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Economy

# The dawn of a new era for interest rates

Stephen Bartholomeusz
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Are lower global interest rates something more than a temporary, albeit prolonged, post-crisis phenomenon or are they likely to be a permanent feature of the economic landscape?

That's a question that was posed by the US Federal reserve's vice chairman Stanley Fischer in a speech in California overnight. The answer was thought-provoking.

Fischer actually posed the question in more technical terms.

"Are we moving towards a world with a permanently lower long-run equilibrium real interest rate?" he asked.

The equilibrium real interest rate (the short form is r*) is the level of short-term real interest rates at which there is full utilisation of an economy's resources.

For the US, it is the level of real rates at which there would be full employment and an inflation rate of 2 per cent.

Fischer said that a variety of model and statistical approaches suggested that the current level of short-run r* could be close to zero and that it appeared likely to rise only gradually to a longer-run level quite low by historical standards.

In some respects, that's what markets and economists expect. They expect US interest rates to rise on a quite shallow trajectory with a return to a more conventional level over a period of several years.

Fischer raised the prospect that rates won't get back to the kind of levels regarded as normal in the past and the explanation for that possibility is fascinating.

As he said, the determinant of r* -- the level of short term rates consistent with an economy functioning at or close to capacity — is the balance between savings and investment.

If there is to be a decline in the long-run levels of r*, one factor would be a persistent weakness in aggregate demand.

Citing analysis by former US treasury secretary Larry Summers, Fischer said that among the possible reasons for a structural change to demand could be the amount of physical capital required by IT companies.

“The amount of physical capital that the revolutionary IT firms with high stockmarket valuations have needed is remarkably small,” he said. The development of physical capital-light but intellectual capital-intensive activity is, of course, having profound and increasing effects throughout economies and societies that go well beyond their impact on interest rates.

Another factor in rates remaining lower for much, much longer might be the slowdown in productivity growth, a feature of the past four years, while demographic trends — the ageing populations in the Western world and Japan and the increasing size of the cohort with high savings rates — could also be contributing.

More broadly, the high savings rates in emerging economies and a dearth of suitable domestic investment opportunities for those savings could be contributing to a global savings glut that imposes downward pressure on rates in developed economies.

For Fischer, whatever the cause the likely lower level of r* suggests that the frequency and duration of future episodes where monetary policy was constrained by zero-bound nominal interest rates — which may have thought to have been a historic aberration caused by a once-in-a-century financial crisis — will be higher in future than they have been in the past.

He answered the original question of whether r* would remain at today’s low levels permanently by saying he didn’t know, with many of the factors that determine those rates, particularly productivity, very difficult to forecast. It appeared likely, however, that it would remain low for the ‘policy-relevant’ future.

Fischer devoted part of his speech to the annual meeting of the American Economic Association to a question that continues to divide central bankers. Should they include financial stability considerations in the conduct of monetary policy?

That has been a longstanding debate within the Fed itself, with some board members concerned about the unintended consequences of ultra-low rate settings — the dramatic decrease in risk premia (or, alternatively, the increased acceptance of risk) as investors have been ‘encouraged’ to search for positive returns elsewhere.

Even before the financial crisis, however, central bankers have been debating the extent to which they should ‘lean’ against developing financial bubbles, given how destabilising they can be for real economies.

Fischer’s view, while accepting the Fed has a limited ability to deploy them, is that macro-prudential tools rather than monetary policy should be the first line of defence.

In Australia, the Reserve Bank (with the Australian Prudential Regulation Authority) has reluctantly used macroprudential measures to try to cool perceived hot spots in the domestic economy without killing off relatively weak general growth.

The housing boom triggered by historically low interest rates has been the biggest source of concern and has seen the implementation of a 10 per cent cap on growth rates in bank lending to investors and an increased focus on lending standards, including 'encouragement' for lower loan to-valuation ratios and tougher servicing requirements.

The global capital adequacy regime, which has seen the banks required to hold more and higher quality core capital, the capital surcharge of the four big banks for their status as domestic systemically important banks and last year's foreshadowed introduction of a floor under mortgage risk-weightings (which forced the major banks to raise about $20 billion of additional capital) could also be seen as macroprudential measures.

Globally, there has been the introduction of counter-cyclic capital buffers, a reversal of the regulators' previous prohibition on banks' stocking away capital in the good times as insurance against the bad. APRA has, for the moment at least, set its buffer rate at zero. That implies it is satisfied that the majors are adequately capitalised.

One of the implications of the global tide of re-regulation and new regulation in response to the financial crisis is that, if and when official rates settings return to more normal levels, bank credit may be more expensive and less available as banks try to generate reasonable returns on capital by juggling their pricing of loans against the implications of asset growth rates for their balance sheets.

Thus, macroprudential measures might also have implications for what growth rates in economies might be and where r* might settle.

In the meantime they do provide a way for regulators to target specific hot spots in their economies — the unintended consequences, perhaps, of their monetary policies — without the economy-wide and potentially counter-productive use of the quite crude monetary policy tool.

At a time of weak and fragile growth in the developed economies and significant spluttering now developing in the emerging economies the near-term certainty is that central banks, including the Fed, will be very cautious in implementing any strategy of normalising their monetary policies.

'Normal', of course, might be defined — as Fischer is suggesting — quite differently in future to the way it has been in the past.

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