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The Next Big Fed Debate: Has the Era of Very Low Rates Ended?
Fed officials trying to figure out just-right interest rate and some think they might be close to that destination

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Investors shuddered on Wednesday after Chair Jerome Powell suggested the Federal Reserve was ready to take a break from cutting rates—and that the total quantity of reductions might be shallower than previously thought.

Powell has described recent rate reductions as an effort to recalibrate borrowing costs to a more "neutral" setting. His framing raises a question that hasn't been relevant until now: What, exactly, is "neutral" in the post-pandemic economy?

The neutral rate of interest, or the rate that keeps the economy at full employment with stable inflation, can't be directly observed. Instead, economists and policymakers infer it from the behavior of the economy. If borrowing and spending are strong and price pressures are rising, the current interest rate must be below neutral. If they are weak and inflation is receding, rates must be above neutral.

The debate over where neutral rests wasn't particularly important earlier this year, because interest rates were at a level nearly all Fed officials deemed to be restrictive. That was intentional. Officials raised rates aggressively in 2022 and 2023 to lower inflation by cooling down economic activity.

But the question is front and center now because the Fed has cut rates by a full percentage point, or 100 basis points, and the economy appears to be in reasonably good shape. Like a captain who tries to avoid slamming into the dock as a boat nears its slip, central bankers could become more cautious in making cuts if they think they might be closer to their ultimate destination because the neutral rate has gone up.

"We don't know exactly where it is, but ... what we know for sure is that we're a hundred basis points closer to it right now," Powell said Wednesday. "From here, it's a new phase, and we're going to be cautious about further cuts."

Finding NeutralFed officials have revised up their estimates of the rate likely to prevail over the long runSource: Federal Reserve*Note: Midpoint of target range

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"We don't know exactly where it is, but ... what we know for sure is that we're a hundred basis points closer to it right now," Powell said Wednesday. "From here, it's a new phase, and In September, Powell suggested it was unlikely interest rates would return to the ultralow levels that prevailed before the pandemic, when many countries were issuing bonds with negative yields. "My own sense is that we're not going back to that, but, honestly, we're going to find out," he said. "It feels to me that the neutral rate is probably significantly higher than it was back then."

Officials are trying to figure out where neutral sits at the same time President-elect Donald Trump has promised to revamp trade and immigration policies. New shocks could complicate efforts to determine the economy's new normal. With inflation still above their target, that could add to further caution in cutting rates.

Estimates creeping up

Following the 2008 financial crisis, economists and Fed policymakers steadily revised down their estimates of the neutral rate. Superlow interest rates and reservoirs of monetary stimulus didn't deliver much of an economic boost. Some economists argued that low interest rates were here to stay, thanks to demographic headwinds from an aging workforce and a chronic shortfall of demand for new investment.

Some of these same economists think neutral rates have gone up in the past few years, after a barrage of fiscal stimulus shocked the economy into a new equilibrium during the Covid-19 pandemic.

The view last decade that borrowing costs would stay low became embedded in bond yields, mortgage rates, equity prices and countless other assets. The prospect of a higher neutral rate suggests mortgage rates, for example, might be stuck above where they were in the 2010s.

Fed officials' projection of the longer-run fed-funds rateSource: Federal ReserveNote: Median projection is displayed

we're Economists cite several factors that could be boosting the neutral rate, including higher government deficits that will reduce private savings. Meanwhile, investment demand could be higher because of the green-energy transition, a desire to diversify supply chains, and an artificial-intelligence-fueled frenzy for electricity-intensive data centers.

Over the past year, neutral-rate estimates by Fed officials have gradually crept higher.

Every quarter, Fed officials project where rates will settle over the longer run, which is in effect their estimate of neutral. The median estimate declined from 4.25% in 2012 to 2.5% in 2019. It stayed at that level through 2023 but has steadily crept higher in all four quarterly projections this year—to 3% in those released Wednesday.

Eight of 19 officials' estimates were above 3%. In June 2023, only two officials thought neutral was above 3%. With the latest cut, the benchmark fed-funds rate will sit around 4.3%.

'Know it by its works'

Powell has long been dismissive of using overly precise estimates of the neutral rate to set policy. The Jesuit-educated central banker often asserts that officials only "know it by its works."

The upshot is that even if the neutral rate has gone up, "we won't have clear, strong evidence of that" in time to set policy accordingly, said Jon Faust, who served as a senior adviser to Powell from 2018 until June.

Faust said there's good reason to think neutral could be as low as 2.5% and as high as 4%.

In the run-up to this week's rate cut, a handful of Fed officials had begun to voice unease with assuming that the central bank could make deeper cuts based on what might be a flawed notion about the location of neutral.

"A strategy of repeatedly lowering the fed-funds target range toward a more neutral level relies on confidence that the neutral level is materially lower than where rates are now," Dallas Fed President Lorie Logan said in a speech last month. Recent data offers evidence that neutral has gone up, and there are "some hints that it could be very close to where the fed-funds rate is now."

Logan warned the Fed would face an unappetizing prospect of having to hike rates if the central bank cuts too far past neutral and inflation reaccelerates.

A new regime

To be sure, the strength of the economy in the face of higher interest rates in recent years could reflect some temporary factors, such as elevated immigration or the ability of households and companies to lock in lower rates during the pandemic. Some economists think as those forces wane, the Fed's interest-rate stance could start to bite into economic activity more than it has.

But as more time passes with the economy growing steadily, "it should at least raise the possibility among policymakers that we've just been shocked into a new regime" of higher neutral rates, said Jason Thomas, chief economist at private-equity manager Carlyle Group.

Just as market participants and policymakers slowly concluded 10 years ago that lower interest rates weren't simply due to the Fed's easy-money policies but instead reflected broader structural forces, so too could investors and central bankers conclude over the next few years that higher interest rates might not simply reflect the Fed's rapid hikes of 2022-23 to corral high inflation.

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Recent data pointing to an increase of labor productivity "signals to me that this is an economy that is fundamentally different than what was observed in the decade after the global financial crisis," said Thomas. By next spring, more economic actors might "come to the realization that 'higher rates were all due to the Fed' is not a full explanation for what's happened."

If officials conclude that the neutral rate has moved up, then the Fed could be done cutting for quite some time, said Thomas.

“This last cut puts them low enough that they could say, ‘This might be the upper bound on where the neutral interest rate actually is, and we’ll just wait it out to see it,’” said Eric Rosengren, who was president of the Boston Fed from 2007 to 2021.