

Economic Strategy

Plain speaking from Janet Yellen

- How the Fed thinks about interest rates.

At a speech to the Executive Club in Chicago on 3 March, Janet Yellen laid out the Fed's intentions for the Fed Funds rate as plainly as possible. To begin, Yellen advanced the idea of the "neutral rate". She said the neutral real Fed Funds rate is neither expansionary nor contractionary when the economy is operating near its potential. "At its potential" means that the economy is operating at full employment. The US economy is at full employment right now. This means that the "neutral rate" is very relevant to the US economy we have right now.

Longer term Neutral Fed Funds rate

Janet Yellen has told us that last December most of the members of the Open Market Committee of the Federal Reserve thought that the longer run value of the neutral real Fed Funds rate was 1%. Now the Fed has a long term target on inflation of 2%. So, an inflation rate of 2% plus a long term neutral real Fed Funds rate of 1% adds up to a long term nominal Fed Funds rate of 3%. This means that the Fed expects the Fed Funds rate to arrive at 3% at the end of this cycle. So we learn that the Fed is targeting a 3% Fed Funds rate in the long term.

Current Neutral Fed Funds rate

What about the short term? Yellen has told us about the *current* value of the neutral real Fed Funds rate. She said this is lower because of headwinds to the US economy, as a result of the financial crisis and perhaps a lingering sense of caution by households and businesses after the Great Recession.

Yellen believes that the current value of the neutral real Fed Funds rate is 0%. To this 0% we must add where inflation is now. The measure of inflation that the Fed uses is the core personal consumption deflator. This is currently 1.74%. The core personal consumption deflator usually runs around 50 basis points lower than the core CPI. To calculate the current nominal neutral Fed Funds rate we must add an inflation rate of 1.74% plus a current neutral Fed Funds rate of 0%. This adds up to a current nominal Fed Funds rate of 1.74%.

This means that to stabilize the US economy at full employment (and we are now at full employment) the Fed needs to move the Fed Funds rate to 1.74%. Right now the effective Fed Funds rate is 66 basis points. The startling conclusion is that to reach the neutral Fed Funds rate, the US now needs four rate hikes. This suggests a rate hike in March, a rate hike in June, a rate hike in September and maybe a rate hike in December.

Janet Yellen is telling us that the period of pretend rate hikes is now behind us. The Fed is beginning to tighten on a regular fashion. By the end of this cycle, the Fed Funds rate should reach 3%.

Conclusion

The period of pretend rate hikes is now behind us. To reach a neutral Fed Funds rate, the US now needs four rate hikes.

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Reference:

"From Adding Accommodation to Scaling it Back", Speech by Chair Janet L. Yellen, The Executives' Club of Chicago, Chicago, Illinois, March 3, 2017.

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