

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?

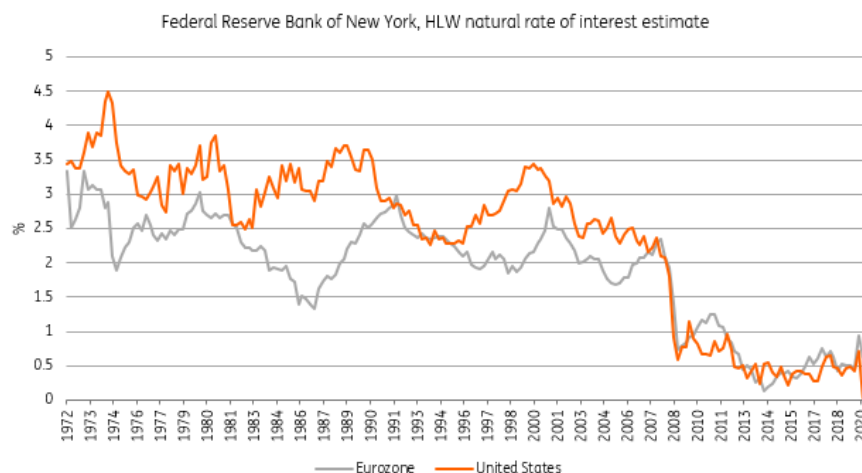


ECB President, Christine Lagarde described the neutral rate as 'unobservable' in a recent blog

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.

Author

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial

instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.