American Enterprise Institute for Public Policy Research

May 2005

Economic Outlook

The Difficult Search for "Neutrality"

By John H. Makin

The Federal Reserve's measured move toward a "neutral" federal funds rate, the short-term rate that keeps the economy growing at about 3.5 percent, is a tricky process. No one knows with certainty what the neutral fed funds rate is, and it changes over time. As long as the Fed keeps raising rates and the economy keeps growing at or above trend, it is reasonable to infer that the neutral fed funds rate is higher than the current rate. The corollary to that proposition is that rates have to be boosted above the neutral rate, inducing an asset market collapse, a real economy slowdown, or both to infer that the neutral rate has been exceeded. It is beginning to appear as though the current rate of 2.75 percent is at or above neutral. If so, that would be about a full percentage point below what many were guessing.

As we enter the spring of 2005, clear signs have emerged of a sharp slowdown in real economic activity worldwide followed by a sharp drop in global equity prices. The other favorite asset market these days—real estate—will not be far behind.

An Elusive Target

It is important to understand that the Fed has been conducting an extraordinarily difficult operation as it attempts to exit from a period of negative real interest rates, akin to the unsuccessful effort by the Bank of Japan a decade ago. The Fed may succeed in its effort, but the hard part of the search for a neutral real fed funds rate is that it varies over time and is probably linked to its own history and to the behavior of important exogenous variables such as energy prices.

The Fed was forced to reduce interest rates in three stages starting in January 2001. It may seem hard to believe now, after a couple of years when the fed funds rate was 1 percent, but at the Fed's Open Market Committee meeting on December 19, 2000, nine months after the NASDAQ collapsed, the rate was still 6.5 percent. With the year-over-year core PCE (personal consumption expenditures) deflator at 2.4 percent, the real fed funds rate was 4.1 percent. The 50-basis-point reduction two weeks later in January 2001 was an unusual inter-meeting move based on the perception of a sharply slowing economy. By August 2001, the rate had been reduced a remarkable 300 basis points to 3.5 percent (a real level of about 1.3 percent). In the several months after the September 11 terrorist attacks, the rate was reduced by another 175 basis points to 1.75 percent. Finally, in 2002 and 2003, a weaker economy and a deflation scare prompted the Fed to drop the rate to the extraordinarily low level of 1 percent.

The real (that is, inflation-adjusted) fed funds rate from the end of 2001 through mid-2004 averaged minus 50 basis points, while economic growth was at about trend (3.5 percent) and inflation remained low or falling, which implies that the real neutral rate at that time was negative. Such extraordinary monetary accommodation along with tax cuts and fiscal stimulus were necessary to sustain real economic growth. The combination of trend U.S. growth and an extraordinary boom in China and India boosted the demand for oil so that oil prices began to rise at the end of 2003. This development, coupled with

John H. Makin (jmakin@aei.org) is a visiting scholar at AEI.

rising equity and real estate markets and firm growth, led the Fed to begin tightening in June 2004.

The Fed recognized that it had embarked on a very tricky experiment: exiting an extended period of nearly three years of a negative real fed funds rate without causing an accident in asset markets or a sharp slowdown in real growth. One of the problems of a prolonged period of negative real interest rates may be that the neutral level of interest rates is itself lowered. Specifically, if achieving trend growth requires a negative real interest rate along with substantial fiscal stimulus, how do you identify the neutral real rate once the fiscal stimulus is removed?

The Fed's appropriate answer was to move very cautiously to raise the rate by a predictable 25 basis points per meeting, which by May 3 of this year will take the nominal rate up to 3 percent. Given the increase in the core inflation rate, as measured by the Fed's favorite consumption price deflator, to a year-over-year rate of 1.6 percent, the Fed will have boosted the real fed funds rate to 1.4 percent by May from a negative 50-basis-point reading ten months prior. The rise in the real rate by nearly 2 full percentage points in the space of ten months is rapid by historic standards, although until March of this year it produced no discernible effect on real economic growth, real estate markets, or equity markets.

