Economic Bulletin

Why Haven't Recent Rate Increases Slowed the Economy More? Look to Unusually Low Private-Lending Spreads

by: Andrew Glover and Johnson Oliyide

August 14, 2024

Despite a large and rapid increase in the policy rate since March 2022, economic activity has remained resilient. We argue that private-lending spreads—the difference between the policy rate and rates private-sector borrowers pay—are surprisingly low and a major factor for why rate hikes have not slowed the economy more. If spreads are as insensitive to rate cuts as they are to rate hikes, then they may dampen the effect of expansionary monetary policy.

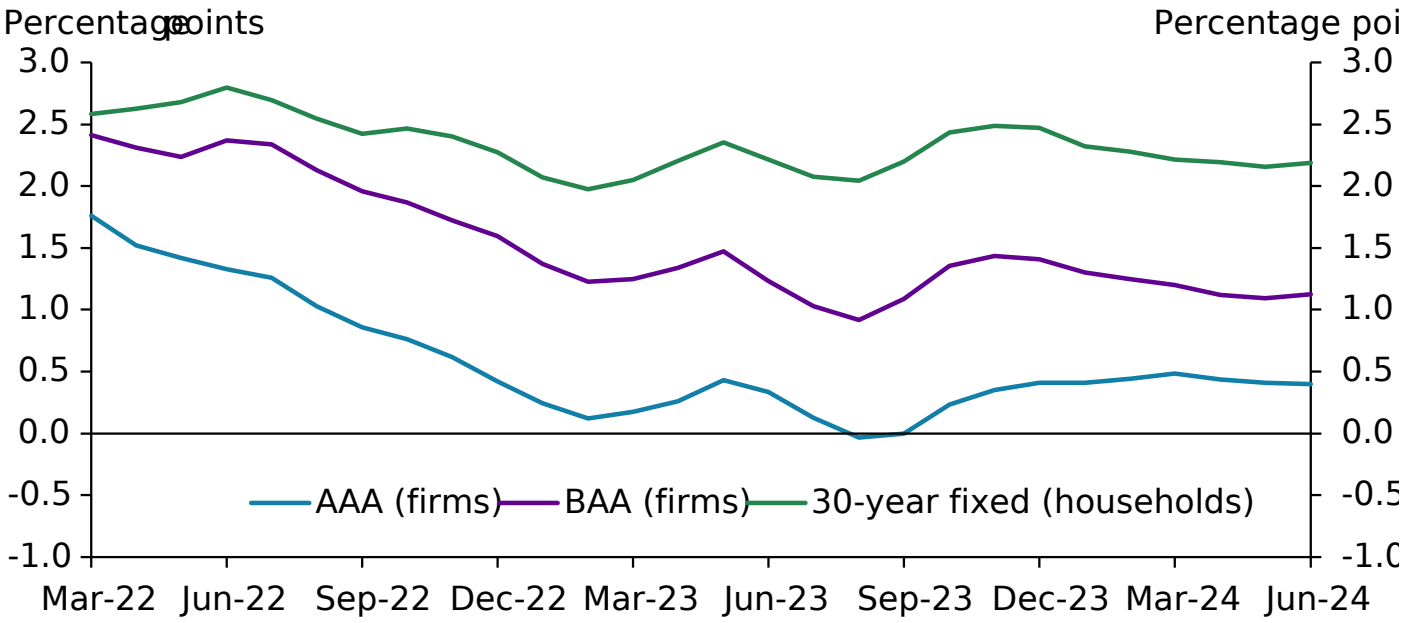
Inflation spiked in 2021 and persisted into 2022, leading the Federal Open Market Committee (FOMC) to increase the federal funds rate from near zero in February 2022 to 5.25 percent in August 2023. Given experiences in historical tightening episodes, policymakers expected an economic slowdown, but the economy remained resilient. For example, at the end of 2023, unemployment was only marginally higher than before the FOMC began policy tightening.

