Equilibrium interest rate to guide Fed’s decision on raising rates

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- THE AUSTRALIAN

- APRIL 28, 2015 12:00AM

Increases in the US cash rate, when they come, will be a dominant influence on bond, share and property markets around the world.

The Fed is now thinking through how it might go about “normalising” its cash rate over time — the rate that’s been set close to zero since the financial crisis hit in late 2008. In particular, the Fed is seeking to avoid a repeat of the market panic, called the “taper tantrum”, of mid-2013 after it foreshadowed the eventual phasing out of bond purchases under the “quantitative easing” program.

Indeed the Fed has recently gone public on an aspect of its approach to monetary policy that had not previously been granted much of an airing: its linking the cash rate to the “equilibrium real interest rate”.

To understand this development in the Fed’s thinking, and the implications for investors, let’s step back a year. In 2014, the Fed was mainly concerned with boosting employment. It was expecting the high rate of US underemployment to fall as the workforce “participation rate” recovered cyclically, keeping a tight lid on inflation. Future decisions on monetary policy would be “data-dependent” and the US cash rate would not be raised, as they said, “for a considerable time”.

The Fed now describes the recovery in the US labour market as “strong’” or “substantial”. Janet Yellen, the Fed chair, is stressing the long lags before the effects of monetary policy are felt. She has stated that “a significant pick-up in incoming readings on core inflation would not be a precondition for me to judge that an initial increase in the federal funds rate would be warranted”.

Even more important — and here I steal a good statistic from the blog of Fulcrum Asset Management’s Gavyn Davies — in one major speech, Janet Yellen mentioned “the equilibrium real interest rate” no fewer than 25 times.

Her predecessor at the Fed, Ben Bernanke, has joined the public discussion, using his blog from the Brookings Institution to say the Fed regularly discusses the equilibrium real interest rate. (He also argues it’s the equilibrium real rate of interest, and not the Fed, that ultimately determines the actual level of interest rates in the economy).

The equilibrium real interest rate is the real interest rate that’s consistent with the economy achieving maximum employment and price stability over the long run. It’s also known as the “natural” or the “Wicksellian” rate after Knut Wicksell, the Swedish economist who first wrote about it.

If the central bank persistently sets interest rates above the equilibrium rate, business conditions will probably deteriorate. Alternatively, if the central bank were to set interest rates persistently below the equilibrium rate the effects would be (in Ben Bernanke's words) that "the economy would eventually overheat, leading to inflation … an unsustainable and undesirable situation".

Alas, the equilibrium real interest rate in any country is difficult to estimate, and varies over time.

To cite Bernanke again: "In a rapidly growing, dynamic economy, we would expect the equilibrium interest rate to be high, all else equal, reflecting the high prospective return on capital investments. In a slowly growing or recessionary economy, the equilibrium real rate is likely to be low, since investment opportunities are limited and relatively unprofitable."

It appears the Fed believes the equilibrium real interest rate in the US would have been negative in the aftermath of the global financial crisis; that it's currently very low; and that the equilibrium real interest rate will take several years to return to its "normal" level, of perhaps 1.75 per cent.

The Fed clearly wants to move the focus of the public discussion on the future of the cash rate away from the timing of the first increase to the pace of the rate hikes that follow. It also wants the public discussion to allow for the Fed's view that the equilibrium real cash rate, which "in the wake of the financial crisis … fell well below zero because of numerous persistent headwinds" is now "rising only slowly over time".

Hence the Fed is stressing that "what matters for financial conditions and the broader economy is the entire expected path of short-term interest rates and not the precise timing of the first rate increase".

Tim Duy, a US blogger well-regarded for his observations on the Fed, adds another reason for the Fed's heightened emphasis on the equilibrium interest rate. He says Yellen "anticipates that the equilibrium rate of interest will return to more normal levels over the next couple of years, but (she) remains wary that this will not turn out to be the case". "This is good news", he says, "as it raises the odds that she will not cut the expansion short". What an ideal outcome that would be for investors around the world!

Alas, the best laid schemes of mice and central banks often go awry. The experience of past cyclic upswings in the US and other countries is that confidence rebuilds; the pulse of the economy quickens; and, in turn, "rising inflation or wage growth … would justify the acceleration of subsequent rate hikes as they would be evidence of a more normal economy consistent with a higher equilibrium real interest rate". (Tim Duy). There will be jolts for investors, notwithstanding the Fed's fascination for a new guiding light.

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