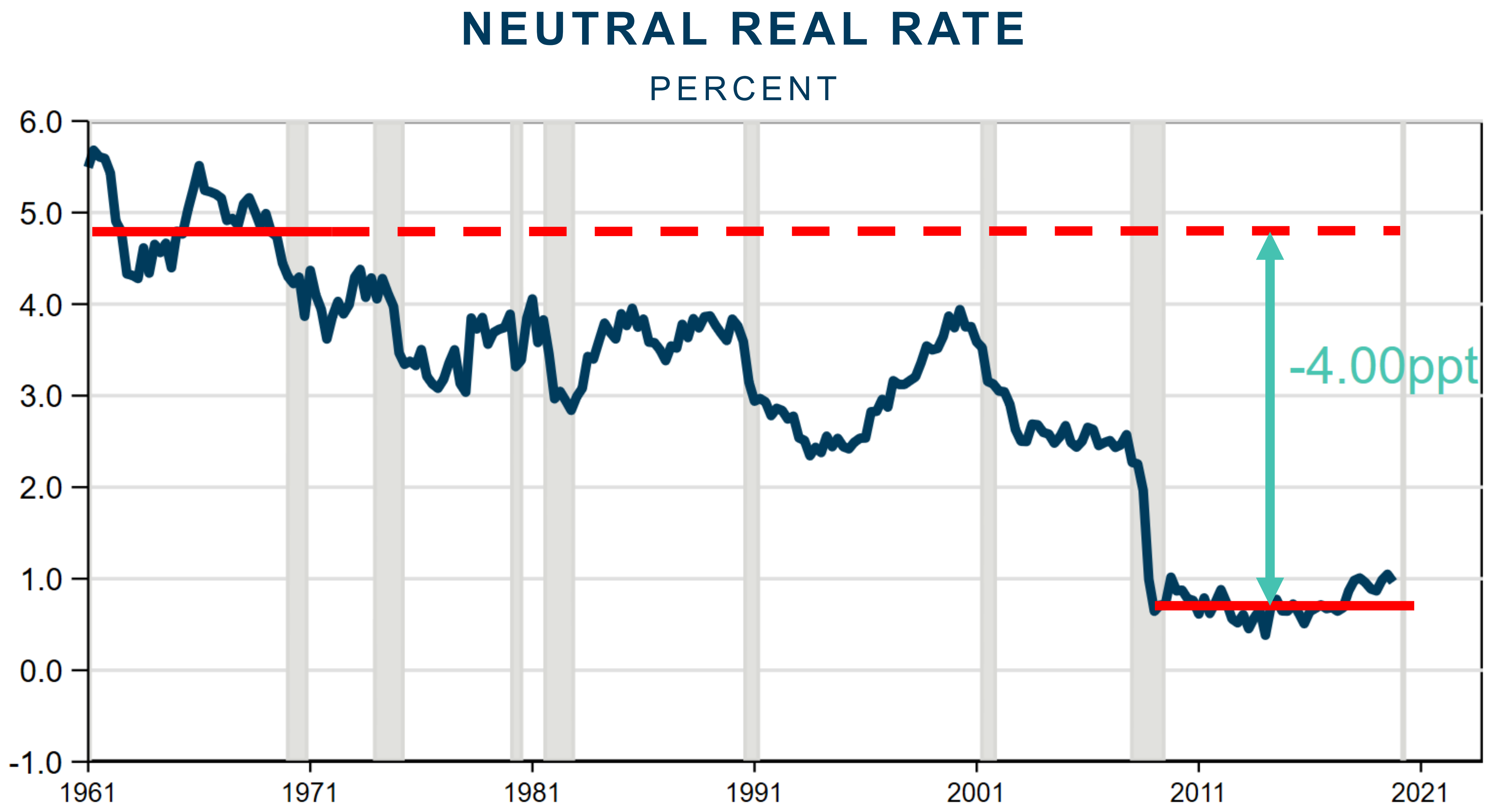


Source: Holston-Laubach-Williams (2017) updated by the Federal Reserve Bank of New York.