Adjusting the Target

A number of exogenous events have combined to produce what probably amounts to a reduction in the neutral real fed funds rate. While energy prices have been volatile, the price of oil in April 2005 is 50 percent higher than it was a year earlier, a fact that many at the spring meeting of G7 finance ministers specifically noted. Many analysts have been misled by the notion that the effects of energy prices on the economy and inflation ebb and flow quickly, so that a rapid drop in oil prices from $56 to $50 in recent weeks has produced sighs of relief. (Even that comfort has evaporated as oil has bounced back to $54 as this essay goes to press.) Serious econometric analysis of the impact of oil prices on growth and inflation suggests that higher energy prices operate on the economy with a lag of about one year. Estimates from the European Central Bank indicate that a 50-percent increase in the price of oil is likely to reduce U.S. growth by a cumulative 2.5 percentage points over a period of slightly more than two years. For Germany, the comparable growth reduction is minus 2 percent—rather serious given that expected growth was below two percent in the first place. The maximum impact occurs with a lag of about a year. Other models corroborate these findings.

Weaker Growth, Weaker Asset Prices

As the global economy has slowed sharply over the past four to six weeks, it appears that the combination of a sharp increase in the real fed funds rate and higher energy prices have cut growth. In the United States, demand growth has fallen sharply as consumer confidence is sapped by higher energy prices and the threat that higher inflation will lead the Fed to continue tightening. The annualized growth rate of retail sales over the three months ending in March fell to 3.3 percent, a sharp slowdown from the 8-percent annual growth rate during the previous three-month period. The 3.3-percent growth rate of retail sales translates into real growth at a rate of only 1.6 percent over that period.

U.S. asset markets reacted sharply in April to the slowdown in the real economy. Between mid-March and mid-April 2005, the S&P stock index fell by 6 percent even as interest rates on ten-year Treasury notes fell by 40 basis points. Normally, a drop in interest rates, even if it is associated with slower growth, provides some support for equity prices. The simultaneous sharp drop in equity prices and interest rates suggests that markets are seeing a sharply slower U.S. economy in the future. Even the heretofore mighty U.S. housing sector slowed sharply in March as housing starts fell 17.6 percent, the sharpest drop since January 1991, the month of the invasion of Kuwait.

Normally, a drop in interest rates, even if it is associated with slower growth, provides some support for equity prices. The simultaneous sharp drop in equity prices and interest rates suggests that markets are seeing a sharply slower U.S. economy in the future.

Foreign economies are also slowing. In Japan, persistent hopes for recovery have evaporated with weak economic data. This slowdown was probably accentuated by a feint from the Bank of Japan in February 2005 for the possible need to raise interest rates sooner than had been supposed. The Bank of Japan is uncomfortable with zero

interest rates and with their ability to stimulate the economy by providing additional funds to the banking system. The answer to that dilemma would be a more aggressive program of stimulation through direct purchases of government bonds, equities, or even property, that would boost expectations of stable to higher prices.

The Bank of Japan has retreated from hints that it will move toward less accommodative monetary policy earlier than had been anticipated and now is trying to reverse those expectations as the economy shows signs of weakness that are reflected in falling stock prices and falling interest rates. The Japanese stock market fell sharply (by over 9 percent) during the week and a half ending on April 18. Meanwhile, yields on Japan's ten-year bonds fell about 10 basis points from an already extraordinarily low level of 1.37 percent to 1.27 percent. In short, Japan's markets are signaling the same sharp slowdown in real economic activity that U.S. markets are indicating.

The simultaneous slowdown of the economies of the United States, Europe, and Japan virtually guarantees a global economic slowdown.

The European economy is slowing sharply. As forecasts of meager growth in Europe have been revised downward, even the usually insouciant European Central Bank has acknowledged that there are no signs of strength in any of the European economies and that perhaps their plans to raise interest rates will have to be put on hold. On April 13, the International Monetary Fund cut its 2005 economic growth forecast for the euro region economies to 1.6 percent from 2.2 percent and suggested that the European Central Bank may have scope to cut interest rates further if growth slows more. Of course, ECB president Jean-Claude Trichet quickly ruled out another rate cut, thereby reinforcing the tendency for European growth to slow further. German stocks, a European bellwether, having held up relatively well, dropped by a quick 5 percent during the few days surrounding the spring meeting of the G7 finance ministers. Meanwhile, between mid-March and mid-April 2005, the already low yields on German bonds dropped from about 3.7 percent to 3.5 percent, repeating the pattern of lower interest rates and lower stock prices witnessed in the United States and Japan.

