EXPERT VIEW

Central banks, a little closer to the stars

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While the recent synchronisation of central banks appears to us to be merely superficial (see our latest Expert View), they all share a common pursuit, followed more or less explicitly and with an almost philosophical dimension: that of the neutral rate, r*[1] (r-star). How should this concept be defined, and how important is it? And why is it essential to revisit it at a time when several central banks are raising their key interest rates?

Since the 17th century, economic philosophers and, subsequently, academic researchers have continuously explored the concept of the "neutral rate". It refers to the interest rate that is expected to balance savings and investment — the rate that neither stimulates nor restrains economic activity and inflation. In other words, the "optimal" level at which an economy can grow at its potential. By definition, this rate is unobservable, and a wide range of statistical models is used in an attempt to estimate it. For central banks, this concept helps distinguish between an accommodative monetary policy, when the policy rate r is below r*, and a restrictive policy, when r is above r*.

It is therefore important to examine its underlying drivers.

Since the late 1980s, r* has steadily declined across advanced economies, and several theories have been put forward to explain this phenomenon. One of the most prominent, developed by Ben Bernanke[2], points to a global imbalance resulting from excess savings, particularly in emerging countries, being invested in safe assets such as US Treasury securities[3], combined with insufficient investment.

This has been compounded by the structural slowdown in growth, productivity and inflation, post-2008 deleveraging, and the increasing shift of our economies towards services.

Conversely, since the Covid-19 pandemic, a combination of factors has suggested that this trend may be reaching an inflection point. The macroeconomic environment has entered a new regime, characterised by various forms of "conflict". Conflict in the literal sense, with the resurgence of geopolitical risk and the exposure of some of our vulnerabilities. But also technological warfare, driven by the development of artificial intelligence, which has given rise to competition for capital. Demographic challenges are pitting generations against one another and calling social models into question. There is also the fight against climate change and the necessary adaptation it entails. Another dimension is the potential tug-of-war between central banks seeking to combat inflation and governments running high deficits or pursuing expansionary fiscal policies. Finally, there is a distributional conflict between labour and capital, which has crystallised in certain electoral dynamics in recent years.

Despite their sometimes ambiguous economic consequences, these developments point to a more volatile macroeconomic regime, with greater capital and investment needs, and structurally higher inflation.

Although central banks are reluctant to use the neutral rate[4] blindly as a compass, they nevertheless refer to it frequently. Without formally establishing it, the Fed (US Federal Reserve) provides an approximation through its long-term dots[5], recently raised to 3.2% in its September quarterly projections, up from 2.5% in December 2019. Kevin Warsh[6] has been highly

[1]Theoretical real interest rate consistent with an economy operating at equilibrium, neither stimulating nor restraining activity and generating neither inflationary nor disinflationary pressures.
[2]Chair of the Fed (US Federal Reserve) from 2006 to 2014.
[3]Debt securities issued by the US government to meet its financing needs.
[4]The nominal neutral rate is considered here, corresponding to the sum of the neutral real rate and the 2% inflation target.
[5]Anonymous projections of the policy rate level provided by each Fed member, including non-voting members.
[6]Current Chair of the Fed (US Federal Reserve).

critical of its use, yet in his latest speech he did not hesitate to state that he had "removed a degree of accommodation" following the Fed's rate hike. In a more poetic vein, Jerome Powell[7] once described the challenge as "navigating by the stars under cloudy skies"[8].

Some influential members of the ECB (European Central Bank) estimate that the neutral rate in the euro area lies within a range of 1.75% to 2.50%, while the Bank of England (BoE) assumes a neutral level of 3% in the simulations contained in its latest Monetary Policy Report. Meanwhile, Bank of Japan (BoJ) research uses an estimated range of approximately 1% to 2.5%. More broadly, although the results vary, mathematical models do appear to point towards a recent increase in the neutral rate.

Looking more closely, the ECB, with its deposit facility rate at 2.50%, therefore appears to be hovering close to equilibrium. The BoE, which has kept rates unchanged at 3.75% since the beginning of the year, appears to be somewhat above it. At 1.25%, the BoJ continues to chart its own course, diverging from the other central banks.

Neutrality, however, is also revealed through actual economic developments and the transmission of monetary policy to the economy. September's PMI[9] releases provide a good illustration. According to these surveys, activity in the euro area grew at a robust pace during the month, supported in particular by momentum in Germany. Inflationary pressures admittedly increased as a result of higher energy prices, but a broader pass-through remains difficult to envisage at this stage, particularly through wages, given that leading employment indicators are not showing particularly strong signs of recovery.

This environment could prompt the ECB and its more hawkish members to raise rates once again in October or December, justified by resilient growth despite the energy shock and concerns about second-round effects[10] on inflation. Even stronger growth, combined with a genuine broadening of inflationary pressures — which we still do not expect at this stage — would nevertheless be required to move beyond the 2.75% threshold, already described as "moderately restrictive". The impact of the recent rise in sovereign yields on household and corporate behaviour will also need to be monitored. As long as this situation persists, this also argues for expecting rate cuts to come later and to be more measured.

In the United Kingdom, weak activity in September should support the case for a prolonged status quo. However, persistently high energy prices could prompt the BoE to raise rates again in November amid concerns about second-round effects.

The United States remains. According to the commentary accompanying the PMI survey releases, growth in activity and employment indicators have rarely been so strong. Inflationary pressures stemming from a renewed acceleration in wage growth are also mentioned. Caution is warranted, and further data points will be needed to confirm this, but it is worth noting that these results are consistent with a trend that has been established for several months, judging by the trajectory of other indicators.

This backdrop therefore lends support to Kevin Warsh's comments suggesting that monetary policy remains accommodative and, at the very least, raises the prospect of a return to the situation prevailing before the three rate cuts implemented in 2025 — namely, a policy rate of 4.50% at the upper end of the target range...

The search for the neutral rate is fascinating precisely because it represents both an intellectual challenge and a form of fantasy. Central bankers are feeling their way forward and learning by doing. Just as the stars we see in the sky are images of those celestial bodies as they existed in the past, central banks are assessing parameters whose precise location remains uncertain — sometimes leaving them misled rather than guided by the stars...

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[7] Chair of the Fed (US Federal Reserve) from February 2018 to May 2026.
[8] *« We are navigating by the stars under cloudy skies. »*
[9] Purchasing Managers' Index (PMI): Indicator measuring changes in economic activity based on surveys conducted among businesses.
[10] A sustained transmission of price increases to wages and subsequently to the broader economy.

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Document finalised on 24.09.2026.

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