THE NEUTRAL INTEREST RATE: PAST, PRESENT, AND FUTURE

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

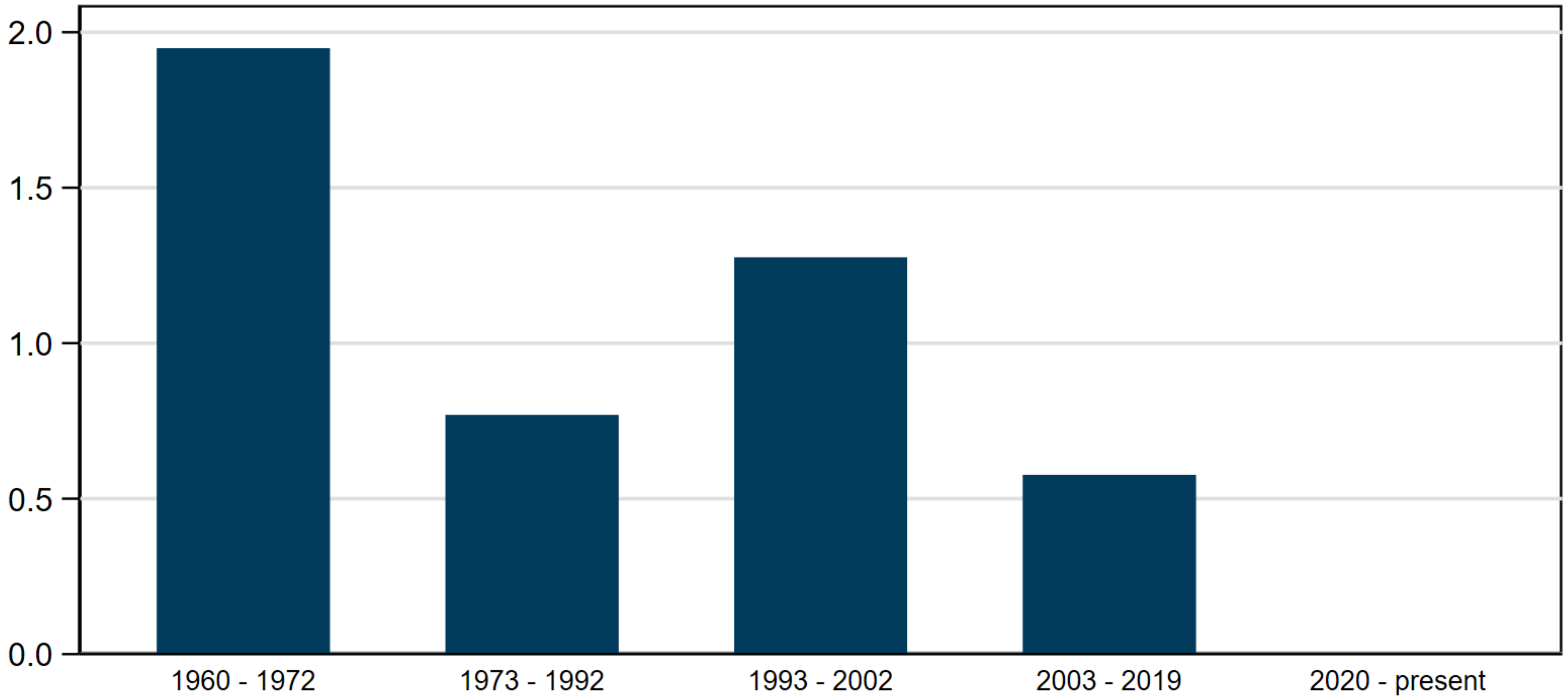
- Factors
    - Productivity growth
    - Demographic transition
    - Demand and supply of government debt (safe asset)

