The Fault Lies in R-Star and in Ourselves

Central bankers should give up the search for the neutral real interest rate.

By Kevin Warsh
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The American financial system was at grave risk of collapse in September 2008. It was among the darkest economic periods in our nation's history. All of us who were then on the front lines at the Federal Reserve and the Treasury have since repaired to less strenuous confines.

The lens of time gives us a clearer, more complete picture of events. Many are using this 10-year anniversary to debate the wisdom of particular responses to the crisis. But we should also convey to our successors which policy ideas now in fashion should be reconsidered or discarded.

Before the onset of the 2008 crash, for example, price stability was thought to be a fair proxy for financial stability. Stable growth and steady, moderate inflation were thought to be persistent features of the macroeconomy. Central-bank announcements were to be aimed at dampening natural market volatility. Some still believe such things, despite strong evidence to the contrary.

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Today, the idea most in vogue in central-bank circles is something called "r-star"—the neutral real interest rate at which monetary policy is neither accommodative nor restrictive. Many policy makers and academics now recommend setting Fed interest rates principally by determining r-star. But like many great theoretical insights—this one originally offered by Swedish economist Knut Wicksell in 1898—r-star has been pushed well beyond its practical utility.

Policy makers are currently rejoicing in their good fortune. The U.S. economy is booming: Output is growing more than 50% faster than the Fed forecast a year ago, wages are accelerating,

and labor markets are the strongest they've been in at least a generation. Capital investment is strengthening, and productivity shows some improvement. Asset prices are high. Credit is cheap and widely available. And inflation is running at or near the Fed's avowed target.

The Trump administration's reforms in tax and regulatory policy were well-timed. They caused a business and wage-earner expansion to follow on the heels of a consumer-driven, housing-led expansion that was starting to show its age. The strong trends in the U.S. economy are likely to continue.

Even so, history and hard experience tell us that a boom is not a time for triumphalism, especially for the guardians of financial stability at the Fed. The most consequential period in economic policy is often when the embers of the last fire are gone and the first sparks of the next are not yet visible. Policy makers should not be dismissive of less likely, but more damaging tail events.

There are risks on the horizon. An escalating trade war between the world's two largest economic powers is happening in real time, though a détente could still be reached. Weaknesses across emerging markets are growing, but lenders and counterparties might escape unscathed. The biggest banks just passed their "stress tests" with flying colors—meaning either that they are insulated from failure or that the tests have lost probative value. The "term premium," which affects long-term funding costs for debtors, is near its lowest level in a half-century. It might stay there for a while, but risks are often highest when market measures are lowest.

Are discussions of these risks central to the Fed's pending policy decision? Not according to recent Fed statements, speeches and meeting minutes, which suggest the predominant policy focus is r-star.

In my view, r-star is not a beacon in the sky but a chimera in the eye. The idea of a "neutral" rate is a useful fiction. It makes for an interesting academic thought experiment. In practice, though, it's unobservable, unpredictable, imprecise and highly variable. That makes it a poor guide for policy makers.

The Fed's search for the neutral rate suffers significant failings. First, productivity growth should be a big factor in determining the neutral rate, but productivity forecasts have been wildly off the mark for the past couple of decades.

Second, the neutral rate is endogenous to economic policy. Policy makers' own choices about taxes, spending, regulation and trade alter the economy's potential growth in lagged and imprecise ways and thus affect any meaningful estimate of r-star.

Third, monetary policy today is not just about rates. The Fed's balance sheet, including nearly $3 trillion of excess assets owing to crisis-inspired quantitative easing, makes monetary policy considerably looser. If the Fed's balance sheet isn't neutral, a neutral interest rate is all the more difficult to ascertain. Unwinding quantitative easing before rate hikes would have been far preferable as a policy matter.

Finally, the search for a neutral rate is significantly affected not only by the Fed, but also by the monetary policy choices of other large central banks. The Fed's domestic, closed-economy bias adds even more obstacles to an already overambitious adventure in policy-making.

Reducing the conduct of monetary policy to a star, or a rule, is tempting but unwise. In his recent remarks at Jackson Hole, Wyo., Fed Chairman Jerome Powell showed suitable humility in questioning the location of r-star. He should go further and question the whole notion that r-star has any significant practical use for the Fed. Rarely are complex problems solved by pointing to a single, hard-to-reach object and assigning magical properties to it. As Shakespeare's Julius Caesar reminds us: "The fault, dear Brutus, lies not in the stars but in ourselves."

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