Keeping it real

The side-effects of low interest rates

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ONE of the most remarkable features of the modern economy is that interest rates are negative in real (ie, after inflation) terms and are expected to remain so. This is not unprecedented. Real rates were negative after the second world war and again in the 1970s. But in both cases inflation was much higher than it is today.

Headline inflation rates are now falling, thanks to lower commodity prices. But with the exceptions of Greece and Switzerland, economists are not expecting outright deflation this year. So with short rates close to zero, real rates will stay negative. As for long-term rates, government-bond yields are below 2% in America, Britain and Germany. The three relevant central banks are targeting an inflation rate of 2% (albeit implicitly, not explicitly, in the case of the Federal Reserve). Whereas the jump in inflation in the 1970s was unexpected, bond investors now expect to lose money in real terms.

The level of interest rates can be viewed as a price which balances the desire for saving with the demand for investment. So negative real rates may simply indicate that savers are incredibly cautious, and that businesses are reluctant to invest in new projects.

Central banks attempt to affect this price by setting “base” rates (the term varies from country to country) at which they will supply liquidity to banks. They have also been using “quantitative easing”—the creation of new money to buy bonds—with the aim of forcing down longer-term yields. Their intervention must have had some impact, although it is hard to quantify.

The aim of these policies is to discourage saving (and boost consumer demand) and to encourage business borrowing (and boost employment). It is a sign of the weakness of the global economy that central banks have forced nominal interest rates to their lowest levels in history.

You would expect the level of real interest rates to be linked to economic growth. When an economy is growing rapidly, there should be an abundance of profitable investment opportunities. Businesses are happy to borrow at high real rates, confident that they can still earn an even higher return.

In a sense, then, the level of real interest rates sets a hurdle by which profitable projects should be judged. If the rate is held at an artificially low level for too long, the danger is that capital may be misallocated. The temptation will be to finance speculative property developments rather than new factories.

In its latest annual report, the Bank for International Settlements (BIS) points to a number of other problems that negative real rates might provoke. First, the fall in financing costs may tempt borrowers into ignoring their balance-sheet problems. The result could be that the problems are left to fester, making it impossible for central banks to raise interest rates to a more normal level in future years, for fear of the damage this might cause.

Banks may also become too optimistic about the ability of borrowers to repay, and fail to make adequate provisions for bad debts. And the easy money that banks can make by borrowing short-term from the central bank and lending long-term to the government is a public subsidy that is insufficiently appreciated.

Pension liabilities are linked to bond yields. As yields fall, the present value of future liabilities rises. The Pension Protection Fund recently reported that the deficit of British pension funds has risen thirteenfold from £24.5 billion ($39 billion) to £312 billion over the past year. That requires firms to divert more money into their schemes—money that might otherwise have been available to finance business expansion.

The BIS also worries that low interest rates in the developed world may have had spillover effects in emerging markets, pushing up exchange rates, causing asset bubbles (such as Chinese property) and, until recently, inflating commodity prices. Finally, the BIS frets that easy monetary policy may be letting politicians off the hook, remarking that: "It would be a mistake to think that central bankers can use their balance-sheets to solve every economic and financial problem."

There will be something wrong if, in five years' time, real interest rates are still negative. Capitalism depends on giving a positive return to suppliers of capital. That said, it would be a mistake to argue that central banks should attempt to raise interest rates soon. The European Central Bank's decision to tighten monetary policy last year looks an even bigger error in retrospect than it did at the time. Savers will have to keep suffering.

Source: http://www.economist.com/node/21557758

Discussions:

1. Find the definition of Headline Inflation rates and Core Inflation rate. What is the difference between the two terms?
2. "Central banks attempt to affect this price by setting "base" rates the term varies from country to country) at which they will supply liquidity to banks". What are Central Bank's "base" rates in your country?
3. "They have also been using "quantitative easing"—the creation of new money to buy bonds—with the aim of forcing down longer-term yields." Why does this policy cause a decrease in interest rate?
4. According to the article, what are the expected consequences of a decrease in real and nominal interest rates?
5. According to the article, what are the side-effects of a negative real interest rate?

Notice:

- The difference between "nominal" and "real" interest rates
- Effect of inflation on "real" interest rate
- Relationship between "real" interest rates and people's economic activities