- Key question: Evolution of these factors going forward

PRODUCTIVITY SLOWDOWN REDUCED NEUTRAL RATE

UTILIZATION ADJUSTED TOTAL FACTOR PRODUCTIVITY

AVERAGE ANNUAL GROWTH, PERCENT

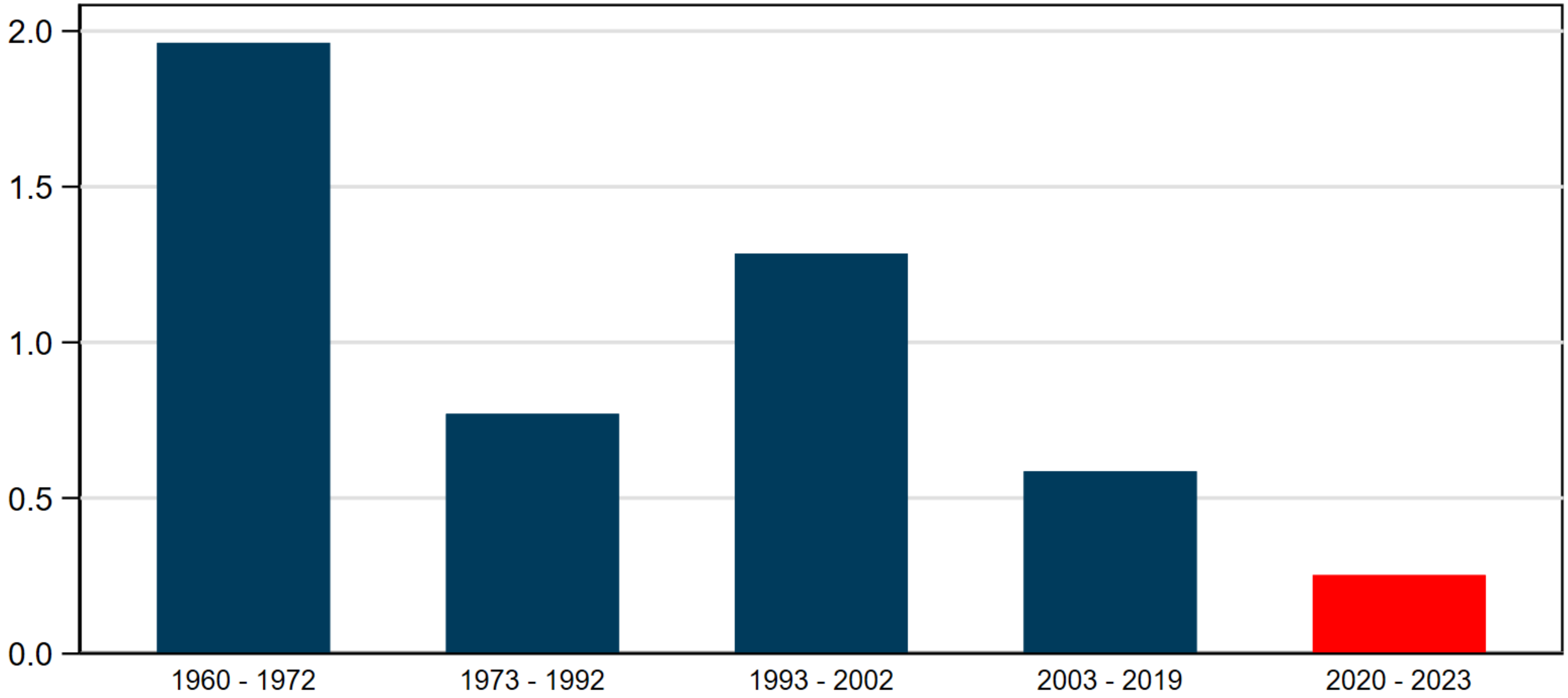


Source: Federal Reserve Bank of San Francisco, Haver Analytics

