R-star Ruminances

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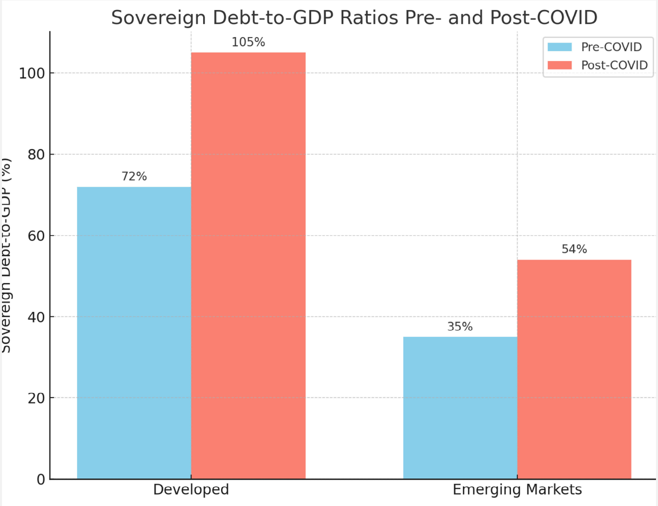
Three Points

- Indebted Sovereign Demand should eventually put downward pressure on short term safe interest rates.
- Rebuilding of the ERP will be a key driver of the R-star of the future
- From the point of view of policy guidance, FCI-star is a better concept than R-star

Roadmap

1. Indebted Sovereign Demand
2. Safe Interest Rate and the ERP
3. FCI-star vs R-star
4. Final Remarks

Sovereign Debt

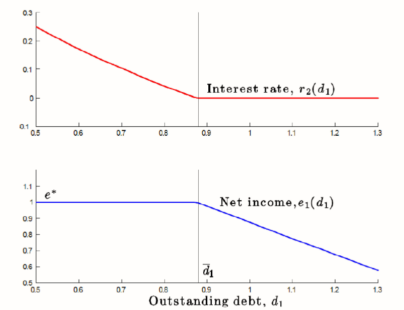


Source: IMF (ChatGPT)

Aggregate Demand Drag

Higher indebtedness implies lower R-star...

Macro equivalent of: "Small loan, a problem for the borrower; Big loan, a problem for the bank."



Source: Korinek and Simsek (2016)

See Ludwig's work for dynamics of this mechanism.

Back-of-the-Envelope: Deficit Adjustment

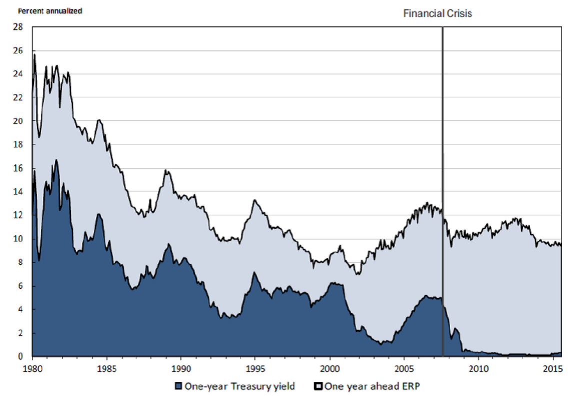
Estimate:

- Assume primary deficits are reduced by an average of 2% of GDP globally.
- Conservative estimates suggest this adjustment can reduce R-star by about 40 basis points from pre-COVID levels.

Timing: Currently delayed but will act as a contingent force (i.e., less fiscal expansion when needed).

Stocks vs. Flows: Term premium shocks imply lower front-end rates (R-star).

Safe Interest Rate and the ERP



Source: Caballero and Farhi (2018); data from Duarte and Rosa (2015)

Back-of-the-Envelope: ERP Rebuilding

Pre-COVID ERP: $\approx$ 400 bps

Current ERP: $\approx$ 40 bps

If we rebuild to half of pre-COVID levels, that implies a drop in rates from current levels of about 160 bps, i.e., from approximately 4.35% to 2.75%.

Speed: To be determined.

- This adjustment could occur smoothly via stable multiples and a gradual decline in interest rates (smooth landing)
- Or, it could happen through a sharp drop in multiples followed by a rapid drop in rates is uncertain....we were at 0 ERP only a few weeks ago...

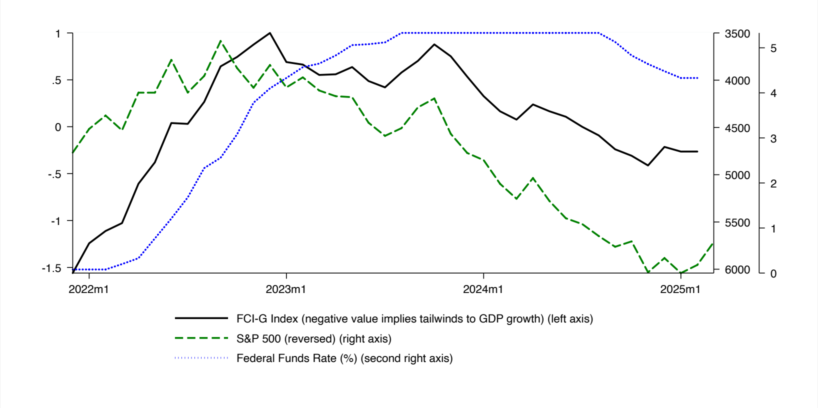
Focus on Financial Conditions

Why focus on FCI rather than R?

