Neutral, Natural, *or* Normal

An interest rate disaster. Be very afraid.

BY BERNARD CONNOLLY

The idea of a natural rate of interest has a long history. Evoked by Henry Thornton more than two centuries ago, it was put center stage by Knut Wicksell more than a century ago. The supreme guru of modern central banking, the "neo-Wicksellian" Michael Woodford, defines it as the equilibrium real rate of return in the (fictional) case of fully flexible prices. Equivalently, in Woodford's world, "the natural rate of interest is just the real rate of interest required to keep aggregate demand equal at all times to the natural rate of output." The problem in the real world is that once there has been a departure from monetary equilibrium, it became virtually impossible to identify the natural rate, still less to establish it.

Anticipating Keynes, one of the greatest—and probably the wisest—of twentieth-century economists, Dennis Robertson, put it very succinctly in 1933, a time when there had very obviously been a departure from monetary equilibrium: "Normality, and its symbol the 'natural rate of interest', seem to be like a path which is plain enough to see while you are treading it, but which is exceedingly difficult to rediscover once you have strayed from it." The truth of Robertson's piercingly accurate judgement can be seen in the monetary events of the past twenty-five years, and not least in the Fed's recent struggles.

Just what has all this got to do with the current obsession of the market and of Fed figures with identifying the "neutral rate," often referred to as the equilibrium rate, $r*$ (a concept derided by Keynes), and working out how far above "neutral" the Fed funds rate will have to go to bring inflation back under control, and how far it can go without creating a deep recession?

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With inflation running in the autumn of 2022 at way above the Fed's 2 percent target, it is not surprising that FOMC members appear to be more or less unanimous in saying that the funds rate will have to go above the "neutral" level even if that will "bring pain," as Fed Chair Jay Powell has warned. Thus, the projections released with the September FOMC meeting statement portrayed the Fed funds rate as peaking at around 4.5 percent in 2023—producing a rise in unemployment and, implicitly, a recession—and then descending over time to a "long run" level of 2 percent.

Ultimately, the Fed will have to recreate bubbles.

What, in the Fed's eyes, is the meaning of the "neutral rate"? In 2003, a very influential paper by two Fed economists, Thomas Laubach (who died tragically young), a close collaborator of Ben Bernanke, and John Williams, now president of the New York Fed, defined the natural rate of interest as the real short-term interest rate that is consistent with output at its potential and stable inflation in the medium term. That was a subtle but important variation on Woodford's theme; it implied an unavoidable recognition that the real interest rate had not always been at its "natural" level. However, it betokened no recognition that Robertson's warning was applicable. Blithely ignoring that warning, one might imagine that the "neutral" Fed funds rate is the Laubach-Williams natural rate plus the target rate of inflation.

So we already have two concepts, the neutral rate and the natural rate, which might or might not be two names for one thing. Confused? In 2005, Bernanke, then a governor in the Greenspan Fed, appeared to add a condition for the "normality" of the natural/neutral rate (Woodford saw the average level of the natural rate—presumably a "normal" rate—as anchored by the rate of household time preference): "The funds rate will have reached an appropriate and sustainable level when, first, the outlook is consistent with the Committee's economic goals, and the slope of the term structure of interest rates is approximately normal, as can best be determined." That statement implied that if maximum (sustainable) employment had been achieved and maintained, and thus that the economy was growing at its present trend rate (say, 1.8 percent, as in the probably optimistic September FOMC projections), and inflation was at its target level of 2 percent, the Fed funds rate would be at an appropriate and sustainable level of 3.8 percent and the yield curve would be modestly upward-sloping, giving a ten-year rate, say, of perhaps just a bit above 4 percent.

It is not at all obvious that such a definition of an appropriate and sustainable rate is consistent with the September FOMC projection of a "longer run" level of 2 percent for the funds rate. Should the Fed not be projecting a longer-run value of the Fed funds rate almost double that resulting from the September FOMC?

The answer to that question is suggested by Robertson's warning: since the conditions of the past twenty-five years have evidently been far from "normal" on anyone's definition, it is indeed effectively impossible to identify the natural rate. Worse, while it is indeed clear that to "bring pain" (in respecting the Taylor Principle) and reduce the above-target inflation rate, the Fed funds rate has to go above the neutral rate in the sense simply of the rate that is neither adding to nor subtracting from the pressure of aggregate demand on aggregate supply, that "neutral" rate may be trending down as it has been doing with occasional interruptions for a generation. Worse still, that downward trend has not been an equilibrium phenomenon produced primarily by demographics, reduced productivity growth, a "global savings glut," or whatever, in which it would still be possible to identify some sort of natural rate. Rather, it has represented ongoing and intensifying intertemporal disequilibrium, caused essentially by the failure by Alan Greenspan and his successors to understand the Schumpeterian nature, the genius, of capitalism.

