Beneath the Surface

July 2023

SIGNET

A Compass for Interest Rates

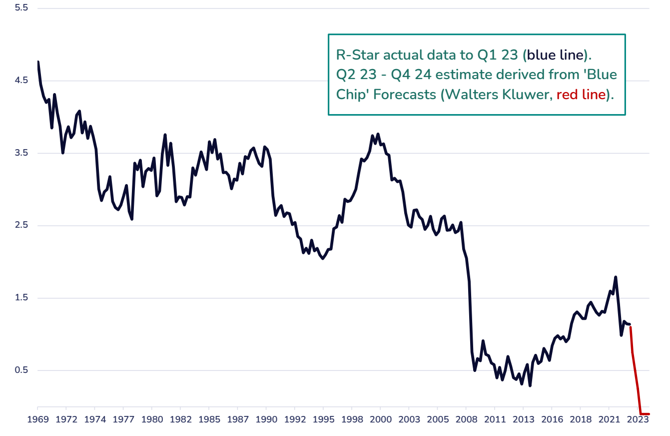
- To understand the likely direction of interest rates, after we account for the ongoing emergency central bank interventions, it may be helpful to understand the expected direction of the 'natural real rate of interest', which is also known by economists as 'r-star' or the 'neutral rate of interest'. The concept of r-star is derived from the economic theories of Knut Wicksell (1898) and as a measure it can't be observed directly; it can only be estimated by economic policymakers. A region's r-star is the inflation-adjusted interest rate that neither stimulates nor constrains its economy, so policymakers need to know the level of r-star in order to gauge the likely impact of their actions. When market (inflation adjusted) interest rates are held below an economy's natural rate, they are stimulatory and boost demand, growth and inflation (asset prices). Conversely, when market interest rates are held above the natural rate, they create contractionary pressure, lowering output, demand and inflation. So, the concept and understanding of r-star is important for a central bank's management of macroeconomic stability.

- A lower r-star implies lower nominal interest rates over the long term. An economy's r-star is driven by demographics, technological progress, productivity and financial factors. It also demonstrates a secular dynamic, in so much that interest rates can be too high or too low as an economy shifts over time. Central banks have kept market rates below r-star for much of the last 15 years and have also been constrained by the 'zero bound' in nominal interest rates. Consequently, alternative easing techniques, such as quantitative easing (QE), have been employed to augment policy during recent negative demand shocks. What are the current expectations for r-star?

- *"Natural rates will likely remain at low levels in advanced economies, while in emerging market economies, they are expected to converge…monetary institutions may have to resort to the same strategies they employed in the decade before the pandemic…when inflation is brought back under control, advanced economies' central banks are likely to ease monetary policy and bring real interest rates back toward pre-pandemic levels."* **IMF World Economic Outlook, April 2023.** *"Based on the new r-star estimates for Canada, the Euro Area, and the United States, we see no signs of a significant reversal of the decline in r-star estimates evident in prior decades…in all three economies, the r-star estimates in 2022 are within 0.2% of the corresponding estimate in 2019…importantly, there is no evidence that the era of very low natural rates of interest has ended."* **John Williams, Federal Reserve Bank of New York, May 2023.**

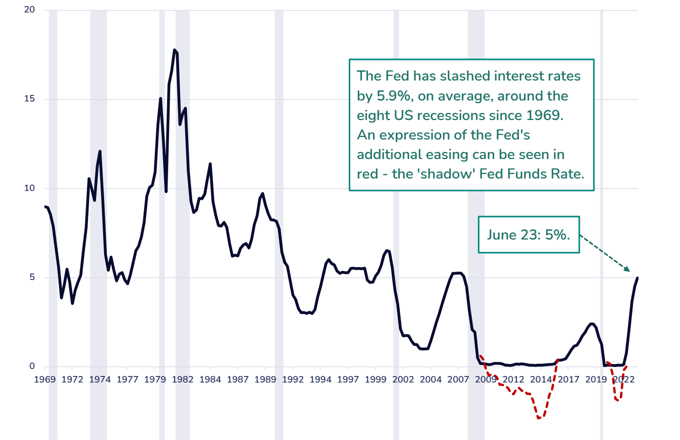
- The Fed publishes r-star estimates for the US and they are depicted below left. They have also just released an analysis of 'Blue Chip' economic forecasts to estimate the r-star out to Q4, 2024. This may have a significant impact on market interest rate decisions in the event of a recession. The Fed has slashed interest rates by 5.9%, on average, around the eight US recessions since 1969 (chart right). If we include the 'shadow' Fed Funds Rate (adjusting for the stimulative impact of QE), interest rates have been cut by 6.5% on average. Investors should position accordingly.

R-Star Estimates for the US (%): 1969-2024



Source: Federal Reserve Bank of New York, Measuring the Natural Rate of Interest, by Thomas Laubach and John C. Williams (originally published in the Review of Economics and Statistics, November 2003).

US Fed Funds Effective Rate (%): 1969-2023



Source: Federal Reserve Economic Data (FRED). Federal Reserve Bank of Atlanta: the Wu-Xia Shadow Federal Funds Rate.