Less Than Zero: The New Normal for Interest Rates?

Will your bank pay you to borrow money?

Back in the 1980s and 1990s, financially sound governments had to pay interest rates of 6-8 percent in order to borrow. Financial advisors and investors used these figures to decide the allocation of portfolios for retirement purposes. If anyone had mentioned the possibility of negative interest rates back then, they would have been laughed at – it would be an aberration, negative interest rates weren't possible in the real world.

Fast forward to today and there is about **US$16 trillion** worth of bonds trading with a negative yield. Some governments – like **Germany's** – can borrow at any horizon (from 3 months to 30 years) at negative rates. And in Denmark, we have seen the **first mortgages with negative interest rates**. Yes, you read that right, imagine getting paid to borrow to buy your house.

What is a negative interest rate?

Remember your first economics class: Do not mistake real and nominal variables. Real variables are adjusted for inflation and are the ones that matter (hence the "real"). Real interest rates have been negative before, in periods where inflation was surprisingly high making the real return become negative. We see this phenomenon now in hyperinflation environments, and we saw it in advanced economies during the 1970s.

What is unique about our current environment is the combination of very low real interest rates and very low inflation. This mix has produced the lowest nominal interest rates ever seen and that are now negative in some cases.

Negative nominal interest rates can be seen as an anomaly because there is already an asset that pays 0 percent: Cash. If you stash some bank notes under your mattress, their value remains constant over time. Because of this, economists like to refer to 0 percent as the "zero lower bound on nominal interest rates". But, as we are in the midst of finding out, 0 percent is not the true lower bound. The reality is that a corporation storing its millions in cash is not a feasible proposition and, as a result, interest rates as low as -1 percent can be seen today in financial markets.

But forget about squirreling away your cash, back to fundamentals, what is going on with real returns? Why should they seem so low relative to previous decades?

It's all supply and demand

In 2005, Ben Bernanke, a few months before becoming the US Fed chair, offered an explanation for low interest rates based on the simplest possible economic model: Supply and demand. Interest rates are price-determined in a market where some individuals try to save (the supply) and some individuals, companies or governments attempt to borrow (the demand). Bernanke's hypothesis was that we were witnessing a global saving glut. For 10 years, a diverse set of forces increased the supply of saving. The countries most likely to pursue this behaviour were China, Japan and other Asian economies, Germany and oil producing nations. As these savers were chasing a limited supply of investment opportunities, they drove up the price of any asset they bought, leading to low returns. Interest rates were low, and most asset prices became high, leading to the mistaken perception that every asset was in a bubble.

Interestingly, Bernanke and his central bank colleagues in other countries were seen as responsible for producing low interest rates with Quantitative Easing (QE), the large purchases of assets by central banks. But there is a limit to which central banks can be blamed for interest rates' declining trend – which, after all, began in the mid-1990s, well before QE. More importantly, central banks issue a new asset to the private sector every time they buy one from the private sector. When a central bank buys a government bond from the private sector, it creates an asset for the same value in its balance sheet. This asset (reserves of commercial banks at the central bank) is also held by the private sector. Ultimately, QE is not a net purchase of assets but simply a trade in which the central bank exchanges one asset for another.

Low interest rates: Happy borrowers?

Savers trying to build capital for their pension naturally dislike the current environment of low interest rates. But for those who want to buy their own home or companies that want to fund new capital investment, this world of low interest rates is ideal.

An environment of low interest rates could be expected to lead to a boom in investments and purchases of fixed assets. This boom should create new jobs, make the current ones more productive and everyone would benefit (even the savers trying to boost their pensions). However, there has been very little of this. Yes, there was a housing boom prior to 2007 and some emerging markets saw an explosion of investment around that time, but overall, the world economy has not been doing so great. Since 2005, growth has decelerated in advanced and emerging markets; and investments have remained weak despite the favourable low-interest rate environment.

Given the number of savers desperate to lend money to someone who offers a great return, why aren't there more start-ups, VCs or large companies investing in productive projects? Aren't there enough projects that produce a positive rate of return? The answer to this question is a depressing no. The low growth environment we have witnessed since 2005 tells us that something else is happening on the demand side. It's not just a global saving glut; there is also a shortage of investment at the global level.

This is not a complete surprise. Economists began warning us about a secular decline in innovation and productivity growth in the mid-1970s. Sure, there was a short period of time where the internet generated excitement, growth and investment opportunities and pushed interest rates to high levels. But as the internet boom faded away in the late 1990s – and contrary to popular opinion about innovation – we have yet to have a significant technology wave that makes use of capital seeking a positive return.

Companies holding record levels of cash or borrowing to fund share buybacks are both signs of a world short on good ideas and investment opportunities.

How long will this last?

To get out of this environment of low real returns, we need more spending, i.e. more investment. For this to happen, economic growth needs to improve and create investment incentives for companies. But without investment, we will not have growth. It feels like a vicious cycle. This pessimistic scenario has been labelled "secular stagnation", a term made famous by Larry Summers in 2013. His view is that the world is in a stage of deficient demand with a structural imbalance between saving and investment.

We, of course, look to central banks to help stimulate the economy, but in a world where interest rates are at zero, there isn't much more they can do. This inability of central banks to act is an additional source of pessimism. Summers, in his recent speech at the Fed's 2019 Economic Symposium at Jackson Hole, referred to the future of central banks as **"black hole monetary economics"**. As central banks are short of ammunition, it becomes increasingly difficult to return to normalcy.

Perhaps these are bleak views and some unexpected combination of innovation and technologies will create a wave of investment that will raise interest rates away from zero. Until that happens, get used to seeing a dash in front of interest rates.

Antonio Fatas *is a Professor of Economics at INSEAD. He is also the Portuguese Council Chaired Professor of European Studies at INSEAD.*

*Found this article useful? **Subscribe** to our weekly newsletter.*

*Follow INSEAD Knowledge on **Twitter** and **Facebook**.*

Find article at
https://knowledge.insead.edu/blog/insead-blog/less-than-zero-the-new-normal-for-interest-rates-12366

Download the Knowledge app for free