



DOW JONES, A NEWS CORP COMPANY

DJIA **26157.04** 0.03% ▲Nasdaq **7407.01** -0.06% ▼U.S. 10 Yr -8/32 Yield **2.737%** ▼Crude Oil **65.32** 0.91% ▲Euro **1.2470** 0.46% ▲

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit <http://www.djreprints.com>.

<https://www.wsj.com/articles/long-after-janet-yellen-leaves-interest-rates-will-bear-her-mark-1517409314>

ECONOMY | CAPITAL ACCOUNT

Long After Janet Yellen Leaves, Interest Rates Will Bear Her Mark

Federal Reserve chairwoman's influence has shifted the neutral rate, anchoring the Fed's entire rate path and justifying the glacial pace of increases



Federal Reserve Chairwoman Janet Yellen, shown at a news conference in Washington in December, persuaded colleagues to lower their estimates of where rates will settle in the long term. PHOTO: JONATHAN ERNST/REUTERS

*By Greg Ip*

Jan. 31, 2018 9:35 a.m. ET

Janet Yellen leaves a huge and largely unappreciated imprint on interest rates that will reverberate long after her last Federal Reserve policy meeting Wednesday.

This isn't because of the rate increases the Federal Reserve chairwoman engineered over the past four years. Rather, it is because she persuaded her colleagues and the broader public to change their views radically on where interest rates should be in the long run.

When Ms. Yellen took office in February 2014, her colleagues generally

believed short-term rates, then zero, would eventually return to their precrisis average of 4% (or 2%, after inflation). The notion of where rates will settle in the long run is also called the equilibrium, natural or neutral rate: low enough to keep the economy growing and unemployment low but high enough to maintain stable inflation. Over the course of Ms. Yellen's term, thanks to her persuasion, Fed officials ratcheted down their estimates of neutral to 2.8% (0.8% after inflation).

The decline in neutral, in turn, plays a key and largely unappreciated role in how the Fed has, and will continue to, set interest rates. Just as distance to the runway determines how soon and how rapidly an aircraft descends, the distance to neutral determines when the Fed raises rates and how quickly. By convincing her colleagues the neutral rate had fallen, Ms. Yellen has anchored the Fed's entire rate path, justifying the glacial pace of increases Ms. Yellen pursued and her successor, Jerome Powell, plans to continue.

The Swedish economist Knut Wicksell first described the neutral rate more than a century ago. Think of a market in which savers supply and borrowers demand funds. At the neutral rate, the supply and demand for funds is in balance. It can't be directly observed, but it can be inferred. If the economy is overheating, then rates are probably below neutral, fueling excess borrowing and spending. If inflation is dropping, rates are probably above neutral; there is too little borrowing and spending.

For years, central banks paid little attention to neutral. It had been pegged to around 4% in the early 1990s and didn't seem to have moved much since. The term, and its variants, appeared in barely 1% of Fed speeches and statements before 2014. Shortly after Ms. Yellen took office, neutral began to occupy the Fed's attention. By 2017, it was cropping up in nearly 20% of Fed speeches and statements, according to an analysis at The Wall Street Journal's request by Prattle Analytics LLC, which quantifies market-moving language from companies and central banks.

After her first full meeting as chairwoman, Ms. Yellen had the accompanying statement hint that neutral had dropped, at least for the time being. More dovish colleagues began making the case in public, and by that summer, most were marking down their estimates.

Initially, Ms. Yellen was looking for an explanation for why such low rates were generating only modest growth. She blamed temporary headwinds, such as the need to pay down crisis-era debts. As the crisis receded, economists such as Harvard University's Larry Summers argued there was more to it: The world had entered a low-rate era. Aging populations and low productivity growth sapped the demand for funds, while high saving in the likes of China and investor hunger for safety buoyed the supply.

The implication: The U.S. economy simply couldn't tolerate rates as high as in the past. If the Fed ignored the lesson, it could trigger a new recession. "My colleagues and I began to realize, Gee, the new normal was very

different,” Ms. Yellen recalled last year, which “led to a big rethink about how much we would actually need to raise” interest rates.

Ms. Yellen faced resistance from insiders such as Jeffrey Lacker, then president of the Richmond Fed, and outsiders such as John Taylor, a Stanford University economist, who thought scrapping longstanding estimates of neutral risked inflation, asset bubbles and lost credibility for the Fed. But the majority sided with her, persuaded in great part by rock-bottom bond yields. John Williams, who had been Ms. Yellen’s research director at the San Francisco Fed and succeeded her as president, and a top Fed staffer, Thomas Laubach, had developed a now-ubiquitous formula that consistently showed neutral to be historically low.

A low neutral rate is likely to remain the consensus within the Fed for some time after Ms. Yellen leaves. Mr. Powell buys into it, Mr. Williams is under consideration to serve as vice chairman and Mr. Laubach will advise Mr. Powell on rate decisions.

The risk for Mr. Powell, as Mr. Wicksell noted a century ago and Ms. Yellen has more recently, is that neutral is uncertain, and it changes. The forces holding back growth and borrowing may in fact be temporary. Productivity, for example, could rise, pushing the neutral rate up with it. Indeed, bond yields are now edging up as investors curb their prior pessimism about the economy.

Ms. Yellen’s bet on a low neutral rate has served the economy well so far. If Mr. Powell has to undo the bet, his term promises to be a lot rockier.

Write to Greg Ip at greg.ip@wsj.com

Appeared in the February 1, 2018, print edition as ‘Yellen Bequeaths a New Normal for Rates.’

Copyright ©2017 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit <http://www.djreprints.com>.