Fed on rough road to normalisation

US interest rates are already at or near their summit

by Neil Williams in London

Thu 25 Apr 2019

The US Federal Reserve, presiding over a shrunken output gap, perkier wage growth and what, at more than 10 years, is about to become the longest business cycle since 1857, remains the test case for whether any central bank can 'normalise' interest rates. I expect the Fed to fail in this endeavour, with the likelihood being that US rates are already at or close to their summit. Even if the Fed surprises markets by raising rates again, this would still leave its official policy rate barely positive in real terms.

Five-year inflation expectations are still no higher than at the start of quantitative easing. They remain sufficiently anchored around the Fed's preferred 2% level that faster wage-growth (averaging 3% in 2018) could be tolerated. Should protectionism build, its room to do more will be curtailed.

As Fed Chair Jay Powell cautions, the flat Phillips curve – identifying the inverse relationship between unemployment and inflation – may not steepen soon. With the lagged effects of at least five of the previous nine quarter-point rate rises yet to come through (taking an average 18 months before they fully affect consumer spending), within-target core inflation and the threat of protectionism, this should mean a peak rate no higher than the Fed's currently inferred 2.75%, and historic average 5%. To avoid recession, the Federal Open Market Committee may have to start easing rates again in late 2020.

The 'Taylor rule' (an interest rate forecasting model) pitches the funds target around 3.7%, assuming the non-accelerating inflation rate of unemployment lies close to the average 3.8% that the FOMC expects until 2021. Yet, by taking account of QE, planned quantitative tightening and the fiscal outlook, Hermes Investment Management's 'Policy Looseness Analysis' suggests a true funds rate in 2020 closer to minus 1.5%, or around minus 3.5% in real terms. We quantify the impact of QE by adjusting real rates for former Chair Ben Bernanke's assertion that the $600bn part of QE2 in 2011 was akin to cutting an extra 75 basis points off the funds target.

Chart 1 suggests the Fed's current rate plans fall short of taking the de facto real policy rate back to pre-2008 financial crisis levels. It also suggests, assuming symmetry for QT, that the Fed could 'take out' up to 50 basis points of further increases in 2019 if it sustains its latest non-reinvestment plan. Based on budget estimates from the Organisation for Economic Co-operation and Development, this would still leave the fiscal side supporting growth.

To go a step further, Chart 2 attempts to map the overall stimulus v. the output gap monitored by the FOMC. The extent of stimulus is gauged by how far the combined monetary and fiscal position lies from its long-run average, using the same variables and trade-offs as in Chart 1. Stimulus is plotted as a negative on the axes, and monetary/fiscal impulses are assumed equal potency. As policy 'normalises', the points should corkscrew back to the vertical axis as recovery (positive output gap) warrants stimulus removal.

On this basis, Chart 2 identifies the rate required in the long-run to get back to 'normal' and gives an idea of how 'normal' will vary from the 'peak' rate hinted at by the Fed. It suggests the economy would need as much as 500-basis-points-worth of extra tightening from somewhere else if the FOMC is to peak at its preferred 2.75% and yet still allow overall policy to reach 'neutrality'.

A sharp fiscal contraction seems improbable before the 2020 presidential election. However, normalisation could on this basis be achieved by, over time, winding down an additional $4tn of QE-bought bonds – over and above current plans – wiping out the Fed's entire balance sheet. This is much lower than FOMC members' latest plan and looks highly unlikely to happen. They are already tapering QT and planning to stop it altogether this October. Even if they reverted to their faster pace from the first quarter of 2019 ($50bn per month), exhausting the balance sheet would still be slow, taking us all the way to the 2024 election.

While the road to 'normal' – for the Fed and other G7 central banks – looks closed off in interest-rate terms, overall policy neutrality could, in principle, be achieved by pulling more aggressively on other levers.

The practical hurdles, though, in doing so (current central bank thinking, growth and political risks) suggest the gaps will stay open – leaving macroeconomic policy loose for much longer yet.

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