

2017-09-21

PRESS RELEASE

The cyclical and structural determinants of the low interest rate environment

(Article for the September 2017 Economic Review)

In recent years, interest rates have dropped to historically low levels throughout the world. That is due largely to a series of (non) standard measures adopted by central banks in the context of the great recession. However, if we take a longer term view it seems that the current low level of interest rates is perhaps not attributable solely to central bank monetary policy or to other cyclical factors which have contributed to the fall in interest rates since the crisis. By way of illustration, long-term sovereign bond yields in the advanced economies have displayed a downward trend which clearly began many years before the crisis erupted, and that trend applied in both nominal terms (decline since the early 1980s) and real terms (fall since the early 1990s). From that point of view, the expansionary monetary policy conducted in many countries since the crisis is in line with the downward trend in interest rates which had already been apparent previously.

Since interest rates have fallen substantially worldwide throughout recent decades, it seems that their current low level is due to global structural factors. In general, those factors probably supported the supply of savings and depressed demand for investment. They could be diverse in character, covering for example sociodemographic trends such as population ageing and increased inequality, and economic changes such as the slackening pace of innovation and the decline in potential growth. As a result of these structural factors, the natural real interest rate, which reflects the macroeconomic equilibrium accompanied by stable inflation, has fallen in the United States and in the euro area, in particular, dropping to historically low levels, as the latest estimates tend to show. During the great recession, central banks also tried to counter the fall in inflation and economic activity by taking real interest rates below their equilibrium level, in order to stimulate demand.

In the medium term, central banks should revise their monetary policy rates upwards once the price stability outlook becomes more favourable, although they cannot guarantee that interest rates could recover to levels comparable to those reached in the past. If central banks no longer aim to encourage demand, they will align real interest rates with the natural interest rate of the economy. However, that rate is still influenced by fundamental structural changes relating to the supply of savings and investment demand. If those structural changes continue to depress the equilibrium interest rate, then interest rates in general will stagnate at relatively low levels.

The persistence of low interest rates would imply monetary and financial risks. The leeway available to central banks for revitalising the economy would be smaller, for example, if they were constrained by an “effective lower bound” when cutting monetary policy interest rates. Moreover, an interest rate environment hostile to the profitability of financial intermediaries could trigger a hunt for yield, among other things. It is therefore necessary to assign a key role to macroprudential policy, which must ensure that the balance sheets and business models of banks and insurance companies remain balanced.

Given these potential risks, an increase in the general level of interest rates seems desirable, preferably via a rise in the natural real interest rate. Such an increase entails economic measures to counter the factors depressing real interest rates. The structural measures would essentially aim to encourage innovation and promote a climate conducive to investment. Measures that would diminish the need for precautionary savings, such as reforms supporting the sustainability of social security, could also increase the real equilibrium interest rate. Alternative strategies modifying the central banks’ price stability objective have the major drawback of potentially damaging central bank credibility.