The Real Cause of Low Interest Rates

Are lower interest rates creating an unstable financial future?

In its annual report, the **Bank for International Settlements** argues that: “Rather than just reflecting the current weakness, low rates may, in part, have contributed to it by fuelling costly financial booms and busts”. According to BIS, the result is too much debt, too little growth and excessively lower interest rates.

This is not a theory with which I can concur.

I agree with Martin Wolf of the **Financial Times,** who argues that the logic of the BIS is "wildly implausible".

We have no economic model (or evidence) that suggests that central banks have been able to manipulate real interest rates for decades, nor do we have any model (or evidence) that supports the idea that a central bank policy of low interest rates will not generate substantial inflation.

The savings glut and monetary policy

Any explanation for low interest rates has to start with some version of the “global saving glut hypothesis”.

Economic, demographic and social changes have expanded the desire to save among a significant portion of the world economy and, to my mind, it is this which has kept interest rates low. This explanation is consistent with any economic model that has an inter-temporal dimension built into it, and there is plenty of evidence that supports it.

But what is the role of monetary policy in this story? Wolf suggests that "*in seeking to deliver the monetary conditions needed for equilibrium between savings and investment at high levels of activity, the central bank has to encourage credit growth*".

I am not sure I follow his argument here. Why do central banks have to encourage credit growth?

The fact that there is a saving glut that puts lower pressure on interest rates already means that somewhere in the world there will be an increase in credit/borrowing. There is no need for central banks to encourage credit. We can talk about whether central banks could have discouraged it, whether they had the tools and whether it was within their mandate, but there is no need to have central banks driving the process of credit growth to make the story consistent with what we have observed.

So what’s driving the dynamics?

What makes the description of the dynamics of interest rates, and the financial flows that result from a savings glut difficult, is the fact that we need to understand heterogeneity among economic agents (individuals, companies, governments). This heterogeneity, combined with a limited regulatory framework, can drive dynamics that are unhealthy, excessive and lead to bubbles and financial crisis. If there is a savings glut, and interest rates are coming down, this is a signal for someone to borrow more. Some of that borrowing will be reflected in increased leverage as it takes the form of house purchases and creation of mortgages. Within some countries, such as China, we might observe that while the country as a whole saves, the private sector increases its internal debt exposure and (because of the exchange rate policies) leverages government demand for foreign safe assets and capital controls that are part of their financial environment.

There are plenty of stories like these that are triggered by a significant change in the economic scenario (i.e. lower interest rates) that might result in the financial imbalances that lead to crisis. In the same way that new technologies created bubbles and financial instability in the nineties, the savings glut generated new and possibly excessive behavior as economic agents adapted (not always well) to the new equilibrium.

The future of interest rates

So what comes next? This is always a difficult question to answer as it requires a good understanding of economic trends across all regions in the world. There are some short-term forces that are playing against the savings glut hypothesis. Oil producing countries are rapidly reducing their saving and in some cases turning into borrowers. But this has been more than compensated by the Euro area that has become a large saver with the borrowers (Greece, Spain) bringing their current account deficits to zero while the savers (Germany, Netherlands) maintain their fiscally prudent behaviour.

This suggests interest rates are likely to stay low and the saving surplus of some countries will have to be absorbed elsewhere (although it is not clear that the surpluses will be larger than in the past). While this may mean a "credit boom" somewhere in the world, it is not necessarily a recipe for imbalances.

What the world is missing is investment demand. The real tragedy is that investment in physical capital has been weak at the time when financial conditions have been so favorable. Why is that? **Jason Furman** (and earlier the IMF) argues that the best explanation is that this is the outcome of a low growth environment which does not create the necessary demand to foster investment.

If this is the case then the story could be one of confidence and possibly self-fulfilling crises and multiple equilibria. But that is another difficult topic in economics and one I will leave for a future post.

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