Article

Financial markets

Why are real interest rates so low at a global level?

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Throughout the last few decades, international interest rates have been on a downward slide, currently reaching unusually low levels. The persistence and intensity of this drop have surprised investors, economic policymakers and academics. A posteriori, various plausible explanations have been provided for the different stages in this slide but what is certain is that the repeated forecasts of a shift towards a sustained upward trend in interest rates have failed to come about, time after time. In fact, at present the consensus once again believes there will be an upshift, inviting us to review the experience garnered over the years, both in conceptual and empirical terms.

There is one important issue to consider first of all: the relevant downward slide refers to risk-free interest rates. In other words, without compensating for expected inflation or the credit risk premium. Since the mid-1980s, a large part of the fall in nominal interest rates was due to a reduction in inflation expectations, which in turn can be essentially explained by the growing credibility of central banks in relation to their price stability targets. In any case, and particularly since the early 1990s, the trend in nominal interest rates has also seen a highly significant reduction in the real component and this is precisely where the surprises have emerged and doubts arisen regarding the future. For its part, the risk premium is currently crucial, for example regarding the euro area's credit and institutional crisis, giving rise to a notable increase in interest rates in the periphery countries. However, the sovereign bonds of countries considered to be safe (such as the USA, Japan, United Kingdom, Canada, Germany and others) have continued to fall, suggesting the presence of common factors.

When the financial crisis started in 2007, debate had already been raging for some time regarding why real interest rates were falling in developed countries. Two basic lines of argument had been put forward. One alluded to the existence of a global saving glut. The other highlighted the easy monetary policies, in particular that of the Federal Reserve (Fed). Unfortunately, a large amount of political ideology arose around this element, at times hindering an objective examination of the facts. With hindsight, both the conceptual arguments and empirical studies seem to support the hypothesis of a saving glut. In fact, the present-day Federal Reserve Chairman, Ben Bernanke, provided one of the most convincing analyses in this respect, dissecting the powerful influence of savings and investment decisions around the globe on the real interest rate curve in developed countries. It can be deduced from his approach that the Fed's handling of the official interest rate (which is the very short-term nominal rate) had merely a secondary, subsidiary role in the sense of adjusting the dynamics in the real variables.

Various factors, all identified to a greater or lesser degree, helped to create the conditions for abundant savings and little investment in a world with increasingly integrated capital markets. Rising oil prices transferred income towards oil-producing countries which usually have high savings rates, particularly those of the Gulf region. In Europe and Japan, demographics and the ageing population also boosted household savings with a view to retirement. More enigmatic but no less relevant was the hesitant business investment. Possibly the most striking developments took place in booming Asia, apparently as a defensive reaction after the traumatic financial crises of the 1990s. First of all, the region's governments increased savings for precautionary reasons and in line with their market-driven strategy, accumulating reserves that were invested in us bonds and those of other countries. The private sector then increased its savings (particularly in the absence of a welfare state that would provide security), at the same time as easing back on investment. All this within a context of poorly developed local financial markets and legal frameworks, pushing resources towards western financial assets which were seen as safe and liquid, giving rise to the so-called safe assets shortage.

On top of this underlying panorama, the situation following the financial crisis that started in 2007 with subprime mortgages, the subsequent post-Lehman escalation and resulting euro area crisis merely prolonged the downward slide in real interest rates. Additional factors came into play while others became stronger. Firstly, the slowdown in the world economy per se, within a context of the inexorable need for numerous economic agents to deleverage, forcing some to increase their savings and others to contain their investment. Secondly, the presence of dysfunctions in the financial system and particularly in financing channels for SMEs, restricting their demand for investment. Thirdly, a greater risk aversion given the high macroeconomic uncertainty and persistant financial instability. Terms such as flight to quality and safe haven demand have constituted the mantra of investors during the tough years of the crisis, pushing up the price of high quality sovereign bonds and pushing down interest rates.

In the last two years, some of these factors have gradually eased but, in spite of this, real interest rates have fallen even further. The USA and the emerging countries have become more economically dynamic and financially calm and the worst of the crisis seems to be behind us, even in the euro area. Business investment is picking up in the USA while public deficits are still very high in developed economies as a whole. For their part, risk assets such as shares and junk bonds have seen gains within a climate of renewed investor appetite. In fact, warnings have reappeared of too much risk being taken on by the system as a whole. However, the nominal and real interest rates are not rising. In this period, it seems that the explanation can be found in the unconventional actions of central banks, first and foremost the Fed and more recently the Bank of Japan. Two measures have been able to affect the real interest rate curve as a whole: forward guidance and quantitative easing. The first alters the path of the short-term real official interest rate expected by agents as long as the central bank remains credible and specific. The second affects the term premium (the extra yield required by investors to acquire long-term bonds instead of investing in short-term instruments). In combination they have a significant effect that extends beyond the country where they are applied.

In short, it could be said that, for years, we have witnessed a chain of perfect storms that have conspired to persistently push down real interest rates, namely a saving glut, safe asset shortage, flight to quality and quantitative easing. Undoubtedly, any prospective analyses must take these elements into account but, given past experience, it is worth leaving some room to venture which surprises might be in store, provided by the global economy, that could once again frustrate the prediction of real interest rates on the rise.

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