Why haven't higher rates slowed the economy more? One possible explanation is a rise in the neutral rate, defined as the interest rate that would prevail if inflation was at target and economic growth at its potential. If the neutral rate rises at the same time as the policy rate, then the difference between the two rates, or the *stance* of monetary policy, would be unchanged and economic activity unaffected. However, another possible explanation for why rate hikes haven't slowed the economy is that higher policy rates have not passed through to the rates paid by private firms and households as much as usual. If the spread between the policy rate and the rate charged to firms and households is lower than usual, then borrowers are unlikely to feel the full effect of policy tightening.[1]

Private-lending spreads have indeed fallen since the onset of monetary policy tightening in March 2022. Chart 1 shows private-lending spreads relative to the two-year yield on U.S. Treasury securities (our proxy for the short-term policy rate) for both households (conforming 30-year fixed-rate mortgages) and firms (AAA and BAA rated corporate bond yields). From March 2022 to June 2024, spreads fell by more than a percentage point for firms (blue and purple lines) and by 0.5 percentage point for households (green line). Declining spreads have offset higher policy rates, so private-lending rates have risen by less than the policy rate. For example, if the BAA spread had remained constant, BAA yields would have risen roughly 4 percentage

points; instead, yields have risen by less than 3 percentage points. As a result, borrowers have likely pulled back less than they would have if spreads had remained constant (or increased).

Chart 1: Private-lending spreads have fallen since the onset of policy tightening in March 2022



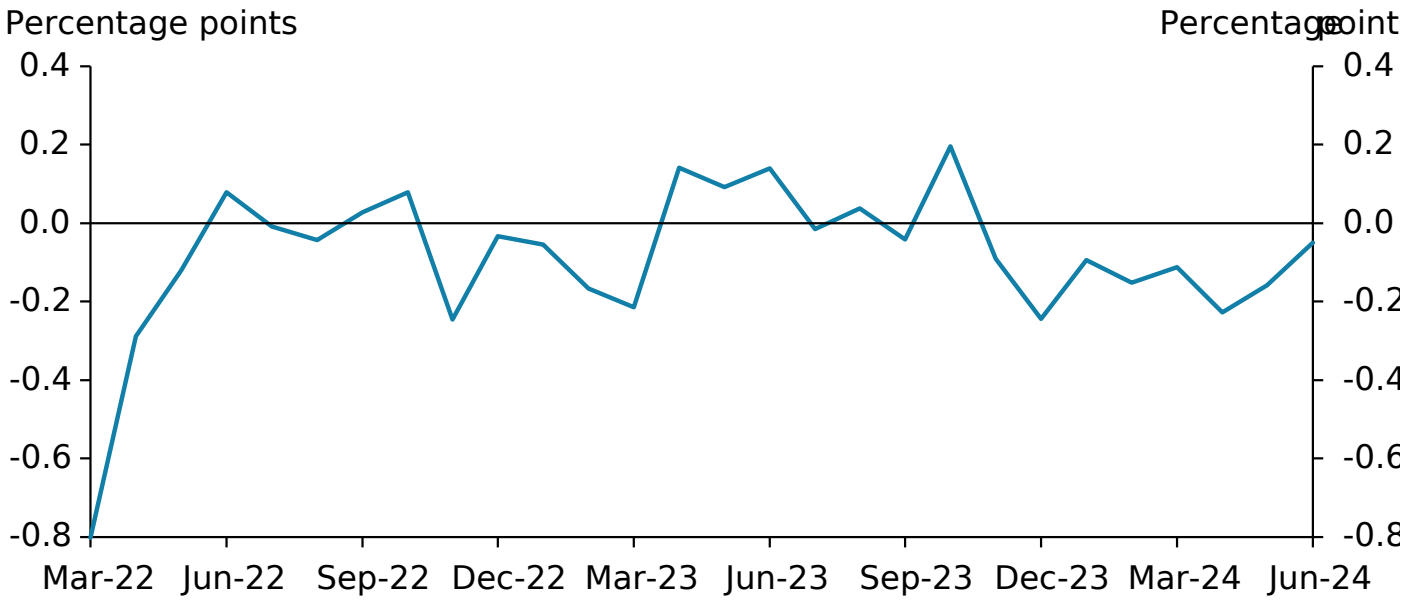
Note: Spreads are relative to the two-year Treasury yield, averaged over the preceding three months.
Sources: Moody's and Optimal Blue Conforming Mortgage Market Index (both accessed via Federal Reserve Bank of St. Louis).

