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A hawkish tone, but for good reason

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- Fed Chairman Powell had little new to say at the annual Jackson Hole symposium, but his tone was more hawkish than in past speeches. He reiterated that the Fed is prepared to raise rates further and that they intend to hold rates at a restrictive level until inflation is “sustainably” moving down to the 2% target. This is expected to require a period of below trend growth, but so far in 2023, GDP growth has come in above expectations and above the longer run trend. This is making the Fed less confident in the trajectory of inflation despite the last two months of promising data.
- Powell noted that we cannot identify with certainty what the neutral rate of interest is, but we can safely say that the current rate is above it. The latest estimates of the neutral rate support this claim, though the difference between the current rate and the neutral rate depends on which estimate you are observing. This uncertainty increases the risk of over or under tightening.

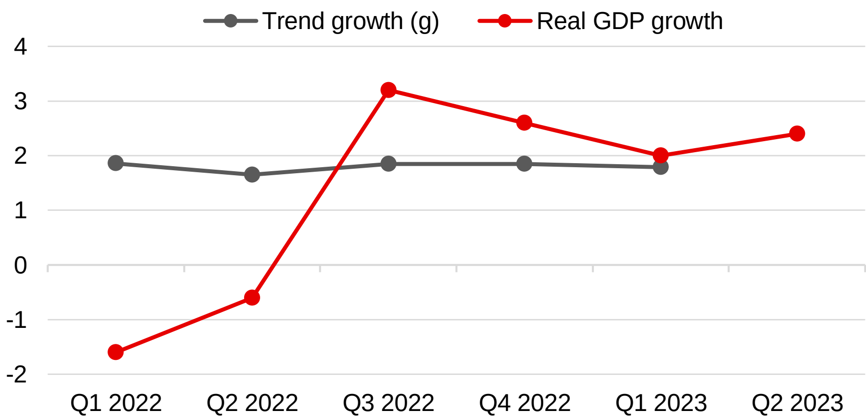
Expanding above trend

In his Jackson Hole symposium speech, Fed Chairman Powell referenced trend growth in the US and its implications for inflation. It’s expected that for inflation to sustainably fall toward the Fed’s target, there will need to be at least some period of growth in real GDP that is below trend. Exactly how long this period must be is unknown, but achieving even one quarter of below trend growth may not happen until 2024.

Trend growth reflects the productive capacity of the economy, and when real growth is consistently above trend, there exists a positive output gap where aggregate demand exceeds aggregate supply. The economy is, at this rate, growing faster than what is sustainable which can lead to inflation.

It would be a mistake to view inflation through this lens alone, but at the very least, having real growth above trend adds upward pressure to prices. This is partly the reason why Powell’s tone came off more hawkish despite inflation falling considerably over the last two months.

The US economy continues to grow above trend
Tend growth (g) and real GDP growth, % AR



Source: New York Fed, MUFG Bank Economic Research

“Confidence” is a key word that Powell repeated. Specifically, “confidence” that inflation is falling toward the Fed’s 2% target. When real growth is above trend, as it was in Q1 of this year, and as it will most likely be in Q2 once trend growth estimates are updated, there is less “confidence” that inflation will continue to fall at the same rate it has in the past 2 months. Combined with the current strong labor market and robust consumer spending, it was right for Powell to have a hawkish tone and to remind markets that inflationary pressures still exist.

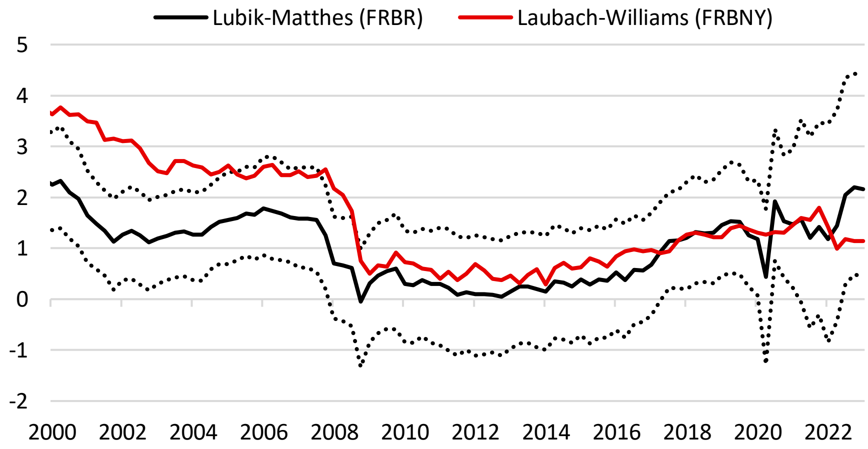
Estimating the neutral rate

As Powell noted, it’s difficult, if not impossible, to identify the neutral rate with absolute certainty. There do, however, exist a couple of leading estimates that shed some light on the neutral rate. The methodology developed by Laubach-Williams and recreated and published by the New York Fed points to a very low neutral rate, just above 1% as of Q1 this year (this also is the source of trend growth estimates highlighted in the earlier chart). Under this methodology, the current level of interest rates is well above the neutral rate, and we are certainly in restrictive territory. If the neutral rate is indeed this low, the risk of over tightening and pushing the economy into a recession is greater.

The second estimate was developed by Lubik-Matthes and is published by the Richmond Fed. With this methodology, the neutral rate begins to rise beginning in 2022, diverging from the estimate published by the New York Fed. As of Q1 2023, the neutral rate is estimated to be above 2%, but there are very wide upper and lower bounds where the neutral rate could be higher than 4% or lower than 0.5%. The risk of under tightening is greater with this estimate.

Neutral rate estimates begin to diverge in 2022

Neutral rate (r) estimates, %*



Note: Dotted lines show the upper and lower bounds of Lubik-Matthes estimate
Source: Richmond Fed, New York Fed, MUFG Bank Economic Research

It was wise for Powell to refrain from commenting on the exact level of the neutral rate, and instead focusing on the uncertainty of estimates. Even if estimates are reliable within a certain margin of error, markets are very reactive and making claims without confidence can only make the Fed less credible.

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