

Playing Loose with Money *The Economist*, 3/11/04

It is time for the Fed to start raising interest rates

MONEY has never been so cheap. The average short-term interest rate in the big economies is at its lowest in recorded history. By slashing interest rates to only 1% after the stockmarket bubble burst, America's Federal Reserve deserves much of the credit for saving the American economy from a deep recession and possible deflation. Many commentators (including *The Economist*) had fretted that low interest rates might fail to spur the economy, because consumers were already up to their necks in debt. But households have borrowed more to keep spending and America's economy is now growing briskly. So does America still need such low interest rates?

The resounding answer from most American economists is yes. Just look at the jobs figures (see article). Measured by employment rather than output, America has suffered its deepest downturn since the 1930s. Although the number of jobs has been growing since last summer, the pace of new hiring has been unusually slow. Moreover, the core rate of inflation stands at only 1%. Thus, conclude most economists, interest rates can safely stay where they are.

But for how long? By many measures, monetary policy is now looser than at any time since the 1970s when inflation took off (see article). Although consumer-price inflation remains low, the liquidity that the Fed has created by holding interest rates down is spilling over into asset markets. Some readers might believe that we are obsessed with bubbles. Yet even normal folk cannot ignore the vast amounts of froth around at the moment. Over the past 12 months, America's stockmarket has enjoyed its biggest gain in real terms for 50 years, and in the fourth quarter of 2003 house prices rose at their fastest rate for 25 years. Household debt rose last year at its fastest pace for two decades as consumers borrowed against those capital gains. This hardly looks like an economy that requires a massive monetary stimulus, which it will continue to get for as long as interest rates remain at 1%.

Japanese jitters

America's low rate of inflation and its weak labour market mean that policy needs to remain accommodative, but a modest rise in interest rates would still leave monetary policy extremely loose by past standards, and thus continue to stimulate demand and jobs. Jack Guynn, the president of the Atlanta Fed, a regional arm of the Federal Reserve, recently put the case rather nicely: "When a patient is seriously ill, the situation may call for prescribing a strong dose of medication. As the patient begins to recover, however, there is a need to recalibrate the dosage or to stop prescribing it entirely to avoid potential side effects." We would argue that it is time for America to reduce its cheap-money dosage. A rise in rates could help to avoid another dangerous bubble by warning investors and homebuyers that asset prices cannot rise for ever.

One argument against raising rates is that the Fed risks repeating the mistakes of Japan in the 1990s. The Bank of Japan allowed deflation to develop when it held policy too tight, partly because it was worried about another asset-price bubble. Last year there did seem to be a serious risk of deflation in America. That is why the Fed was right to cut rates then. But conditions today in America are very different to those in Japan in the 1990s. Japanese house prices, and hence household wealth, were falling, and have continued to do so. America's monetary policy is much looser than Japan's ever was. Through most of the 1990s, Japanese interest rates remained higher than its nominal GDP growth—ie, policy was restricting, not stimulating, the economy. And third, America's banks have long been in much healthier shape than Japan's.

In its desire to learn from Japan's mistakes, the Fed risks making a different sort of mistake. A rise in rates now could indeed hurt asset prices and so the economy. But the alternative, of allowing a bubble to inflate which is bound to burst eventually, would be even more painful. Until the Fed starts to lift interest rates, we will continue to watch warily for bubbles.

Enough liquidity: it is time for the Fed to start raising interest rates

NO ONE expects the Federal Reserve's open market committee, the policymaking body of America's central bank, to raise interest rates when it meets on March 16th. Indeed, a growing number of economists believe rates will remain at 1%, a 45-year-low, at least until the end of 2004. Yet the case for an increase is strengthening.

The main reason why the Fed is expected to hold rates is the feeble state of America's labour market (see article). In February, payrolls rose by only 21,000, an unusually low figure for a briskly growing economy. Not only would it be politically provocative to raise rates—especially in an election year—but sluggish jobs growth will hold down wage pressures and hence inflation. Core consumer-price inflation (ie, excluding food and energy) is only 1%, a bit low for comfort, so there appears to be no reason to tighten policy. That is the view of most American economists. More important, it is also thought to be the view of Alan Greenspan, the Fed's chairman.

However, some Fed officials, along with several foreign central bankers, are starting to wonder whether policy is being kept too loose for too long. The Fed was right to cut interest rates immediately after the stockmarket bubble burst; it saved America's economy from a deeper recession and the risk of deflation. But rates cannot stay where they are for ever. Monetary policy is the loosest for 30 years.