Although private-lending spreads may explain why borrowers haven't been deterred by rate hikes, the economy can be resilient to higher rates for other reasons, such as lower default risk. If households and firms have substantial cash buffers, for example, then borrowers may be less likely to default on loans and thus pay lower spreads. In this case, spreads may be falling in response to policy being unrestrictive, rather than policy being unrestrictive because spreads are falling.

To account for the potential role of default risk in lowering spreads, we examine the "excess bond premium" as introduced by Gilchrist and Zakrajšek (2012). The excess bond premium first measures the spread between a firm's outstanding corporate bond yields and similar maturity government debt, then subtracts an estimate of that firm's probability of default and averages this risk-adjusted spread over all firms. In this way, the excess bond premium controls for changes in default risk: a positive premium means the average corporate bond yield is higher than we would expect based purely on risk adjustment, while a negative premium means the opposite.

Chart 2 shows that the excess bond premium marginally increased early in the tightening cycle but has been roughly constant and low since mid-2022. Thus, while the excess bond premium has not dampened the effects of higher policy rates, it has not amplified them, either.

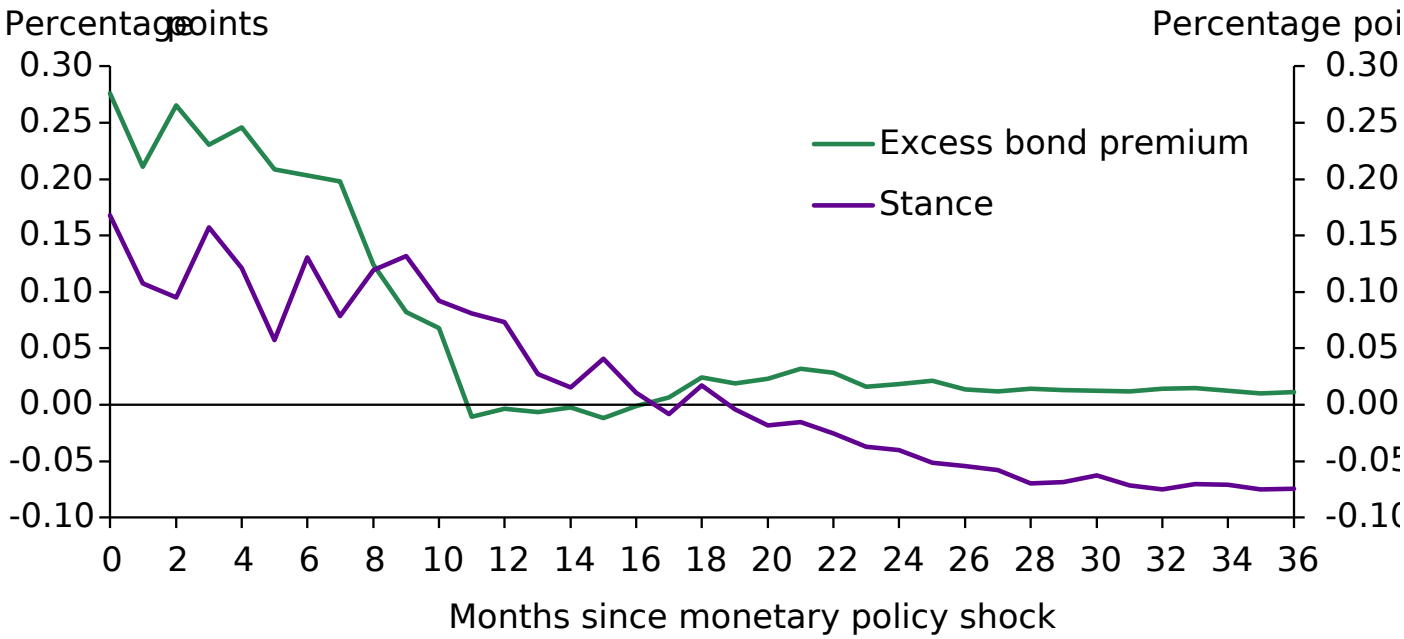
Chart 2: The excess bond premium, which controls for default risk, has remained low



