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FED SHADOW

Yellen's March to Neutrality

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Donald Luskin

She mentioned the "neutral interest rate" 18 times. That makes it official. It's a policy rule.

With Fed chair Janet Yellen's speech on Friday, we rest our case. The reason why markets didn't throw a tantrum last week – as a rate hike became a certainly at the March FOMC (see "Joint Session Overshadows FOMC Session" March 1, 2017) – is that *the Fed is indeed, as we have been saying, now operating under a "policy rule" driven by its conception of the "natural interest rate"* (see "Yellen Gives Conservatives Something to Cheer" February 17, 2017). *This will drive only gradual rate hikes as the "natural rate" gradually recovers. If those hikes only track the "natural rate" higher, they won't act on the economy as policy tightenings.*

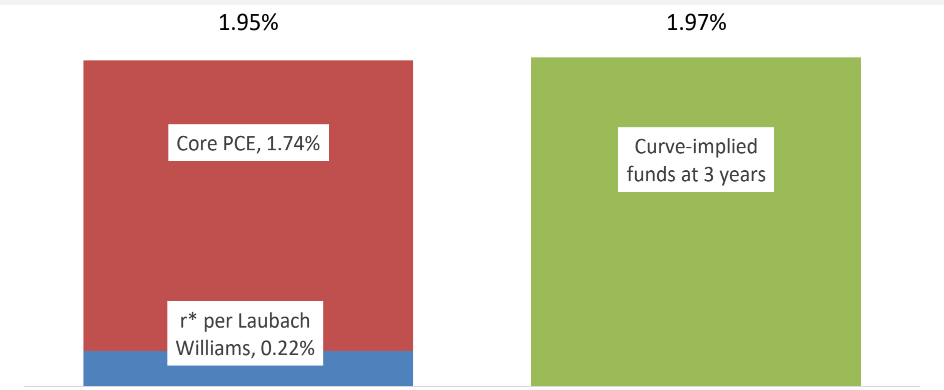
- Specifically, the Fed is now focused on its modeled proxy for the natural interest rate, which it calls the "neutral real rate of interest," sometimes referred to as "r*" or "r-star."
- Explaining this to a client on Friday before Yellen's speech, we proposed a drinking game in which you take a shot every time Yellen says "neutral real rate of interest" or some close equivalent.
- We hope our client didn't take us up on that – she would have passed out on the floor in minutes. *Yellen referred to the "neutral real rate of interest" no less than 14 times in her speech, and once in the footnotes. And she referred to the closely related idea of a "neutral policy stance" three times.*
- The market is very much geared to this policy framework – which is why there was no tantrum last week as March suddenly went "live."

Update to strategic view

US FED, US MACRO: Yellen's speech Friday, in which she mentioned the "neutral interest rate" or equivalent concepts 18 times, proves our case that Fed policy is now being guided by that concept in the manner of a policy rule. It explains why there was such low global inflation despite ZIRP, NIRP and massive asset purchases. A March hike is a certainty now. And with future gradual rate hikes now timed to gradual increases in the "neutral rate," these hikes won't be actual policy tightenings and won't choke off growth.

[Strategy dashboard]

Neutral rate of interest versus market fed funds expectations



Source: BEA, SF Fed, Bloomberg, TrendMacro calculations

- The funds rate implied by the Treasury curve three years out isn't following the FOMC's "dots." It has been and remains almost exactly at the inflation-adjusted level of the most recent reading of the Laubach-Williams model, the Fed's best estimate of the "neutral real rate of interest" (please see the chart on the previous page).

As we have been explaining to clients in calls and meetings, this new orientation for the Fed has some aspects of institutional expediency. The Fed and other major central banks need an excuse for the global economy's poor performance after they have seemingly done so much with zero interest rates, negative interest rates, and massive asset purchases. After all the Fed, the ECB and the BOJ have failed to sustain target inflation for eight years, and in the UK, for four years.

- The explanation must be, they now argue, that in the era of "secular stagnation," the "natural interest rate" is itself zero or negative, making all their seeming policy accommodation not really accommodative at all.
- So we have seen modern monetary theorists like Fed vice-chair Stanley Fischer making recourse to the 19th century theories of Knut Wicksell – in a May 2016 speech quoting no less than 914 of the Swedish economist's words.
- Wicksell wrote in 1898 that administered interest rates cause inflation only when they are below the rate of interest that would have occurred in the absence of such an intervention – that rate being the unobservable "natural rate."
- *So there's the Fed's excuse. And it just happens to be true.*
- *The important thing is that the Fed has learned from it. And according to Yellen on Friday, the Fed is very much being guided by it as the economy gradually recovers, and the "natural rate" gradually recovers with it. And the Fed, with commensurate gradualism, will index its rate hikes to that recovery.*
- *So just as the idea of the "natural rate" explains why there was no hyperinflation despite seeming excessive Fed accommodation, going forward it will explain why Fed rate hikes are not, in fact, tightening policy and choking back growth.*
- While Yellen started talking about the "neutral interest rate" in the press conference following the December 2015 "liftoff" FOMC, and has mentioned it in her last three semi-annual testimonies before Congress, it has yet to be cited by name in an FOMC statement.
- We predict that it will make its debut on March 15.

Bottom line

Yellen's speech Friday, in which she mentioned the "neutral interest rate" or equivalent concepts 18 times, proves our case that Fed policy is now being guided by that concept in the manner of a policy rule. It explains why there was such low global inflation despite ZIRP, NIRP and massive asset purchases. A March hike is a certainty now. And with future gradual rate hikes now timed to gradual increases in the "neutral rate," these hikes won't be actual policy tightenings and won't choke off growth.

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