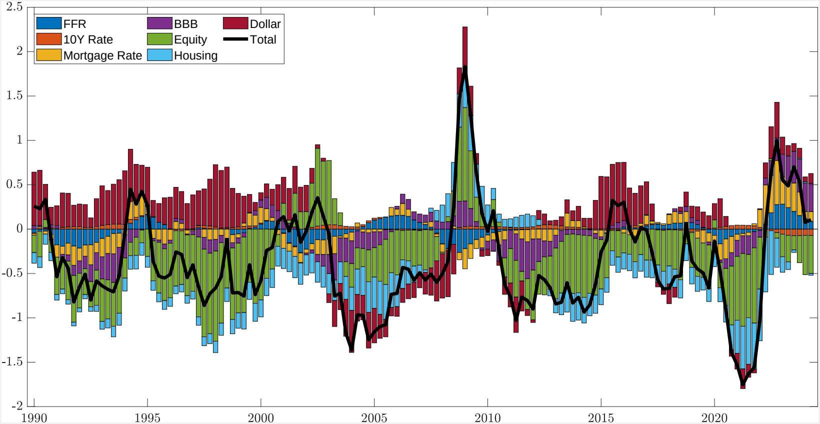
- R suffers from an "omitted variables" problem
- FCI has one less degree of separation from aggregate demand.

  "Financial conditions matter to us because...they are the main channel to the real economy through which our policy has its affect..." (Chair Jerome Powell's Press Conference, March 2025)
- FCs fluctuations are dominated by *risky* asset prices fluctuations (e.g., stocks & FX), which are driven by a variety of sources beyond monetary policy

FCI dominates R

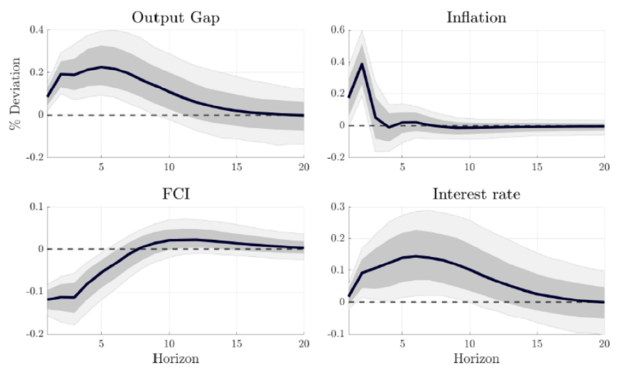


US FCI is Driven by Asset Prices



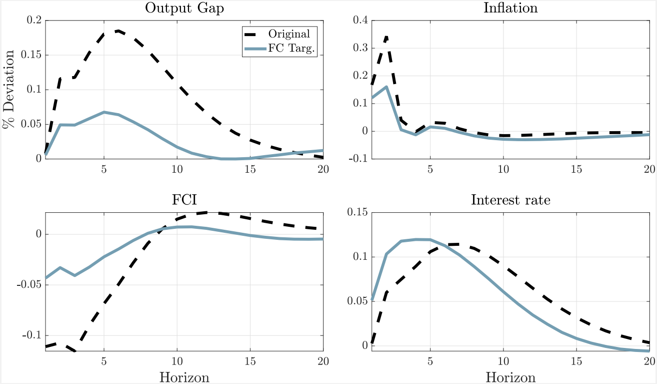
Source: Ajello et al (2023)

Financial Noise Shock



Source: Caballero, Caravello, and Simsek (2024)

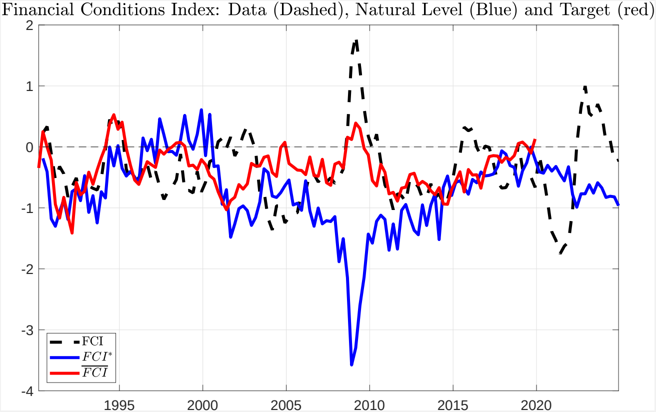
FCI Targeting/Guidance



Source: Caballero, Caravello, and Simsek (2024)

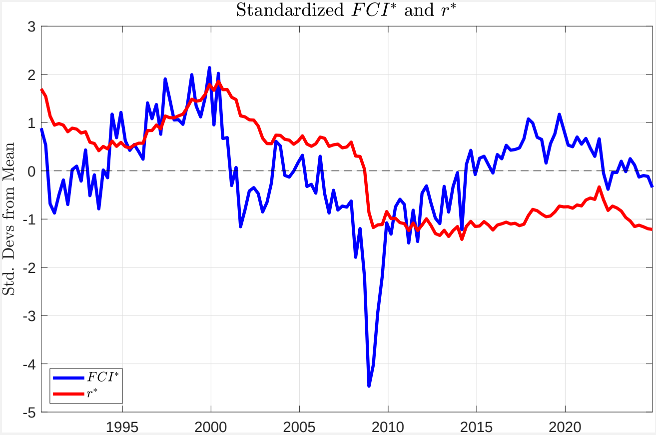
Note: This approach dominates interest rate forward guidance by not constraining the response to noise and engaging market participants in real time.

FCI-star



Source: Caballero, Caravello, and Simsek (forthcoming)

FCI-star vs R-star



Source: Caballero, Caravello, and Simsek (forthcoming)

Final Remarks

My Best Guess:

- R-star will probably converge to the 2.25–2.75% range.
- However, R-star is an unstable concept.
- We prefer to think in terms of FCI-star.
- Currently, FCI is probably very close to FCI-star; only the composition is off.