Sources: Gilchrist and Zakrajšek (2012) and Board of Governors of the Federal Reserve System.

A low excess bond premium is surprising, as historical evidence suggests that the excess bond premium typically rises substantially in response to monetary tightening. Chart 3 estimates how an unexpected 25-basis-point contraction in monetary policy typically affects the excess bond premium as well as the stance of monetary policy (here, our proxy for the short-term policy rate minus a proxy for the neutral rate). Positive values indicate that the variable is higher than it was before the shock. In contrast to its behavior during this tightening cycle, the excess bond premium (green line) typically rises significantly and persistently following a monetary contraction. Furthermore, this increase is usually larger than the increase in monetary policy's stance (purple line) because the neutral rate typically rises to offset a higher policy rate. In this sense, it is unsurprising that monetary policy's stance has risen less than policy rates since 2022, but the low excess bond premium has truly defied expectations.

Chart 3: Historically, a contractionary monetary policy shock raises risk-adjusted lending spreads



Notes: Figure plots estimates of response of each variable to a 25-basis-point contractionary monetary policy shock, as estimated and provided by Bauer and Swanson (2023), defined as the change in federal funds rate futures around an FOMC announcement beyond what would be expected given current economic conditions at that point. Stance is the real two-year Treasury yield minus the real five-year, five-year forward Treasury yield. The real two-year rate is the difference between the two-year nominal yield and two-year expected inflation estimated by the Federal Reserve Bank of Cleveland. Data cover January 1983–February 2020.
Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of Cleveland, Gilchrist and Zakrajšek (2012), Kim, Walsh, and Wei (2019), and Bauer and Swanson (2023).

In summary, recent monetary policy tightening appears to have been less restrictive than expected largely because private-lending spreads have been unusually low. The excess bond premium usually rises sharply and persistently following a monetary contraction and slows economic activity: Gilchrist and Zakrajšek (2012) estimate that an increase in the excess bond premium significantly reduces growth and inflation. However, the excess bond premium has remained low during the current tightening cycle. Understanding *why* the excess bond premium is low and whether policy has played a role is important not only for predicting the effects of future tightening, but also for understanding how expansionary potential rate cuts will be. Because spreads did not increase during monetary policy tightening, they may not decrease as much as expected during loosening, which may require policy recalibration.

Endnotes

[1] We use the real two-year Treasury yield as a proxy for the policy rate when comparing to the neutral rate. Many proxies for the neutral rate have increased recently, and Matschke and von Ende-Becker (2024) argue that policy's stance has become slightly restrictive only recently.

Authors

Andrew Glover

Research and Policy Advisor

Andrew Glover is a research and policy advisor in the economic research department at the Federal Reserve Bank of Kansas City. His research studies labor and credit markets from a macroeconomic perspective. Prior to joining the Federal Reserve of Kansas City, Mr. Glover was an assistant professor of economics at the University of Texas at Austin. He earned his PhD from the University of Minnesota in 2011.

Johnson Oliyide

Research Associate

Johnson Oliyide is a Research Associate at the Federal Reserve Bank of Kansas City. He joined the Economic Research Department in 2024 after graduating from the University of Maine with a MS in Economics. He also holds a BS in Economics from the Federal University of Agriculture, Abeokuta in Nigeria. Johnson supports Andrew Glover and Didem Tüzemen with their macroeconomic and labor economics research.