What do the Latest Fed Estimates of the Neutral Rate Show?

The neutral rate of interest is a theoretical concept that attempts to calculate the economy-wide balancing point. When the fed funds rate is above this point, the economy slows, and inflation decelerates. The opposite is the case when the fed funds rate is below this point. The economy speeds up and inflation accelerates.

Although interest rates may be slightly restrictive according to Fed Chair Powell, they may still need to rise further. The fact that some economic data such as the interest-sensitive housing sector could be reaccelerating is consistent with the Powell view.

The primary determinant of the neutral (or natural) rate of interest is long term potential growth — which is a mainly a function of productivity and to a lesser extent demographics. Hence, slower potential GDP growth should warrant a lower neutral rate. But there is another factor that influences the real equilibrium rate. That is debt. The fact that debt levels have grown so dramatically since before the financial crisis is another reason why the neutral may have fallen. The economy cannot handle higher rates because of excessive debt service costs.

The neutral rate is never really known. It is a theoretical guesstimate. But since it is important to the FOMC, investors pay close attention to what it is doing and whether monetary policy is tight enough to achieve the Fed’s objectives. The New York Fed had been publishing its estimate of the neutral rate but stopped publishing it in mid-2020. Fortunately, that has changed with the Bank restarting its periodic estimates last month. What do the NY Fed’s latest estimates show?

Prior to last month’s update, the last Fed estimate of the natural rate was around just 35 basis points (bps). But updated estimates show that figure was revised up to 125 bps. While the natural rate has fallen since then, the NY Fed’s current estimate is 115 bps. That is big change from where it had been before. Monetary policy may not be at tight as previously thought. Perhaps this is a reason why the Fed has remained so hawkish. Policy has been too loose.

However, given the uncertainty of what is the “true” natural rate, it is possible that the Fed’s estimates are much too high which means the Fed is embarking on a major policy error. After all, that is what the inverted treasury curve has been telling us for some time. But for now, the Fed is not paying attention. Barring a shockingly weak employment report, another rate hike is coming next month.
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