PRODUCTIVITY GROWTH REMAINS WEAK

UTILIZATION ADJUSTED TOTAL FACTOR PRODUCTIVITY

AVERAGE ANNUAL GROWTH, PERCENT



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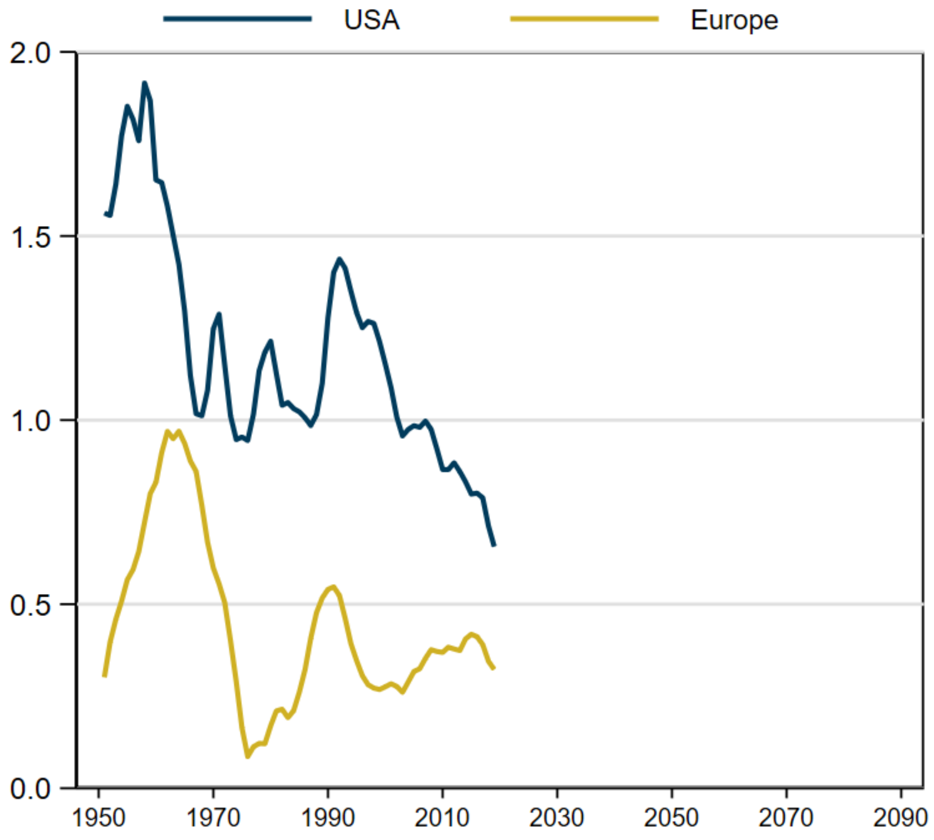
DEMOGRAPHIC TRANSITION REDUCED NEUTRAL RATE…

