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Fed Must Go Full Monty on 'Natural' Rate Estimate

David Beckworth

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The Fed began a new chapter in its history in December by raising interest rates for the first time in almost a decade.

A key reason for this historic liftoff of interest rates is the belief by Fed Chair Janet Yellen and other monetary officials that the "natural" interest rate has risen and the Fed must follow suit.

So what is this mysterious natural interest rate, and why must the Fed follow it?

The natural interest rate is the value to which interest rates naturally gravitate, based on the health of the economy. It rises when the economy is heating up and falls when the economy is cooling down.

For example, during the economic boom of the late 1990s, firms saw rising profitability and wanted to expand production. They financed it by borrowing funds or using their savings. Households saw rising future incomes and responded by borrowing against their future incomes and saving less.

These developments meant both an increase in the demand for credit and a reduction in the supply of savings. Interest rates were "naturally" being pushed up.

The opposite happened during the Great Recession. Firms saw less profitability, and households saw lower future incomes. They consequently borrowed less and saved more. Interest rates were "naturally" pushed down.

The natural interest rate, in short, is the market-clearing level of interest rates. A neutral monetary policy is one where the Fed aligns its target interest rate with the natural interest rate.

Below Zero

Back in 2008, Fed officials believed that the natural interest rate was falling sharply, and therefore it rapidly lowered interest rates. The Fed, however, was not able to keep up with the descent of the natural interest rate once it passed zero percent.

Beyond that point, people would begin to hoard cash rather than earn a negative interest rate. So the Fed stopped there and resorted to other measures, like its large-scale asset-purchase programs, as a way to stimulate the economy.

Fed officials saw the slow recovery that followed 2008 as indicating a slow return of the natural interest rate to zero percent. That is why they kept interest rates at zero percent for so long. They did not want to get ahead of the natural interest rate.

Only now do Fed officials believe the natural interest rate has gone high enough to warrant the first interest rate hike since 2006. And so begins a new chapter in the history of the Fed.

An important part of this new chapter appears to be an increased reliance by the Fed on the natural interest rate to help guide monetary policy, a development that economists are watching closely.

Considerable discussion was given to it at the October 2015 Federal Open Market Committee meeting, followed by speeches on it by Fed Chair Janet Yellen and Fed Governor Lael Brainard. All this attention suggests that the Fed is moving toward a more "au naturel" approach to doing monetary policy.

This is a much welcomed development but for one big problem: the Fed will not reveal to the public its estimates of the natural interest rate. This makes no sense.

When the Fed started targeting the M1 money supply in the mid-1970s, it reported the actual M1 supply. Similarly, when the Fed switched to targeting non-borrowed reserves in 1979, it reported the actual non-borrowed reserves supply.

So why isn't the Fed reporting its natural interest rate estimates now that they are increasingly being used as a kind of target to guide interest-rate setting?

It is true that the natural interest rate is not directly observable and that there is some uncertainty surrounding its true value. But the Fed has sophisticated estimates of the natural interest rate that account for this uncertainty, as Yellen revealed in a recent speech.

The Fed should regularly update and release these data to the public. They would help everyone better understand what the Fed is doing. This is especially true going forward as the Fed continues to normalize monetary policy. The Fed can only help itself by publishing this information.

Imagine if this information had been available over the past seven years. The Fed could have pointed to it every time someone claimed, "The Fed has artificially lowered interest rates!" and shown that it was simply tracking the natural interest rate, which had fallen below zero percent. It would have saved the Fed a lot of grief, but instead the Fed chose not to reveal this information.

Going au naturel means that you reveal everything. This is just as true for the Fed as it is for a nudist colony. Neither place works if key parts are concealed. For the Fed, that means going full Monty with its natural interest rate estimates.

Until then, the Fed is only hurting its au naturel credibility.

Beckworth, a former U.S. Treasury economist, is adjunct Cato Scholar and associate professor of economics at Western Kentucky University.