Standard Life Investments

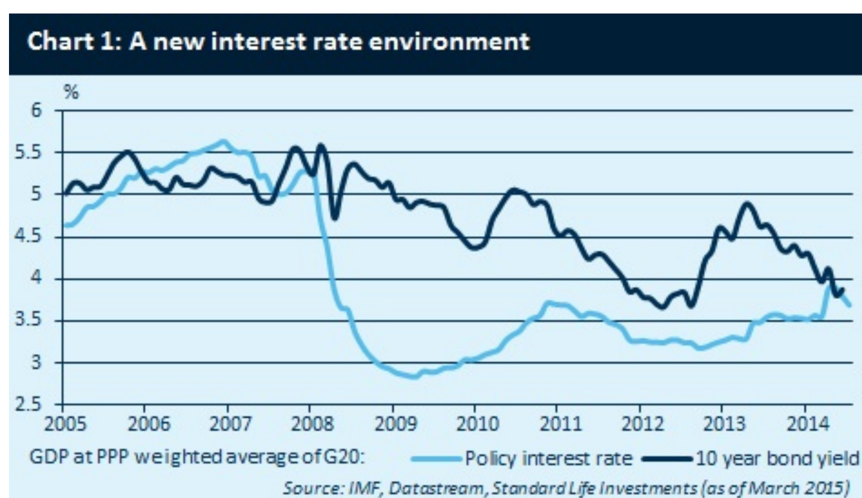
Weekly Economic Briefing

24 March 2015

A new neutral?

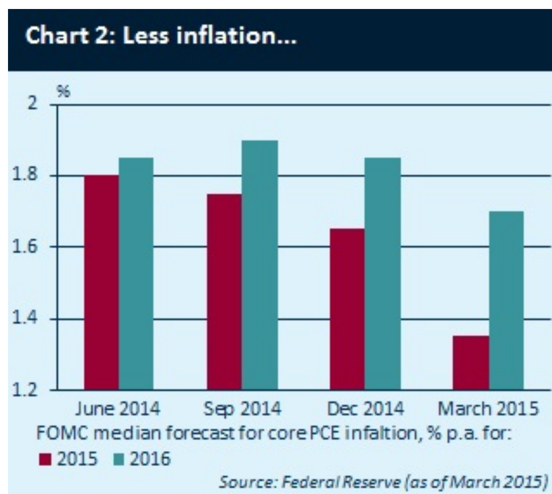
With short and long-term interest rates low and, in many cases, still falling around the globe, it is natural to ask how permanent the decline will prove to be (see Chart 1). One factor that should have pushed down equilibrium interest rates is the widespread fall in potential growth seen in many parts of the global economy. Population aging is lowering labour utilisation rates in most countries, while productivity growth is well below historical norms. Excess leverage also plays its part; globally, the ratio of aggregate private and public debt to GDP is higher than before the financial crisis. Borrowing rates will need to remain low for many years in order to enable debtors to meet their financial commitments without defaulting. A third factor is the impairment of financial systems, which has reduced credit availability and increased lending margins, meaning that policy rates have to be lower to achieve a certain level of stimulus. A fourth factor is government financial regulation. Policies introduced since the crisis have forced banks to hold more capital against their riskier activities and incentivised holdings of safe, liquid assets, pushing down term premia in the process.

Lowflation is another reason for low interest rates, both because policy will have to remain accommodative for many years to get inflation back to central banks' targets and because it reduces the compensation that investors require for holding longer-term interest rate risk. Finally, unconventional central bank policies have weighed on interest rates across the curve. Large-scale asset purchases have stuffed central bank balance sheets full of government bonds, negative short-term interest rates have forced investors to rethink the meaning of the lower bound and forward guidance has helped to anchor expectations of future policy rates. Of course, while the demand for duration is insatiable now it will not always be so. Economies will gradually delever, financial systems will be repaired, inflation should be brought back to target and central banks will eventually scale back their balance sheets. Even productivity growth has a tendency to move in long wave cycles, propelled by the force of human ingenuity. Therefore, while the curious case of low interest rates may persist for a while yet, it is unlikely to be permanent.

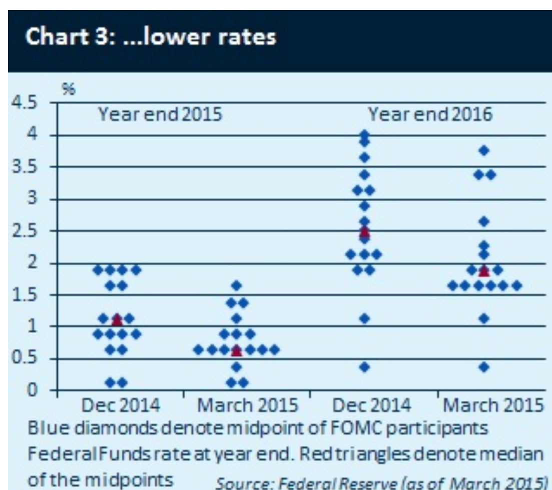


Lower for even longer

The Fed has sent a clear and powerful message that the federal funds rate will not be raised until the rapid improvement in the labour market is accompanied by stronger evidence that inflation is also moving back toward its 2% target. On that score, the Fed's projection materials revealed that most members of the Federal Open Market Committee (FOMC) thought that the inflation trigger for tightening policy would now be met later than they did back in December. Thus, the median forecast for core PCE inflation was revised down from 1.65% to 1.35% at the end of 2015 and from 1.85% to 1.7% at end of 2016 (see Chart 2). Although the Committee's near-term unemployment rate forecasts were also revised lower, so were its long-term forecasts, implying that most members thought that the non-accelerating inflation rate of unemployment (the NAIRU) had also declined. This was a reaction to the failure of wage growth to pick up even as employment growth has hit new highs in recent months. Meanwhile, the FOMC also marked down its forecasts for economic growth which was perhaps not a surprise following disappointing data at the start of 2015.



The upshot of those collective changes was that the Committee's median federal funds rate projections fell significantly too, from 1.125% to 0.625% at the end of 2015, and from 2.5% to 1.875% at the end of 2016 (see Chart 3). This now makes it very unlikely that the first rate hike will take place in June. It is hard to see inflation indicators moving decisively higher over the next three months and the Fed has now shown that it is reluctant to act on the basis of its unemployment forecasts alone. An intriguing aspect of the meeting is the role the rising dollar might have played in the Committee's deliberations. Yellen was typically coy when asked about it, other than to acknowledge that net exports would now be a larger drag on growth. **However, it is hard to escape the conclusion that the currency's appreciation is doing part of the Fed's work for it.** Although the US economy is less sensitive to exchange rate effects than most other economies, appreciation still acts as a brake on growth and inflation. Monetary policy must be sensitive to those impacts when the Fed has failed to hit its inflation target for the past four years.



Another argument that has been put forward for holding the policy rate lower for longer is uncertainty about the neutral real interest rate, i.e. the real interest rate that applies when the economy is operating at full employment and inflation is at target. In the presence of uncertainty, a more inertial policy rule might be desirable. Indeed, some recent studies have suggested that the neutral real rate could be as low as 0.5%, which would imply that current policy is not as loose as implied by standard policy rules. Reasons put forward for the neutral rate being this low include weak productivity growth, private and public sector deleveraging, and tight lending standards. **Of course, keeping the policy rate at zero when unemployment is falling creates risks of its own, including the potential for excess inflation and financial instability in the future. Only time will tell if the Fed has achieved the right balance.**

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