LOWER POPULATION GROWTH RATE

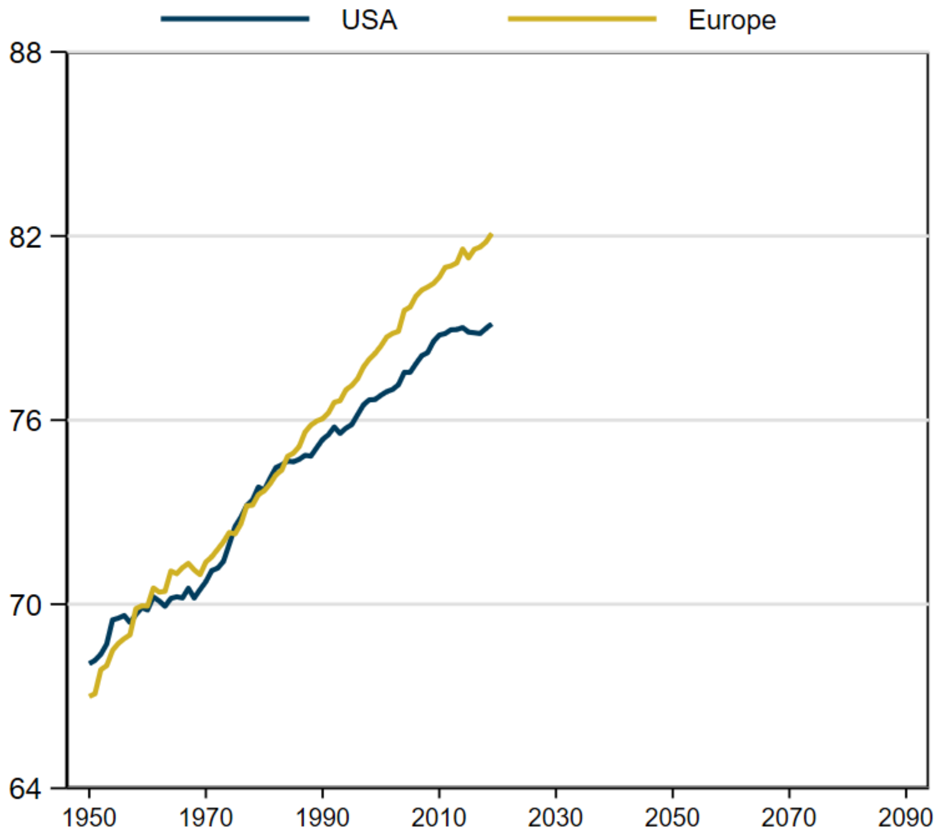
PERCENT



Source: United Nations World Population Prospects

HIGHER LIFE EXPECTANCY

YEARS



DEMOGRAPHIC TRANSITION REDUCED NEUTRAL RATE…

- Lower population growth reduces the growth rate of the economy, and thus the neutral rate (similarly to lower productivity growth)

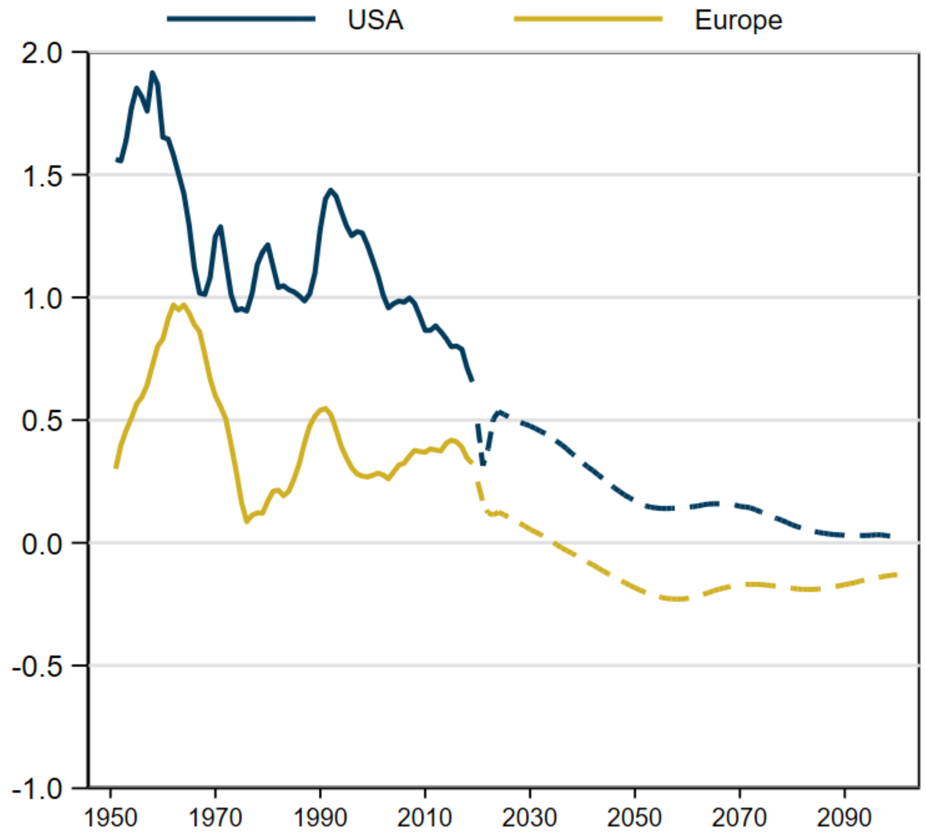
- Higher life expectancy increases savings (higher dependency ratios) and reduces the neutral rate
    - Need to finance longer lifespan
    - Older cohort tend to save more (health risks, bequest)

