Low Rate Conundrum

The policy significance of today's low interest rates.

By John M. Berry

In almost every developed country, interest rates are extremely low by historical standards, so low that briefly this summer yields on U.S. Treasury ten-year notes reached the lowest point ever, 1.32 percent. In Germany, yields are even much lower, actually negative for maturities out to fifteen years, and in Switzerland for up to half a century!

At the short end of the yield curve, none of the major central banks, save the Federal Reserve, is contemplating raising its target for overnight rates, typically not much above zero, because the outlook for economic growth is so dismal. And the Fed is hesitant to do so because even in this country the economy is hardly surging ahead, while inflation remains below the Fed's 2 percent target.

Rates fell, of course, in the wake of the financial crisis that began in 2007, nearly a decade ago. And many analysts believe they may remain depressed for many years to come. That prospect has ramifications for many aspects of the world's economy. First and foremost, it signals that very slow economic growth is expected to continue, and that central banks have little ammunition with which to fight a renewed recession.

Harvard economist and former Treasury secretary Lawrence H. Summers, in his blog, called that all-time low in U.S. ten-year rates "a remarkable financial moment." Indeed it was.

"I believe that these developments all reflect a growing awareness of the importance of the secular stagnation risks that I have highlighted over the last several years," Summers said. "There is a growing sense that the

---

John M. Berry has covered the economy for four decades for the Washington Post, Bloomberg News, *and other publications.*

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

world is demand-short—that the real interest rates necessary to equate investment and saving at full employment are very low and may be often unattainable given the bounds on nominal interest rate reductions.

"The result is very low long-term real rates, sluggish growth expectations, concerns about the ability even over the fairly long term to get inflation to average 2 percent, and a sense that the Fed and the world's major central banks will not be able to normalize financial conditions in the foreseeable future."

Neither inflation nor interest rates can fall much more.

After the Fed lowered its target for overnight interest rates effectively to zero and the sluggish economy still needed a boost, the central bank turned to so-called quantitative easing, or QE. It began to purchase longer-term Treasury securities with the intent of lowering longer-term interest rates and encouraging investors to move into other types of assets. While QE did help, its impact was limited, even Fed officials agree.

As Summers says, persistently low rates also suggest that real returns on equities and bonds will be lower in coming years than they have been in the recent past; that businesses may have less incentive to invest and thus will likely achieve smaller productivity gains; and that overall economic growth may be reduced.

On the other hand, low rates do make it easier for governments and households to service their debt. For instance, according to the Fed, American households now use only 10 percent of their disposable income to cover principal and interest payments on their debt, the lowest amount in nearly forty years. Meanwhile, rates on new thirty-year fixed-rate mortgages are less than 4 percent.

A recent report by a trio of researchers at the McKinsey Global Institute also suggests that low rates have become a new normal. Richard Dobbs, Susan Lund, and Sree Ramaswamy noted last month that over the past thirty years, real total returns on equities in the United States and Western Europe were between 1.4 and 3 percentage points more than the average in the hundred years since 1914. Similarly, total real bond returns in the United States were 3.3 percentage points higher than the hundred-year average, and were an even greater 4.2 percentage points higher in Western Europe. These outsized returns, not surprisingly, "have shaped the expectations of most investors and executives," they said.

Four highly beneficial conditions were responsible: "lower inflation; falling interest rates; strong global GDP growth that was fueled by positive demographics, productivity gains, and rapid growth in emerging markets, particularly China; and corporate profit growth in excess of GDP, thanks to the expansion of global markets, lower borrowing costs, lower taxes, and efficiency gains from automation and global supply chains," the analysts concluded.

But now all four of these conditions have weakened or reversed, they said. The decline in inflation and interest rates that added to capital gains, especially for bondholders, is largely over, as rates hover around zero. The employment growth that boosted economic growth is waning because of demographic shifts. "And after a period of exceptional profitability, the strongest since the late 1920s, U.S. and Western European corporations face tough new margin pressures from emerging-market competitors, technology firms moving into new sectors, and smaller companies using digital platforms such as Alibaba and Amazon to turn themselves into "micro-multinationals," the report said.

The overall result? Equity returns over the next twenty years that are 1.5 and 4 percentage points lower than in the past thirty. For fixed-income returns, the gap could be between 3 and 5 percentage points, and in some areas even larger. "In Western Europe, for example, our projections indicate that total real fixed-income returns could be near zero—or even negative for a few years," they wrote.

Even what looks like a very low nominal rate may be much less accommodative that it appears.

Of course, there is no way of telling whether the McKinsey Global Institute projection will turn out to be correct, but certainly neither inflation nor interest rates can fall much more. Nor can China continue to grow so rapidly with its high investment in manufacturing facilities focused on ever greater exports; indeed part of the current global slowdown is the result of cooling in

China's outlook. Meanwhile, productivity growth in the United States has slowed significantly for reasons economists are having a hard time explaining.

China also has a serious demographic problem: Because of its longstanding one-child-per-family policy, the size of its labor force is about to begin shrinking, if it hasn't already done so. The Census Bureau estimates that its total population will peak in just a few years.

The Congressional Budget Office assumes in its budget projections that interest rates will "normalize."

As Summers points out, anther troubling fact about rates is that during and after the financial crisis, estimates of the real overnight interest rate consistent with full employment and stable inflation—the so-called natural rate of interest—dropped by several percentage points and remains below zero, according to estimates by John Williams, president of the San Francisco Federal Reserve Bank, and his colleagues. That's another reason that Fed officials will be very cautious in raising the federal funds target over the next couple of years. Even what looks like a very low nominal rate may be much less accommodative that it appears. Fed Chair Janet L. Yellen has said she expects the natural rate, which cannot be measured directly, to rise again as the economy improves—indeed, so does Williams—but it doesn't seem to have happened yet.