The simultaneous slowdown of the economies of the United States, Europe, and Japan virtually guarantees a global economic slowdown. Consequently, equity prices in the rest of Asia and in Latin America have fallen sharply as well. Korea's closely watched Kospi Index dropped by about 6 percent during the week surrounding the G7 finance ministers' spring meeting. The Hong Kong stock market fell by about 7 percent during the six weeks ending in mid-April 2005, with the sharpest decline coming during the few days of the G7 finance ministers meeting.

China, the perennial wild card, has moved toward a less growth-oriented stance that emphasizes domestic consumption over investment. That means that whatever China's growth is, it is less supportive of growth in Japan and elsewhere. The countries that export capital equipment to China have suffered from China's emphasis on consumption over investment. There are other doubts about the situation in China. The eruption of anti-Japanese riots coincides with riots that are not tied to Japan but are instead linked to deteriorating economic conditions in parts of China away from the coast. It is probable that the toleration by the Chinese government of anti-Japanese riots is related to a decline of economic conditions in China.

The patience of the G7 economies with China's intransigence on the peg of its currency to the dollar has run out. The spring meeting of the G7 included a specific call for the Chinese to allow their currency to float freely to a market-determined level. Both Europe and the United States have threatened retaliation with trade measures if the Chinese refuse to act. Meanwhile, the Chinese have rejected such pressure from outside sources in what they claim is a domestic matter. Whatever the outcome, the combination of a potential trade war along with a global economic slowdown is not helpful to the outlook for earnings and growth. Stock markets have reacted accordingly.

Even the dramatic events in the real economies and stock markets of most G7 countries during March and April have failed to deter optimists. Their standard rejoinders to the slowdown forecast are to observe that oil prices fell slightly in the first three weeks of April and that the U.S. housing market continues to be strong. The former point is undercut by the fact that energy prices are 50 percent above year-ago levels, which implies a serious growth penalty from the present over the next two to three years. The latter point was undercut by weak March data on housing starts.

Some have suggested that after a pause during the second quarter, U.S. capital spending and increased levels of hiring will resume as the economy re-accelerates in the second-half of the year. Given that the spring slowdown

is tied to a sharp drop in demand growth, which in turn has resulted in enough inventory accumulation to cut production growth, it is difficult to imagine why firms working off inventories would hasten the hiring of labor and purchases of capital.

The Fed Faces a Difficult Period

The other problem plaguing the United States, in particular, is the persistence of inflation pressures already in the pipeline. Weaker asset markets and slowing growth are especially unattractive in combination with continued rising inflation pressures. Such a stagflationary environment pulls the central bank in two directions. The slowing economy says to stop raising interest rates while rising inflation says to continue raising them. With a 200-basis-point increase in the real fed funds rate having been achieved in the space of ten months, asset markets and economic data are already suggesting that interest rate increases have been more than sufficient to slow growth. Persistent higher inflation figures would place the Federal Reserve in a very uncomfortable position indeed. If the weaker economic data, falling interest rates, and stock markets persist, the Fed may well undertake one more rate increase at its May 3 meeting and give serious consideration to a tightening pause at its two-day mid-year meeting late in June.

Flexibility is the most important point for policymakers to emphasize in this difficult period of searching for neutrality when neutrality is hard to define. The Bank of Japan and the European Central Bank need to be very careful not to exacerbate the slowdowns of their respective economies already underway given the threat of higher inflation from higher energy prices. The Federal Reserve also faces a difficult task. Higher energy prices will probably seep through and produce higher core inflation approaching a 2.5-percent rate by fall. If, however, the real economy and markets fail to recover even as interest rates continue to fall, the Fed will need to give serious consideration to holding the fed funds rate around 3 percent and allowing a slowing global economy to ease the upward pressure on energy prices. That said, a sharp drop in stock prices or the housing market should not result in a Fed easing, since even more inflation pressures, especially from energy and resurgent asset markets, would only require a disruptive resumption of rate increases in the near future.

No one at the Fed or in the marketplace ever said that the search for neutrality would be an easy one. Events in the spring of 2005 are reinforcing that message.

#18282