- Demographic transition is a global phenomenon

…AND WILL LIKELY PUT FURTHER DOWNWARD PRESSURE…

LOWER POPULATION GROWTH RATE

PERCENT



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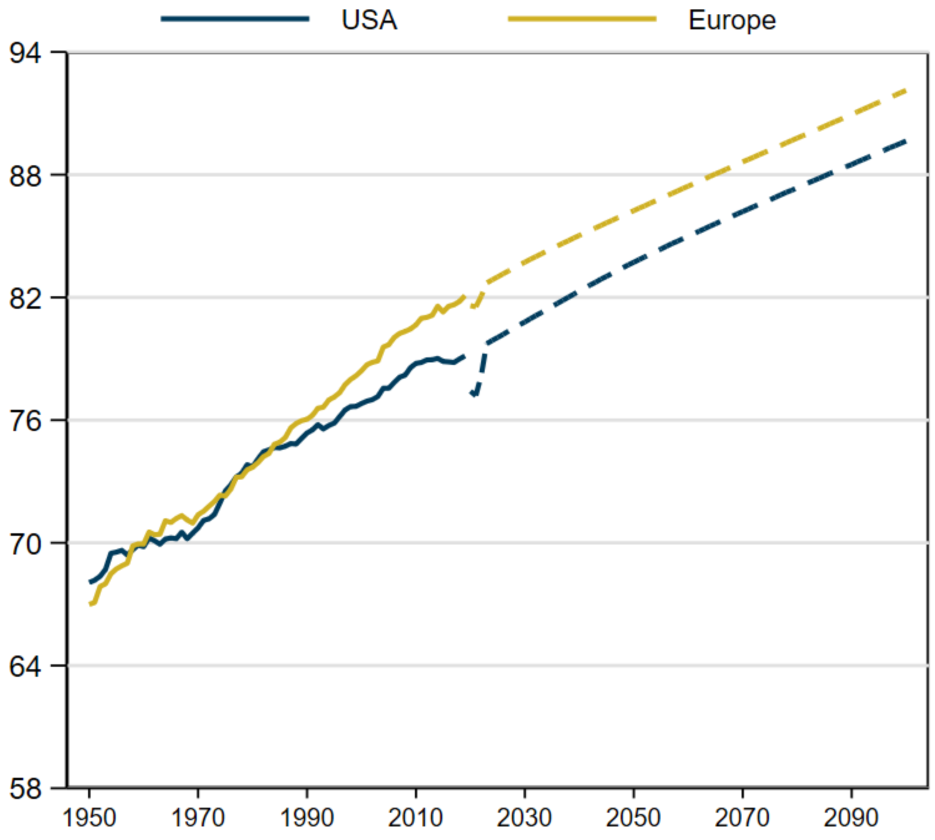