Be very afraid.

Making a better mousetrap—the "New Economy" of technological innovation so rightly admired by Greenspan—implies putting at least some makers of the Mark I mousetrap out of business. That is as it should be. New mousetrap factories have to be built before they can produce. So resources have to be diverted from other activities; some spending must be deferred to the future, when additional output from newly built capacity becomes available.

In turn, that implies that the "natural" rate must rise when new capacity is in the process of being installed, and then fall back, encouraging demand, when that burst of factory-building has been completed and productive

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potential has been increased. Greenspan got the time sequence wrong, with lasting adverse consequences. The Fed initially restrained real long(ish) rates when "New Economy" investment was booming (even cutting the Fed funds rate repeatedly in response to the incipient financial crisis in the autumn of 1998), propagating bullishness throughout the economy, encouraging investment in activities corresponding to obsolescent Mark I mousetrap factories, failing to "bend" the consumption path, and allowing a frantic stock market bubble to develop. When the burst of tech investment was completed, there was no previously deferred demand to replace it and to take up the increased level of productive potential. In response, the Fed had to embark on its first journey to effectively zero rates.

By targeting, in effect, a Laubach-Williams neutral rate, the Fed set up a succession of cycles in which growth was dependent on ever-bigger bubbles in asset prices and in credit—in effect, Ponzi games. Those bubbles were necessary if recession was to be avoided—or deferred—to counter the tendency, in the absence of Ponzi games, for consumption to trend downwards, after an initial spike up, relative to full-employment income when interest rates are pushed below the rate of household time preference. The Fed, followed eagerly or reluctantly by other central banks, thus created a state in which any upward departure from the inflation target must, if tardily countered by monetary policy, produce a much deeper recession than the central bank anticipates and a real risk of financial crisis.

The long and the short of it is that economies as deep in intertemporal disequilibrium as the U.S. economy—one among many—is, will, along with their financial systems, not now be able to withstand significantly positive real rates for long. In the seven months from March 2022, the seven-year constant-maturity index-linked Treasury yield, perhaps the yield most relevant to business investment projects, leapt, from a deeply negative starting point, by a staggering three hundred basis points. What does that

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mean? Debt continued to balloon after the financial crisis, in tandem with—and induced by—the secular falling trend in real rates. But over the past twenty-odd years, whenever real rates have spiked above the trend implied by rising corporate debt, there has been a Minsky moment: in 2000; in 2007; and in 2022. In all three cases, the result was an equity crash. In all three cases that was (or will be, in the present episode) followed several quarters later by a collapse, actual or incipient, in the economy. The period from 1999 to 2003 saw the Fed do one lap around the interest rate circuit. It did a second lap in 2004–2008. It is now condemned to do a third lap, in which real rates will have to go steeply negative again and recreate bubbles. But this time, with inflation having been allowed to get out of control, the Fed cannot react at the first signs of collapse.

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The risk of financial instability, in the United States and globally, is thus very real. Ultimately, the Fed will have to recreate bubbles. In doing so, it may fall off the knife-edge between liquidation and inflation. Even if it does not, the adverse consequences for productivity growth and for inequality will kill capitalism. The short-lived Truss/Kwarteng attempted policy in Britain, however ham-fisted, was aimed at promoting growth based on initiative, enterprise, and rising productive potential rather than on bubbles in housing and other markets. It was widely condemned as "ideological." The global *nomenklatura* which issued such condemnation and ensured the failure of the attempted escape from intertemporal disequilibrium is, unwittingly or—in many cases, one fears—wittingly, the true slave of ideology, hating the capitalist system which is the only one capable of producing prosperity, freedom, and fairness and the only one consistent with democracy.

That is depressing enough. But the British episode, and its impact on global financial markets, illustrates something even worse. Even if the near-miracle of increasing the anticipated non-bubble rate of return to the rate of time preference, thus allowing the real rate of interest to regain alignment with the rate of time preference (that is, allowing a return to "normality") could be achieved, the long period of intertemporal disequilibrium has so distorted the financial system, with debt piled on debt, that there would be a tremendous financial crisis and a rush into socialism. Be very afraid. ◆