SALT INSIGHT

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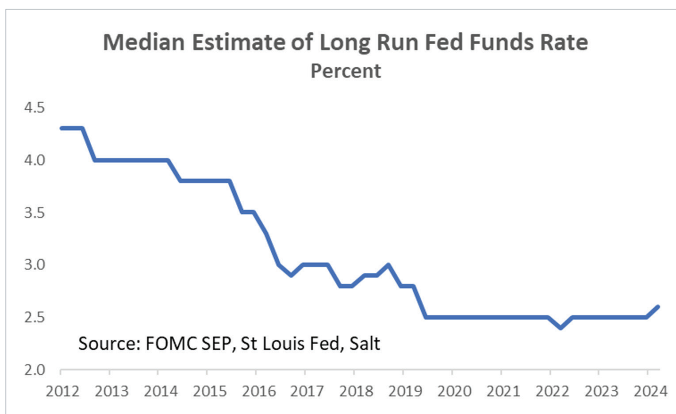
Neutral rising

Last week's Federal Open Market Committee (FOMC) appeared relatively benign on the surface. No change in interest rates on the day – as expected – and the Committee continued to indicate three cuts in the Federal Funds (Fed Funds) rate appeared likely in 2024 – as was also expected, at least by the market.

However, there were some quite important shifts further out on the interest rate horizon. A closer look at the "dot plot" reveals the Committee increased their Fed Funds forecast for the end of 2025 and 2026, and in the longer run.



That seems to suggest that at least some members of the Committee are starting to believe that neutral interest rates may be higher in the future than we have come to expect in the recent post-Global Financial Crisis but pre-pandemic past.

Importantly, this is not just a US phenomenon. Even here in New Zealand, the Reserve Bank of New Zealand's estimate of the long-run neutral rate is also starting to nudge higher.

What is the neutral interest rate?

The neutral interest rate is the interest rate at which monetary policy is neither expansionary nor contractionary. It is impossible to observe in real time, with most estimates being determined by econometric models analysing the past. Its future path is thus the source of considerable debate and conjecture. It can also be thought of in nominal or real (inflation adjusted) terms. The latter is affectionately referred to in the literature as r*.

The changing view in the FOMC fits with our view that both short and long-term neutral rates are indeed now higher. Even Fed Chair Jay Powell seems to agree. In his post meeting press conference last week, he said his "instinct is that rates will not go back to the very low (pre-pandemic) levels".

That has a couple of noteworthy implications. Firstly, a higher short-term neutral rate means the current nominal policy interest rate is less restrictive than it would be if the neutral rate were lower. This would help explain the strong data recently seen out of the United States (the hard vs soft vs no-landing debate).

Secondly, a higher longer run neutral rate will limit the extent to which interest rates may be cut in the future. In other words, the "policy rate gap to neutral" is presently smaller than if the neutral rate were at its previously assumed (lower) level.

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Indeed, this is why we were warning readers of our research earlier this year not to get too carried away with US (or NZ for that matter) market pricing of monetary policy outcomes in 2024 that seemed to us to be predicting interest rate cuts that were both too early and too large.

Trend decline in interest rates

Interest rates have been on a downward trend since the 1970's. In terms of r* (the bit of the neutral rate excluding inflation), changes are driven by changes in the balance between overall savings (supply of capital) and investment (demand for capital).

Thinking about the trend decline in r* since the 1970's in this way, key contributors to this decline have been lower productivity growth (less demand for investment capital) and ageing populations driving higher savings (increasing supply of capital). With increased supply and declining demand, the price (r*) has fallen.

On top of this, inflation expectations have also fallen significantly since the 1970's, further contributing to a lower nominal neutral rate.

What's changed?

We've been writing about the potential for higher neutral interest rates for some time now. We see a number of structural forces contributing to both higher inflation and higher neutral interest rates in the period ahead. These include:

1. **De-globalisation.** Anti-trade populist tendencies of a number of political leaders (Trump 2.0?) are contributing to reshoring of some economic activity. This has become intertwined with the response to Covid-19 which is seeing some businesses wanting to establish more local supply chains. This will increase investment, leading to a higher r*.

2. **Geo-political tensions.** As the world becomes more fragmented and factionalised, the trend towards regionalism will see increased investment and a higher r*.

3. **Net Zero.** Government's commitment to net zero carbon emissions requires significant investment, as do more general infrastructure deficits around the world, contributing to a higher r*.

4. **Ageing Populations.** Much is made of the impact of ageing populations and the need for higher savings. But once populations have aged, they stop saving and start spending, contributing to a higher r*.

5. **Reduced "glut" of savings.** The so-called pre-GFC savings glut, whereby China in particular ran a large current account surplus to build its foreign reserves for fear of a repeat of the Asian Financial Crisis, is now dramatically reduced, leading to a higher r*.

6. **Easier fiscal policy.** There are ever increasing pressures on Government spending, well beyond those already mentioned. Only the most disciplined will be able to manage this pressure within existing base lines, leading to greater spending, higher debt and upward pressure on r*.

7. **Higher inflation expectations.** We believe there are reasons to believe that inflation will be higher in the future than it has been in the recent past. To the extent that feeds through into higher inflation expectations, it will impact on the nominal neutral rate.

The bottom line is that we are not surprised to see estimates of the long-term neutral rate starting to nudge higher. This supports the notion of "higher for longer". It also means remaining wary of calls for aggressive rate cuts in the period ahead, and that when the time comes for cutting interest rates, central banks are likely to proceed with only the utmost caution.

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