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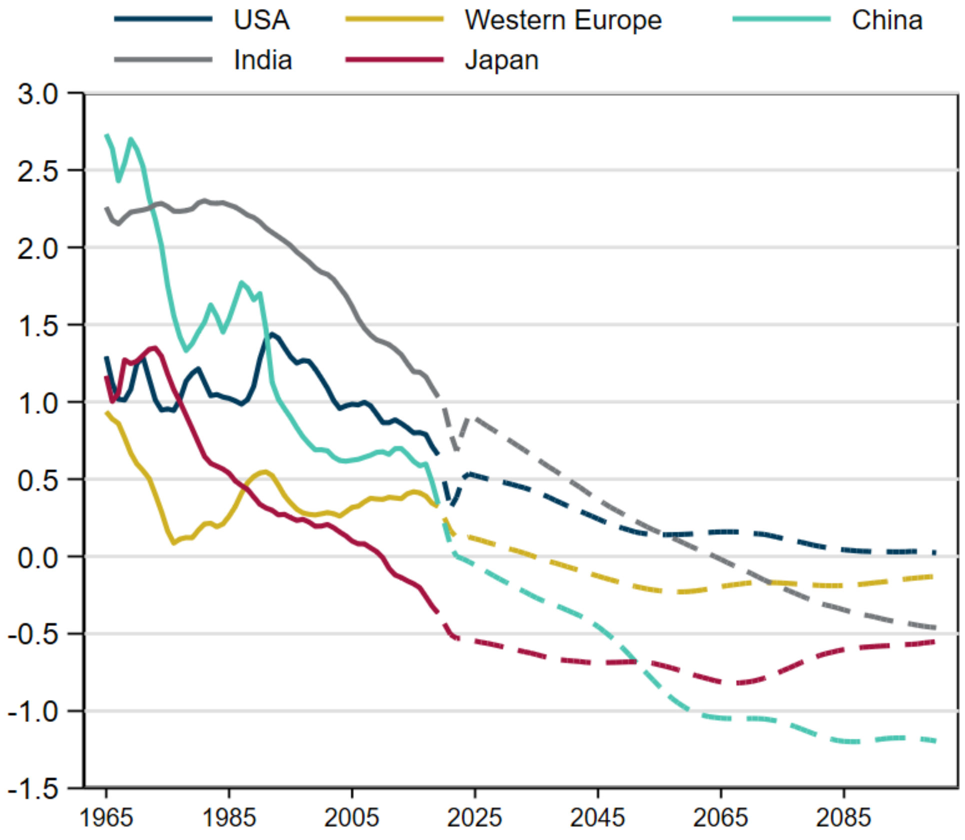
...GLOBALLY

LOWER POPULATION GROWTH RATE

PERCENT



HIGHER LIFE EXPECTANCY

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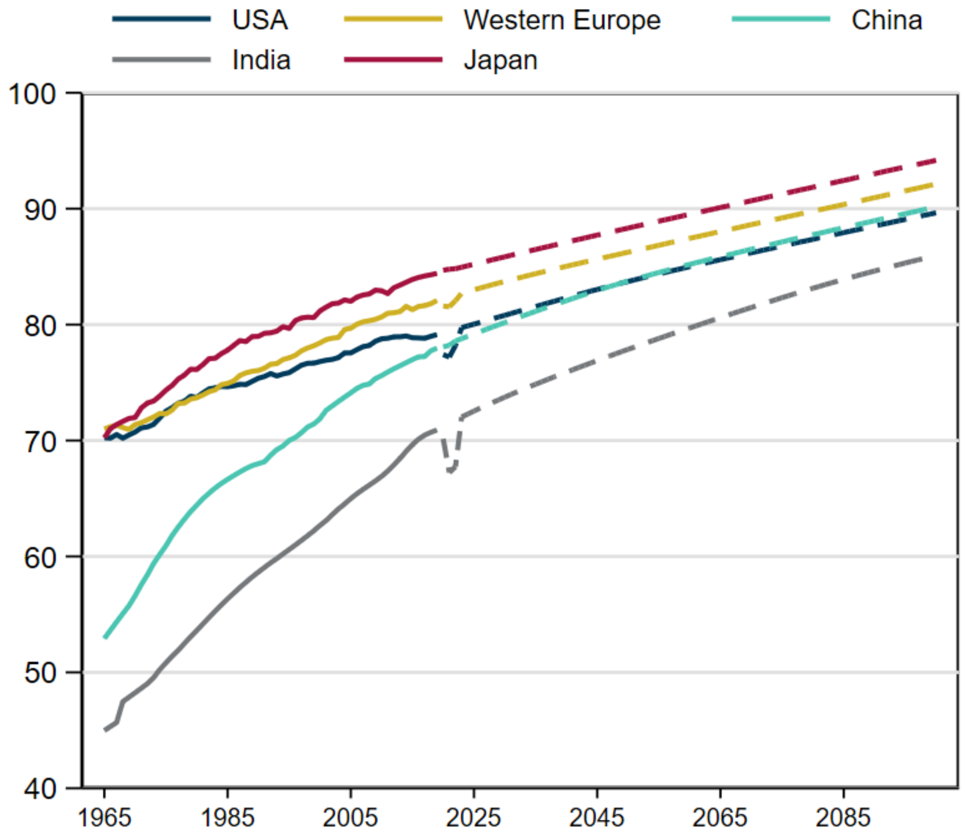

