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Interest Rates Look Kind of Low Right Now

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ANALYSIS

You've heard the reasons the Fed will probably raise rates, if not this week then sometime soon: the inflationary effects of the AI investment boom and the Iran war energy crunch. There is another critical factor you may not have considered: Interest rates are, simply, low. For now, and for the foreseeable future, rates at today's level or higher should be considered normal.

You might ask, low relative to what? Theoretically, there is a "neutral" interest rate that keeps growth, unemployment and inflation steady, like the optimal thermostat setting that keeps your house comfortable. Over the long run, rates should average around neutral.

In September, the median Fed official thought the fedfunds rate would be 3.2% over the long run, well below its current setting of 3.75% to 4%. That is why many Fed officials had described rates as "restrictive," i.e., holding back demand and price pressure.

But neutral can't really be observed. It must be inferred from the economy and markets, and neither is behaving as if rates are restrictive: Growth is solid, stocks are near a record, and big speculative companies like Anthropic are raising billions of dollars.

One way to measure neutral is to ask where markets think rates will be for the next 10 years. A popular model developed by economists Tobias Adrian, Richard Crump and Emanuel Moench (known as the ACM model, for short) and maintained by the New York Fed divides a 10-year bond yield into expected short-term rates over the next decade and a "term premium," the extra return investors demand to lock up their money for years instead of weeks.

With the usual caveat that models are imprecise, this one as of last week said markets think short-term rates will average 4.3% over the next decade, which implies today's rates are relatively low.

Fed Chairman Kevin Warsh has played down "neutral" as a useful concept but has said financial conditions don't look restrictive, implying he is comfortable raising rates further.

This will disappoint borrowers hoping for a big drop in rates once inflation and oil recede. The good news is that a higher normal for rates points to a higher normal for economic growth, too. *This appeared in the WSJ Economics newsletter. To subscribe to the newsletter, go to wsj.com/newsletters.*

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