



## Forever Low?

### Path of global long-term rates is an open question.

#### ECONOMIC OUTLOOK

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Are low interest rates the new norm?

In a 2012 television commercial in the United States, a stage curtain goes up to reveal Nobel laureate in economics Tom Sargent. A voice asks: “Prof. Sargent, can you tell me what CD rates will be in two years?” Sargent replies with a confident “No.” The curtain goes down.

Real, long-term interest rates have been slipping globally for 30 years. Look no further than the yields on U.S., U.K., and Japan inflation-linked bonds to see the persistent decline. For other countries, which lack liquid markets in inflation-protected bonds, economists adjust market yields for expected inflation to estimate real interest rates. Those estimates tell the same story: ever-lower real rates. Global composites show real rates declined from 4% to 5% in 1985 to about zero in 2012 (EXHIBIT 1).

Students of the real interest rate have chalked up its decline to various factors. I will discuss which ones I find most plausible and then ponder what might reverse the trend.

#### Why Interest Rates Fell

The most cited reason why real interest rates have tumbled is the “global savings glut.” Former U.S. Federal Reserve chairman Ben Bernanke gets credit for the term. According to a report by the International Monetary Fund (2014), faster income growth in emerging markets lifted savings, which the West wasn’t able to absorb quickly. A persistent abundance of capital reduced its price.

Saving alone, however, tells us nothing about the equilibrium interest rate. In the aggregate, saving

must equal investment. Excess desired saving—or the shortfall of desired investment—is what depresses the real interest rate. For interest rates to fall, then, investment needed to fall as well, or at least rise less than desired saving. That’s presumptively what has happened since the 1970s in mature economies. The McKinsey Global Institute (2010) estimated that capital spending from 1980 through 2008 was \$20 trillion less than if the investment rate had remained stable. Granted, investment in emerging countries soared. But saving rates rose even more, so developing nations became net exporters of capital.

The lower demand for investment can be traced, in turn, to two other factors. Lawrence Summers (2014) argued that the entrepreneurial ventures of the 20<sup>th</sup> century required millions of dollars to start, whereas today’s startups need just a few thousand dollars in seed capital. Also, investment demand has gone down because the relative price of capital goods has declined. A truckload of widgets buys more computers than ever before.

Another explanation is that the income distribution changed. The capital share of income has risen; so has wage inequality among workers. For corporations, a bigger piece of the income pie has implied more saving, because businesses’ demand for capital has grown less than profits. Among households, the saving rate is much higher at the upper end of the income distribution. When

the financial crisis hit borrowing-constrained households, the gap between desired saving and borrowing grew wider.

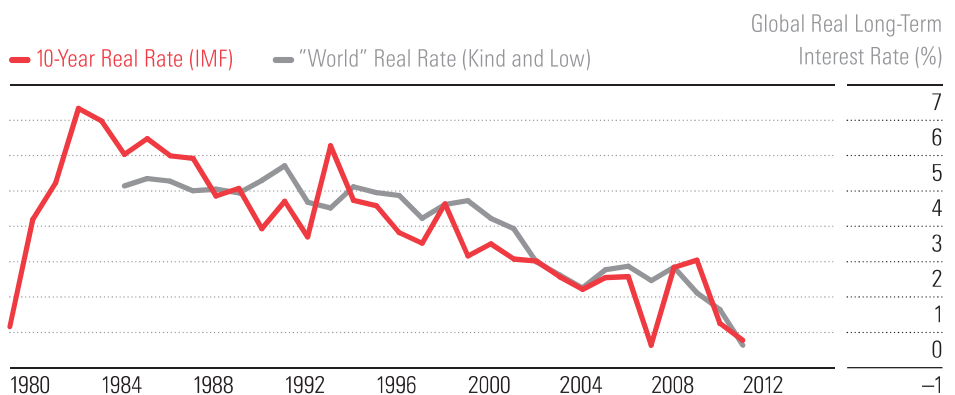
A declining labor force implies a falling natural interest rate as well. This point was famously made by Alvin Hansen (1939) when he laid out his secular stagnation hypothesis. He guessed the decline in population growth and “the failure of any really important innovations” would hold back growth and depress rates. The next 30 years proved Hansen spectacularly wrong—clearly on the innovation count—but the demographic concern seems relevant in the 21<sup>st</sup> century.

Barriers of our own making can contain investment, too. That’s an explanation favored by the “supply siders” in this debate, such as John B. Taylor and John Cochrane. Policy uncertainty, bad regulation, and distortions, they say, have discouraged investment.

