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What is R-star and Why is it Important?

R-star is the real, or inflation-adjusted, equilibrium rate of interest. In theory, this natural rate of interest is the rate that aligns economy-wide supply and demand. **When R-star is in equilibrium, the economy and inflation are in a steady state**. R-star, the equilibrium rate and the natural rate of interest are all interchangeable terms.

Unfortunately, **R-star is not directly observable**. Moreover, there is substantial divergence among economists' estimates of R-star even within the Federal Reserve system. For example, the NY Fed estimates R-star somewhere in the range of 0.9% to 1.2% while the Richmond Fed estimates a wide range between 1.4% to 3.1%.

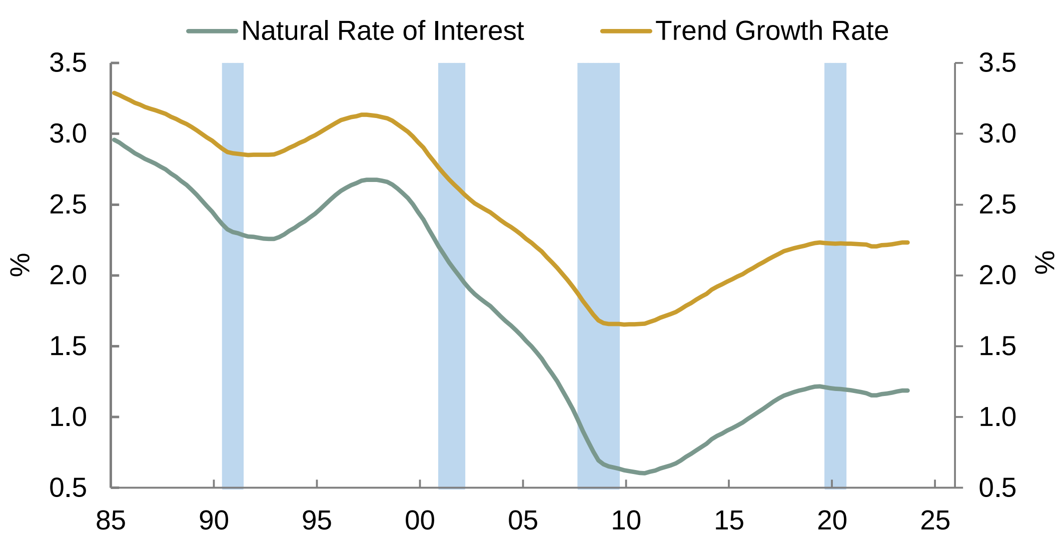
While monetary policymakers are unable to pin down a precise estimate of the natural rate or even a narrow range, **some Fed officials, such as Atlanta Fed President Bostic, have hinted at the possibility that R-star is rising**. This could partially explain why the economy has avoided recession so far. Monetary policy may not be as tight as previously assumed. But is R-star really rising? In our view, it is much too soon to know, but our best guess is no.

R-star is heavily influence by the economy's potential growth rate or how fast it can expand without leading to a cyclical lift in inflation. As we can see in the chart below, estimates of the natural rate and trend GDP growth move in lockstep. The slope of the lines on both series are also nearly identical. When potential growth is high and rising, R-star tends to rise and vice versa. Higher returns to capital that come with faster GDP necessarily warrant higher interest rates.

Potential GDP is a function of two factors: productivity and labor. Regarding the former, output per hour is up 2.7% over the last four quarters, but the series is extremely volatile and prone to substantial reversals both up and down. Over the last eight quarters however, productivity is up just 0.3%. Hence, the big 2023 gain could be temporary. The fact the income side of the economy has yet to confirm the productivity improvement is notable. We will know more when complete 2023 gross domestic income data are released on March 28th.

Regarding the labor force, it grew 1.2% last year, the same as in 2019. But last year's growth may not be sustainable. Last month, the labor force participation rate fell several tenths to a low 63.5% reading, and long-term US demographics remain poor. Hence, labor is unlikely to be an incremental, meaningful contributor to potential output going forward. If anything, it could be a drag. There is little to suggest potential GDP growth has increased.

If potential growth is still modest, then R-star is not increasing, and monetary policy is still restrictive. If so, **real GDP growth should slow over the course of 2024, and the Fed should be able to adjust interest rates accordingly**. We expect Chair Powell to state as much when testifying before the Senate Banking Committee on March 7th.



Source: NY Fed, Haver, SMBC Nikko

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