Source: United Nations World Population Prospects

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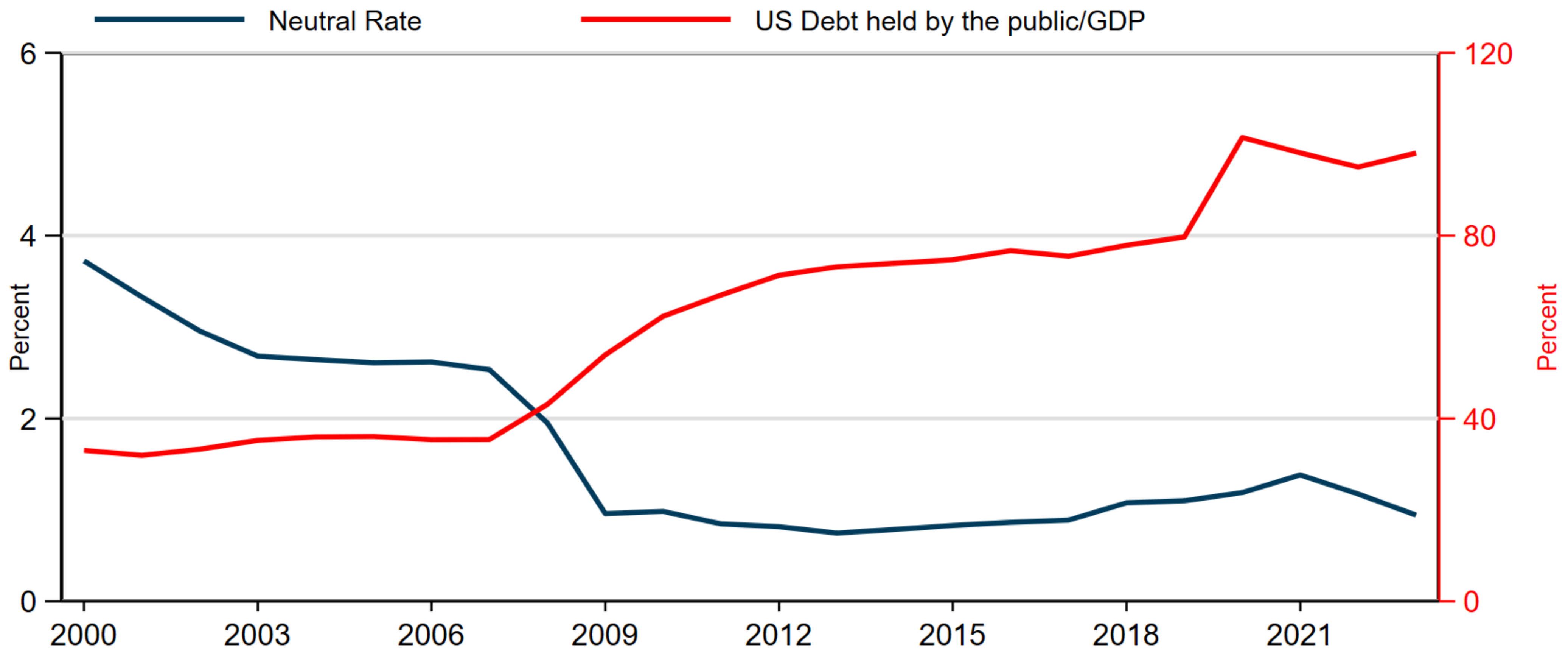
STRONG DEMAND FOR U.S. DEBT REDUCED NEUTRAL RATE

- 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



Source: Office of Management & Budget, Holston-Laubach-Williams (2017) updated by the Federal Reserve Bank of New York, Haver Analytics.

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?
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