By: Bevan Graham Economist

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Interest rate cuts: How far and how fast?

Most developed market central banks have either started or are close to starting to reduce the restrictiveness of monetary policy.

Of the central banks we watch most closely, the European Central Bank, the Bank of England and the Reserve Bank of New Zealand have all started, and if Jerome Powell's speech at the annual Monetary Policy Symposium at Jackson Hole is to be believed, the US Federal Reserve will be taking a first step on September 18th.

There are always exceptions. The Reserve Bank of Australia is unlikely to be cutting rates until next year, while the Bank of Japan is at the other end of the spectrum in currently acting to reduce monetary accommodation.

With the question of when to start now answered for most central banks, two further questions immediately arise: How far, and how fast?

How far?

To have an idea of how far, the concept of the neutral interest rate is critical. The neutral interest rate is the rate at which monetary policy is neither restrictive nor accommodative for an economy growing near trend.

Think of the nominal neutral rate as having two components, the real (inflation adjusted) component, commonly referred to as r* (r star) in the economic literature, and the level of long-term inflation expectations. In the United States, r* was generally thought to be around 0.5% prior to the pandemic. Assuming well-anchored inflation expectations of 2%, that gives a nominal neutral rate of 2.5%.

Sound straightforward? The problem is neither the neutral interest rate, nor the trend growth rate for that matter, are directly observable and are not able to be estimated with any reasonable degree of confidence. But while the level is hard to estimate, we can have greater confidence in the direction of travel.

In our recent paper "Neutral Rising" we put forward the case that r* is likely higher now than it was prior to the pandemic. Key points in that argument are as follows:

1. **De-globalisation.** Populist anti-trade policies are leading to increased demand for investment funds as firms home-shore some economic activity. This has become intertwined with the response to Covid-19 which is seeing some businesses wanting to establish more local supply chains.

2. **Geo-political tensions.** As the world becomes more fragmented and factionalised, the trend towards regionalism and "friend-shoring" of economic activity will see increased investment. Geo-political tensions are also contributing to higher defence spending.

3. **Net Zero.** Government's commitment to net zero

carbon emissions requires significant investment, as do more general infrastructure deficits around the world.

4. **Ageing Populations.** This is the controversial one. The consensus view is that an ageing population is deflationary as those approaching and in retirement consume less and save more, putting downward pressure on r*. But we think ageing populations put upward pressure on r* given that once populations have aged, they stop saving and start spending at the same time they are not producing, contributing to a higher r*.

5. **Productivity advancements.** Firms looking to increase productivity through adopting the latest technological advancements (AI) will increase demand for investment funds.

6. **Reduced "glut" of savings.** High levels of savings, typically from Asian countries typified by large current account surpluses, are now diminished. As demand for investment funds is increasing, the supply of savings is falling. Other things being equal, higher rates are thus needed to attract savings.

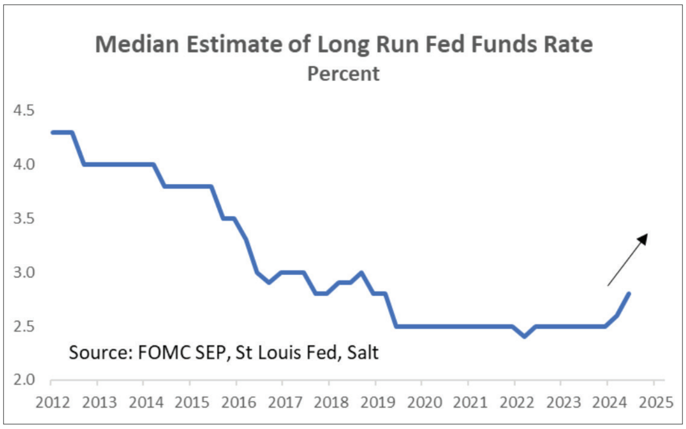
7. **Easier fiscal policy.** There are ever increasing pressures on Government spending, well beyond those already mentioned. Only the most disciplined will be able to manage this pressure within existing base lines, leading to greater spending, higher debt and upward pressure on interest rates.

