The Real Reasons for Low Real Rates

By Robert Pringle, EconVue Expert

The lowest interest rates in history are failing to spur sustained recovery. Rather, low real rates mirror financial and structural weaknesses

Economists cannot agree on the causes of these low real rates. They discuss various hypotheses.

Central banks have held policy rates low for years – have these ultra low nominal rates reduced real rates, by damaging the real economy? They could be doing so if they lead to the buildup of imbalances, higher leverage and debt ratios and thus repeated booms and busts. Such economists (including those at the BIS) posit a "debt trap" where at certain stages in the financial cycle governments and central banks feel they have no option but to increase debt – and debt ratios – if they are to spur recovery, but then find themselves unable to raise rates in time for fear of imperiling the recovery. Hence the boom-bust syndrome, which itself gradually erodes the resilience of the real economy (this is reminiscent of the "Stop-Go" problem that affected the UK economy especially in the 1950s and 1960s; but that was under fixed exchange rates; floating was supposed to get rid of all that).

Other economists see "secular stagnation", pointing to lower investment opportunities. On this view, low real rates must reflect an excess of savings over planned investment. Others blame "the savings glut", pointing the finger of suspicion at the Chinese and Germans, among others, for saving "too much" and running large current account surpluses. Such economists usually hail from the US and UK, two countries running large deficits – to finance consumption rather than investment.

The market view behind low real rates

However, these explanations fail to account for the ultra low or even (in some currency areas and jurisdictions) negative real rates on very long term government bonds. That must reflect the market view that rates will remain low for 30-50 years! To believe investment opportunities will be absent for the next two generations strains credibility. Yet low real rates cannot be the result of monetary policies, as central banks can only affect nominal rates, they say.

Perhaps markets expect governments to start to reduce debt to GDP ratios – that they act as if there is a debt ceiling – after which they will raise taxes

and reduce spending to retire debt. And that this will go on for the next 50 years. According to Allan Meltzer, this is the only hypothesis that can account for the facts; the market's view is that the US – and by implication other developed countries with excessive debt-gdp ratios – will avoid a crisis by adopting a plan to reduce debt gradually over the next 30 or more years:

"We will no longer borrow freely. In place of the policies followed during the past 50 years, the federal government will aim to balance its budget or run small surpluses to slowly retire debt as it did following the Civil War and WWI"

Meltzer believes that the expected increase in saving is the main driving force behind low or even negative long-term real interest rates. The rates are real rates for 30 or more years. There is no way central banks can PERMANENTLY alter such rates. The alternative explanations are too short term, Meltzer believes.

Share prices near peak levels

Meanwhile, look at financial markets, what do we observe? With real economies weak, many banks with their backs to the wall, debt-to-gdp ratios high and possibly approach their limits, and with economists at odds about diagnoses and cures and with public discontent as well as geopolitical tensions running high, at such a time as this, behold, many asset prices globally are at record levels! As if investors didn't have a care in the world! Stocks (other than those of banks) are at or close to all time peaks, and the world's greatest ever bond extravaganza has been bubbling away courtesy of central banks. As Brendan Brown has pointed out, the boom times have extended to commodity extraction industries, emerging markets (including real estates sectors), export sectors of developed economies supplying China and other emerging markets and in Silicon Valley.