Finally, besides a mismatch between intended saving and investment, a portfolio shift took place. The demand for safe assets increased, primarily by central banks and sovereign wealth funds in emerging countries. This shift, the IMF report said, further pushed down yields on liquid, “safe” assets. On this count, declining interest rates reflect scarcity of “safe,” liquid assets. Quantitative easing also may have compressed term premiums since 2008, although it’s unclear how much.

#### EXHIBIT 1

**Falling Real Rates:** Real rates have declined from between 4% and 5% in 1985 to about zero in 2012.



Sources: IMF (2014); King and Low (2014).

### Back to Historical “Normal”?

What might undo this decline of interest rates? A big player is China. Between 2001 and 2013, the Asian mammoth exported more capital than all other emerging countries combined, as measured by current account balances. China, therefore, probably did more to depress interest rates than any other country, due to policies that curb consumption. This will change, but it's not obvious what that means for global interest rates.

If China hits a debt wall—as I think it will—investment will fall, perhaps even in absolute terms. Reducing private saving shouldn't be difficult, as the government policies that repress consumption seem to be binding. This may or may not reduce China's excess saving, depending on the size of the investment and consumption shifts. If done the “right way,” as Michael Pettis (2013) calls it, saving would decline more than investment, and the current account balance would shrink. This has been happening already: China's current account balance may have peaked in 2012.

Things could go differently tomorrow, though. The IMF projects that China's excess saving will creep up through 2019. Pettis explains Beijing is finding it hard to raise consumption. If saving is sticky, and China heeds recommendations to lower investment, net saving could easily rise. Besides, policymakers in surplus countries like China and Germany see net saving as a virtue, and routinely resist calls to reduce their current account balances.

How about other countries? In the future, developing countries may not grow as fast as they used to. A new study by the IMF (2014b) shows the potential growth rate in emerging markets is now 1.25% lower than in the 2000s. Lower growth can sap saving, pushing interest rates up. The McKinsey Global Institute (2010) also thinks we should say goodbye to cheap capital—but for the opposite reason. The McKinsey paper posits that an investment boom is imminent in developing economies. Rapid urbanization is lifting the demand for roads, ports, power grids, schools, hospitals, and housing. That, plus a decline in saving, will reverse the secular decline in real long-term interest rates.

Three things bother me about this hypothesis.

One, it may underestimate the likely slowdown of investment in China. Two, those projections are tied to the fact that, in emerging markets, the capital stock per capita is low. Yes, poor countries grow faster. But Korea and Taiwan remained capital-poor for centuries. The investment-led race to riches is open to others, like India or Indonesia, but we don't know whether the gates will open in 2014, 2020, or 30 years from now. Three, the investment surge will be smaller if we use today's GDP growth forecasts rather than the ones from 2010, when the paper was written.

Age-related spending also will weigh on saving, public and private, in mature economies. The 60-and-older segment of the population will peak by 2030. Pension and health-care spending will balloon with it. Households will begin to spend their savings. It doesn't help that productivity increases more slowly in health-care and domestic-help services than in other sectors. This additional consumption will put upward pressure on interest rates.

Other factors, however, indicate interest rates will stay low. Aging, for example, operates through the portfolio channel to decrease the interest rate. As baby boomers retire, I expect a rebalancing toward income portfolios, which would hold interest rates down. Oil exporters made up at least 30% of the world's combined current account surpluses in the period from 2001 to 2013, and a big fall in their saving is unlikely unless the price of oil collapses.

Another reason interest rates may stay low is that policymakers want it that way. Interest payments in Western Europe, the United States, and Japan, whose governments are deeply in hock, may become unsustainable if rates go up. To ensure the cost of debt stays low, they may engage in “financial repression.” The term describes a host of fiscal and regulatory measures that work to hold interest rates down. One example is stuffing public pension funds and government-owned entities with sovereign debt; another one is capital requirements that nudge banks and insurers to hold Treasury securities.

### Higher Soon, but Unpredictable Later

So, can we predict which way rates will go? I'm positive Sargent's discussion would be better than mine. But I bet his bottom line would be “no.”

If I must produce an outlook, I think real interest rates will go up through the next recession. In the short term, monetary policy will steer market interest rates higher, especially at the Fed and the Bank of England. The European Central Bank and the Bank of Japan will lag behind, but will eventually follow.

Beyond cyclical ups and downs, however, real interest rates are subject to multiple moving forces. I started out with one question, and I end with many more: Can India become the new locomotive of global investment? Will wage inequality keep rising? Will the return to capital exceed the rate of economic growth, thus widening income inequality? Will the renminbi become a convertible currency, thus expanding the potential supply of liquid, “safe” assets? Will Internet-based technologies spur productivity growth, overcoming stagnation? Any one of these questions may shape the path of real interest rates. ■■

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