8. **Global "debt mountain."** The willingness or capacity of indebted states to reduce, rather than roll over their debts, appears to have diminished. Though the relationship is controversial, if an increase in the supply of public debt is not completely offset by a corresponding increase in investor demand for sovereign bond assets, long-run neutral real interest rates may rise. Simply put, this is because the bond buyers are not an identical group to the taxpayers who will service debt obligations into the future.

There are thus good reasons to believe that r* is higher now than it was pre-pandemic and that it may continue to move higher in the period ahead. How much higher is moot, but a move up from 0.5% to 1% or perhaps even 1.5% is not out of the question in our view.

The good news is that with inflation expectations remaining anchored at 2%, that will limit the rise in the nominal rate from 2.5% to between 3.0% and 3.5%. So, higher than it was pre-pandemic, but still lower than the 4.5% to 5.0% level that prevailed prior to the Global Financial Crisis.

Central banks are already revising up their estimates of the long-term neutral rate with the latest Summary of Economic Projections showing the Fed's rate setting committee, the Federal Open Market Committee (FOMC), median estimate at 2.8%, up from the recent low of 2.5%.



How fast?

Assuming the FOMC gets the easing "glide path" perfectly right and can stop cutting rates at neutral, that suggests scope for 200-250bp of easing from the current Fed funds rate of 5.5%.

Some commentators are already calling for fast and furious interest rate cuts from the Fed, based on the presumption the US economy is deteriorating quickly and the central bank is already behind the curve in easing. We disagree. The US economy has surprised with its resilience while wage growth and core inflation have moderated. We still believe a soft landing is more likely than not.

There is certainly a chance that the FOMC decides to cut by 50bp in September. Whether they start the rate cutting process with a 50bp or 25bp cut will likely to come down to the August Labour market report due earlier in September. The prior month saw weaker than expected payrolls growth that if repeated would likely see them cut by 50bp, though a bounce-back in hiring would likely see them go 25bp.

More generally, we know from the Fed's July meeting, and as was reinforced in Powell's speech at Jackson Hole, that the FOMC is now less concerned about the outlook for inflation and more concerned about the outlook for the labour market. So, there is certainly scope for some front-loading of cuts, but not a lot given the now likely higher level of the neutral rate.

So, a number of 50bp cuts is not out of the question, but as the actual Fed funds rate gets into the vicinity of the new neutral rate, which recall we are putting at around 3.0-3.5%, there is a strong case for policy to become more cautious and nuanced. The FOMC may even elect to pause once the Fed funds rate get to, say 4%, to take time to reassess before maybe lowering rates a bit further.

Fiscal policy outlook and election critical in near term in US

The assessment of the likely future level of the neutral interest rate and the factors influencing it is necessarily speculative. But one factor that is impacting on monetary policy and the level of short- and long-term interest rates right now is fiscal policy.

We've written about this many times before so won't labour the point again. The outlook for US fiscal policy is no less than daunting. Indeed, even several Federal Reserve officials have characterised current settings as "unsustainable".

The Congressional Budget Office has US Federal Debt rising from 97% of GDP currently to 122% of GDP by 2034. That projection is built on a "no policy change" basis which assumes Trump's 2017 tax cuts expire at the end of 2025. If they are extended CBO estimates that will add 11 percentage points to the Debt-to-GDP total.

Urgent action is required by the next President and Congress to bring the fiscal outlook back to more sustainable levels. A lack of meaningful action means a higher r* and higher interest rates across the yield curve as the increased debt is funded.

Conclusion and other jurisdictions

Likely higher neutral interest rates will constrain the degree of easing from central banks in the next phase of the interest rate cycle. While this paper has focussed on the US, the issues and conclusions are much the same everywhere, allowing for occasional idiosyncrasies.

In New Zealand that means the neutral rate is also higher here than it was prior to the pandemic and that a similar level of caution needs to be applied to the pace and scope of interest rate cuts. Using the US 3.0% to 3.5% neutral as the global benchmark, we expect the new nominal interest rate here in New Zealand to be in the order of 3.5%-4.0%.