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What is America's neutral interest rate?

THE decision by America's Federal Reserve to raise the federal funds rate by a quarter of a percentage point, to 2.25%, on December 14th should have surprised no one. The Fed has nudged rates up in quarter-point steps at each of its last five meetings, and makes no secret of its intention to carry on doing so for a while yet. Its chairman, Alan Greenspan, said recently that anyone who has not prepared for higher interest rates is "obviously desirous of losing money." Once again the Fed said this week, in the statement accompanying the interest-rate increase, that it "believes that policy accommodation can be removed at a pace that is likely to be measured."



By any calculation, America's real (ie, inflation-adjusted) short-term interest rates are still extremely low. The Fed's favourite gauge of inflation, the rate of increase of the core personal consumption expenditure deflator, was 1.5% in the year to October, implying a real interest rate of only 0.75%. According to another measure, the University of Michigan's estimate of expected inflation over the next year, now 3%, the real fed funds rate is still negative.

Naturally Swedish

So how high might the fed funds rate go? It is commonly agreed both on Wall Street and in Washington that rates are heading back towards a "neutral" level. The notion of a neutral (or "natural") rate of interest was developed by Knut Wicksell, a Swedish economist writing about a century ago. Wicksell saw this rate as one that was consistent with stable prices and that balanced the supply of and demand for capital.

In its modern incarnation, the neutral rate is the real, short-term interest rate consistent with stable inflation and an economy that is growing just in line with its potential: it keeps the pot cooking, without either boiling over or losing heat. If the real interest rate is below neutral level, monetary policy is loose: if above, policy is contractionary. Several monetary-policy rules of thumb (notably the Taylor rule, named after John Taylor, an economist who is now an official in America's Treasury Department) rely heavily on the idea. The neutral rate is also implicit in the Fed's explanation of its strategy. When it speaks of removing "accommodation" it is, in effect, saying that real rates are below their neutral level.

So much for the theory. What, in practice, is the neutral rate? Unfortunately, the real rate that would keep the economy growing in line with potential and inflation stable cannot be measured directly. It has to be inferred from the actual, nominal rate, the current level of output, estimates of the trend rate of growth and measures of expected inflation. Some economists like to estimate the real federal funds rate over long periods of time and use that as a proxy for the neutral rate. Over the past 40 years, for instance, this has averaged around 3%. Because this period spans several recessions and booms, as well as rising and falling inflation, this average might be a fair guess at the rate of interest consistent with trend growth and stable prices. If the neutral rate is 3%, this implies that the Fed might raise rates by at least a further two, and maybe more than three, percentage points in all.

However, the number varies with the time period chosen. If it includes the 1950s, for example, when rates were low, the average is pulled down. Another problem with this approach is that it assumes the natural rate to be constant. Given the changes in America's economy over the years, that may be a stretch.

More sophisticated approaches estimate the neutral rate using statistical techniques that take into account not only nominal interest rates and inflation, but also variations in output. One method relates the neutral rate to trend growth, and adjusts it when GDP diverges from its trend. In this way, Thomas Laubach, a Fed economist on leave at the OECD, and John Williams, an economist at the Federal Reserve Bank of San Francisco, found that America's neutral real rate has fluctuated widely, ranging from just over 1% (in the early 1990s) to a little more than 5% (in the late 1960s). Analysis in the OECD's recent *Economic Outlook* puts the neutral real rate at just over 2% in the third quarter of 2004—implying that the fed funds rate is now at least a point or two below neutral.

A further snag, though, is that revisions to economic statistics, which are frequent and inevitable, can change estimates of the neutral rate substantially. According to the OECD, America's neutral real rate of interest in 2002, based on past data alone, was estimated at more than 3%. But if more recent numbers for inflation and output growth are fed in, the estimate drops to just over 2%. Two economists at the Federal Reserve Bank of Kansas City, Todd Clark and Sharon Kozicki, looked at these problems recently and concluded that it was "very difficult" to rely on model-based estimates in analysing current policies.

Some at the Fed share this concern. Roger Ferguson, the Fed's vice-chairman, argued recently that not only was the neutral rate hard to pinpoint, but that there were several

reasons why it might, temporarily, depart from its long-run equilibrium. For instance, it might have tumbled in the aftermath of the stockmarket bubble. Other factors, such as Americans' need to save more or the withdrawal of fiscal stimulus, might continue to pull down the neutral rate today. Mr Greenspan, asked by a senator in July where America's neutral rate lay, replied, "We don't know what neutrality is until we get there."

And maybe not even then. For now, Fed officials can head for neutrality, even while acknowledging that they do not really know where it is. A nominal fed funds rate of 2.25% is still below any sensible estimate of neutrality. But as the nominal rate creeps upwards, monetary-policy judgments will become increasingly difficult. However attractive the theory of a neutral rate, it will not be of much practical help.

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