There are several ways to test the tightness of monetary policy. One is the level of real interest rates, which are currently around zero (using the core rate of inflation). This is in fact no lower than in 1993, when the Fed also faced a jobless recovery. However, some economists argue that a better gauge is a comparison of interest rates not with inflation but with nominal GDP growth. As a rule of thumb, when rates are above nominal GDP growth, monetary policy is restrictive; when rates are below it, policy is expansionary.

One way to interpret this is to see America's nominal GDP growth as a proxy for the average return on investment in America Inc. If this return is higher than the cost of borrowing, investment and growth will expand. Nominal GDP is rising at an annual rate of 6%, five percentage points above the federal funds rate (see chart). This gap is wider than at any time since the 1970s when inflation took off.

Another useful measure is Goldman Sachs's financial conditions index. This takes account not only of real interest rates, but also of bond yields, the dollar and the stockmarket. In February the index hit its lowest point in the 35 years it covers, implying that monetary conditions are extremely loose.

Level pegging

It is popularly argued that central banks should raise interest rates if inflation exceeds its target, and cut them if inflation falls below, but otherwise keep them constant. But this is wrong. Glenn Stevens, the deputy governor of the Reserve Bank of Australia, neatly explained why in a recent speech focused on his own country. It is, he argued, the level of interest rates that matters most for the stance of monetary policy, not the direction of change. Monetary policy does not stop working when rates stay constant. A low interest rate will continue to stimulate the economy and will eventually produce ever-rising inflation. Apply Mr Stevens's argument to America: even if rates were raised by a full percentage point, monetary policy would still be expansionary.

Once the circumstances that required super-low American interest rates—ie, the risk of deflation—have passed, rates need to rise towards what economists call the “neutral” rate of interest. This is the rate that neither stimulates the economy nor reins it in, but allows it to expand in line with its underlying productive potential, keeping inflation constant. The concept can be traced back to Knut Wicksell, a Swedish economist who a century ago defined the neutral (or, as he called it, “natural”) rate of interest as that earned by fixed capital. If the rate set by central banks is lower, firms will invest more, boosting growth and, eventually, inflation.

America's neutral rate of interest is probably around 5%. While the economy still has spare capacity, interest rates need to be below that rate. But they probably no longer need to be quite so low. It is true that there seems to be little risk of inflation surging in the near future. Higher prices of oil and other commodities, along with a weak dollar, may push up the headline rate of inflation, but wage demands remain moderate. Better still, inflation may stay low because central banks have done a good job in the past: the Fed's reputation is now so strong that households and investors have much lower expectations of inflation than in the past.

Nevertheless, all the liquidity being pumped out by the Fed's lax policy has to flow somewhere. It may not be showing up in conventional inflation, but it could be encouraging asset-price bubbles and excess credit growth. In the fourth quarter American house prices rose at their fastest rate for almost 25 years (see next article); share prices have been booming again; and interest-rate spreads look indecently low as investors desperately seek higher returns, seemingly heedless of the risk.

In recent weeks, Mr Greenspan and other Fed officials have started to send out warnings that interest rates will eventually need to rise, but with no great sense of urgency. In contrast, Stephen Roach, the chief economist at Morgan Stanley, has called on the Fed to raise interest rates immediately by two percentage points. This, he argues, is needed not only to avoid bubbles but also to give the Fed ammunition with which to fight the next economic shock. At current interest rates, the Fed would have no room to cut rates if the economy took a turn for the worse.

Mr Roach's favoured interest rate of 3% would, in theory, still leave policy accommodative. But such a sharp rise could easily cause the next shock, sending the prices of homes, shares and bond prices tumbling. The Fed would do better to act gradually. But it needs to start now.

The Fed faces a difficult choice. A rise in interest rates when employment is barely growing would provoke sharp criticism. If it triggered a slide in share or house prices, recession could even ensue. On the other hand, the longer the Fed leaves rates so low, the greater the risk that asset prices will inflate to unsustainable levels—and the greater the risk of a deeper downturn in the future. In an election year, however, even a policymaker as officially independent as Mr Greenspan is unlikely to inflict short-term pain for long-term gain.

Aiming for a Happy Medium *The Economist*, December 16, 2004

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.