The unprecedented level of interest rates is solid evidence that an expansionary fiscal policy is needed in most major countries.

Yellen encountered a bizarre complaint from Rep. Bill Huizenga, a Michigan Republican, recently when she testified before the House Financial Services Committee. Huizenga, among the Republicans very hostile to the Fed, accused her of violating the law that allows the central bank to pay interest on excess reserves banks have on deposit at the Fed. The law limits the rate on reserves to what is available in the market, he said. But the banks are getting 50 basis points while, with the fed funds target rate set by the Fed is 25 to 50 basis points, the prevailing rate in trading was only 38 basis points. Isn't that 12-point difference a violation, Huizenga heatedly demanded?

"No, it isn't," Yellen replied.

Low rates of return are a particular problem for some investors, such as managers of pension funds and insurance company portfolios, with long-term fixed commitments. This has been one force driving many companies to shift from defined benefit pension plans to defined contribution plans, where the onus is on individual employees to make investment choices. And many people, both retired or still on the job, have complained bitterly about the tiny rates being paid on most bank certificates of deposit and savings accounts. Even with the higher returns of past decades, many, perhaps even most, public employee pension plans in the United States are woefully underfunded.

In Japan, fiscal stimulus and the most aggressive QE program anywhere have generated neither growth nor inflation.

If Democratic presidential nominee Hillary Clinton wins this year, the projections of lower rates of return on most types of savings could bolster her campaign's argument that Social Security needs to be expanded to help retirees with inadequate personal saving. Indeed, many older workers have much too little in the way of savings to fund an adequate retirement, according to Fed surveys, even if higher returns from the past were still available.

One place in which very low interest rates are having a significant but positive impact is in the cost of servicing government debt. Last year, according to the Congressional Budget Office, the average interest rate on federal debt held by the public was just 1.7 percent. Over the last ten years the level of debt by that measure rose from $4.8 trillion to $13.1 trillion, and it more than doubled as a share of GDP. Yet interest paid to the public last year was just $223 billion, slightly less than the $227 billion paid a decade ago. In 2005 dollars, last year's interest bill was only $184 billion.

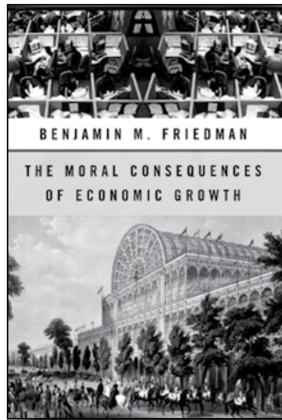
Ten years ago, interest rates were much higher partly because the Fed was tightening monetary policy to cool off the economy. Had rates last year been that high, the government's interest bill would have been nearly $400 billion greater than it was.

The Congressional Budget Office assumes in its budget projections that interest rates will "normalize" over the next several years, with the average rate paid on the publicly held debt eventually more than doubling to 3.5 percent. Five years from now, net interest is projected to be $557 billion, but it could turn out to be significantly lower if rates generally do not return to historical levels.

The continued low level of rates is a pointed reminder that the heated warnings at the beginning of the Obama administration about an excessively easy monetary policy and added federal spending to stimulate the crisis-wracked economy generating high inflation and high interest rates were totally off. Budget deficits did soar as the economy plunged into the worst recession since the Depression of the 1930s, and many conservatives pushed to cut spending with some success. There was never a hint of so-called crowding out—that federal government borrowing would make it harder and more expensive for private borrowers to obtain credit. At times credit was difficult for some weaker borrowers to find for other reasons, such as lower home values and increased banking regulation, but interest rates were hardly affected by those developments. Meanwhile many large corporations have been sitting on such large quantities of cash that they did not need to borrow to finance investments. Many have issued new bonds simply to pay off older, higher-cost debt.

Low rates do make it easier for governments and households to service their debt.

Stronger growth would do more than almost any other policy change to deal with the reality of income inequalities by increasing the demand for workers. Harvard University economist **Benjamin M. Friedman** *made that case eloquently several years ago in his book,* The Moral Consequences of Economic Growth *(Knopf, 2005).*



Interestingly, debates over debt and deficits have played little role in this year's presidential election even as efforts by some Republicans to hold down spending have tied Congress in knots and delayed passage of appropriation bills. Next year, particularly if Clinton is elected, the spending wars probably will again pit congressional conservatives against the president unless Democrats were to control by the House and Senate.

Summers, in his blog, noted how low interest rates should affect that debate.

"In a world where interest rates over horizons of more than a generation are far lower than even pessimistic projections of growth, traditional thinking about debt sustainability needs to be discarded," Summers argued. "In the United States, UK, Euro area, and Japan, the real cost of even thirty-year debt will be negative or negligible if inflation targets are achieved." Under these conditions, an expansionary policy could "pay for itself," he said.

In any event, the unprecedented level of interest rates is solid evidence that an expansionary fiscal policy is needed in most major countries. Stronger growth would do more than almost any other policy change to deal with the reality of income inequalities by increasing the demand for workers. Harvard University economist Benjamin M. Friedman made that case eloquently several years ago in his book, *The Moral Consequences of Economic Growth* (Knopf, 2005). So has Summers in a recent blog.

Expansionary fiscal policy would also make central bank officials' lives easier in many countries, except perhaps in Japan where fiscal stimulus and the most aggressive QE program anywhere have generated neither growth nor inflation. Unfortunately, in Europe, where Germany continues to insist on austerity, a truly expansionary budget approach is very unlikely. And in this country, of course, smaller government remains the goal of many Republican senators and representatives. ◆