Global Counsel

Fed slashes interest rates again

Blog post by Chief Economist Gregor Irwin, 21 June 2016

That is the headline you did not read last week, but in many ways it should have been. The focus of analysts has naturally been on when the Federal Open Markets Committee – the group that sets US monetary policy – will next raise interest rates, following the first rise in seven years last December. For now, the Fed is on hold, with expectations falling of another increase when it next meets in July, particularly after disappointing jobs figures in May. But in sharp contrast to this picture of inactivity, the Fed has been steadily revising down its forecast for longer term rates. This tells us much about the future prospects for the US – and global – economies.

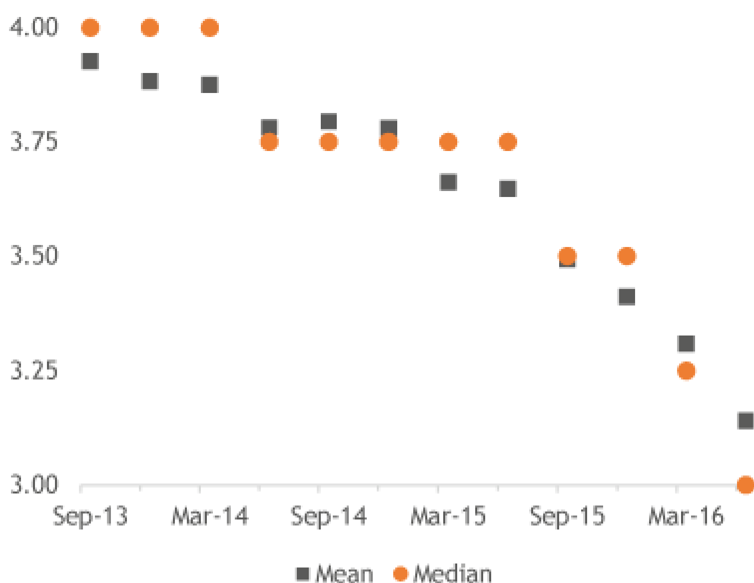

Fig: Longer run targets for federal funds rate
Source: Board of Governors of the Federal Reserve System

Every quarter the members of the Open Markets Committee are asked to give their "longer run" forecast for the key policy rate, known as the federal funds rate. Figure 1 shows how both their average and the median forecasts have steadily declined over the past three years. The average has now fallen from around 3.9% to 3.1%. Even more striking is what this implies for real interest rates. If there is one thing Fed policymakers typically agree on it is that in the longer run inflation will tend to converge with the target of around 2%. This means that the drop in the real rate is even more dramatic – falling by nearly one half from around 1.9% to 1.1%.

What lies behind this? It has been observed for some time, starting before the 2008 financial crisis, that market measures of long-term real rates have been falling, as seen from a steady decline in the yield on ten-year government debt in the US, while allowing for falling inflation. A similar pattern has also been seen in many other countries. More recently a debate has simmered among academics and policymakers about what may be causing this and whether it is structural or a just part of a long cycle. The signal from the Fed is that they think it is structural.

Why it is happening is another matter. It could reflect pessimism about sustainable growth rates (as the real interest and real growth rates tend to track each other over the longer run) or demographic or technological changes which have structural implications for aggregate savings and investment (the real interest rate is the price that matches them). In practice it is likely to be a combination.

Global Counsel

Either way this is a more difficult environment for monetary policymaking. It means interest rates are likely to be lower for longer, with less room to respond to shocks. It also has implications for wider asset pricing and potentially also debt sustainability for governments.

This means anyone wanting to understand US - and global – economic prospects should be paying as much attention to Fed thinking on longer run rates as they do to the next headline policy announcement.

© Global Counsel 2016