Neutral interest rates: phantoms worth chasing?

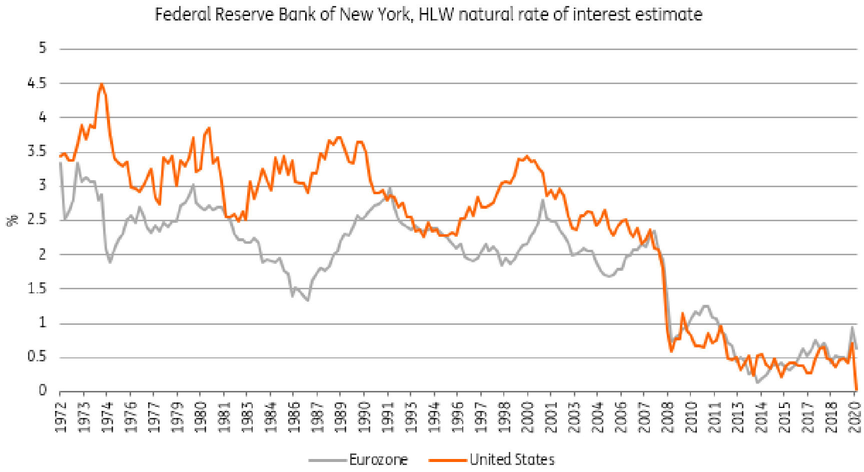
Officials at the Federal Reserve and European Central Bank have started to talk about the neutral level of interest rates again, some louder than others. But what is this neutral rate, and does it really make much sense?

ECB President, Christine Lagarde described the neutral rate as 'unobservable' in a recent blog

In both the US and eurozone, central bank officials have started to talk about neutral interest rates again, using this theoretical level as a benchmark for how much they can potentially hike rates without taking policy into restrictive territory. Of course, every rate hike is a tightening of monetary policy compared with the previous level. The new stance will be less accommodative by definition but it can still remain accommodative.

In the US, the nominal neutral rate has recently been estimated to be around 2.5%. In the eurozone, ECB policymakers such as Villeroy de Galhau have put the nominal neutral level of interest rates in the range of 1% to 2%. But what exactly is this concept of neutral interest rates?

The New York Fed produced estimates of neutral real interest rates until the pandemic, after which they deemed conditions too volatile to properly assess neutral rates



Source: Federal Reserve Bank of New York

Defining the neutral rate

The concept of a neutral interest rate is often used to describe the stance of monetary policy. If policy rates are below the neutral level, monetary policy is accommodative and if they are above, policy is restrictive. This neutral rate is often defined as the rate or range of rates consistent with full employment, an economy growing at potential, and stable price growth. An economy in this state presumably wouldn't need to be stimulated or slowed by monetary policy. However, defining the neutral rate is much simpler than calculating it.

The neutral central bank rate has no explicit value, it is an estimate, and as economists famously disagree on many issues, they can also disagree on the range in which the neutral rate falls, and how it might change over time. Even the factors that determine the neutral range are complicated and varying. In the early 2000s, Fed Chairman Alan Greenspan was quoted saying: "*It's very difficult to know where that so-called neutral rate is. But we probably will know it when we are there because we will observe a certain degree of balance, which we had not perceived before, which would suggest that we are somewhere very close to where that is.*"

Neutral rates are currently higher than during most of the lacklustre 2010s

To illustrate the difficulty of estimating neutral interest rates, one only needs to remember how difficult it is to determine when an economy is in a neutral or equilibrium state. We know how often estimates of structural economic growth and estimates of output gaps are revised. A lot. And even if output gap estimates were a safe bet in determining the neutral level of the economy, there have been very few occasions in the eurozone with a closed output gap: 2003-2005 and 2017-2019. The ECB's main policy rate in this period was 2%, 2.25%, and 0%. So where is this neutral level?

Well, what seems to be clear is that neutral rates are currently higher than during most of the lacklustre 2010s. With output gaps almost closed or already positive for the eurozone and US respectively, inflation rates well above target, and inflation expectations higher than during most of the past decade, the neutral rate seems to have been on the move. Still, it is nigh impossible to give a good sense of where this rate currently is. Post-pandemic effects have made it especially difficult for most experts to pinpoint where the economy is in relation to potential (consider factors like reversing stimulus, pandemic spending patterns, increased saving rates, etc.), let alone which interest rates correspond to that neutral state.

An invisible moving target

As much as we acknowledge the attractiveness of having a pseudo target level for policy interest rates which gives the illusion of being neither accommodative nor restrictive, this concept is flawed. Neutral interest rates can be used as an analytical tool, after the fact, to measure the monetary policy stance but they are not useful tools to guide markets or indeed give forward guidance.

A better option for central banks to gauge their normalisation paths, provide forward guidance and have regular assessments of the normalisation process so far would be to revert to the concept of financing conditions. As real interest rates have actually dropped to tremendously low levels on the back of rising inflation rates in recent months, monetary conditions have become looser. However, financing conditions - which not too long ago were a very special needle in the ECB's compass - have actually tightened considerably recently. Just think of nominal bond yields, stock prices, spreads or interest rates on loans to corporates and households. Focusing on monetary conditions or interest rates alone could lead to restrictive monetary policy pretty easily.

Neutral rates are an invisible and moving target and should not be used as a policy target but rather as an ex-post monetary policy stance assessment. We hate the term but, right now, with highly volatile times for the global economy, it would be better for central banks to use a holistic approach to determine when monetary policy might again be neutral.

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