

ROUNDTABLE ON MONETARY POLICY IN A LOW GROWTH, LOW INTEREST RATE ENVIRONMENT

Salvatore Rossi

Senior Deputy Governor of the Bank of Italy

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The role of interest rates—short- or long-term, nominal or real—is pervasive in modern economies. Changes in interest rates affect: the value of wealth accumulated by savers, their propensity to save, the financing cost for borrowers, the evaluation of investment projects, the sustainability of fiscal debt, the stance of monetary policy. And the list could go on.

We know that in many advanced economies, short- and long-term nominal interest rates are at historically low levels. And they have been very low for several years by now.

This environment should not be viewed merely as a consequence of the central banks' reaction to the global financial crisis; in a longer time perspective, it is also the end point of a trend. Some data: since the early 1990s the 10-year nominal yields on Government bonds have declined by 10 percentage points in the UK, 9 in the euro area, 6 in the US and Japan; short-term nominal interest rates have followed a similar pattern though with a larger volatility.

How come? What are the associated risks and policy changes?

In trying to answer these questions let me first recall that the nominal interest rate can be viewed as the sum of three components: 1) the real interest rate, 2) the expected inflation, and 3) a term premium.

Economic theory tells us that the real interest rate is the price that equates the supply of savings with the demand for funds aimed at financing investment. Supply and demand, in turn, are determined by factors such the preference of households to smooth consumption across time and the productivity of capital.

The expected inflation and the term premium components of the nominal interest rate are self-explaining: when buying a long term bond I want a return that could compensate me for the potential loss in my future purchasing power, and for the risk of a potential capital loss if I needed to sell the bond prior to maturity. A lot of influencing factors are involved here: expectations about future economic growth and inflation; the degree of risk aversion; financial markets volatility, domestically and abroad, since capital markets have become globally integrated.

Which of these factors can explain the current low interest rate environment? I would indicate two sets of factors: *transitory*, and *structural*. The latter are particularly important, since they may suggest that the current environment is a long-run phenomenon, bound to stay with us for quite some time.

The *transitory factors* are evident: first of all the expansionary monetary policy stance put in place by many central banks in response to the global financial crisis, and, in the euro area, also to the sovereign debt crisis. We know that most central banks in the advanced countries, as policy rates were reaching the zero lower bound, have enriched their monetary policy toolbox with various unconventional measures, the most important and visible one being programs of securities purchases (QE).

Another transitory factor is the de-leveraging by the private sector. In part this is due to a financial regulation becoming much stricter than before the crisis.

And here comes the *structural factors*. They can be summarized as follows: an excess of desired saving over desired investment, leading to lower economic growth and real interest rates. This is essentially the secular stagnation hypothesis proposed last year by Larry Summers.¹

Barry Eichengreen, one of the most prominent economic historians of our times, has recently written an illuminating article on this topic.² He discusses four possible explanations.

- 1) High savings rates in emerging-market economies. This is the well-known global savings glut hypothesis put forward years ago by Ben Bernanke.³ The idea is that in some emerging countries, China in particular, social protection systems are so limited and weak that households feel forced to increase their precautionary saving.
- 2) The decline in the relative price of investment goods (machinery, equipment, ICTs), thanks to technological progress. For a given investment project, a fall in the relative price of investment reduces the demand for funds. With less investment spending chasing the same savings, the result can be a lower real interest rates and, potentially, a chronic excess of desired saving over desired investment.
- 3) A lower rate of population growth, in the advanced economies and now also in some emerging markets. It is reflected in a slower growth of the labor force, in turn requiring less investment.

¹ Summers, H. L. (2014), "U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound." *Business Economics*, 49, pp. 65-73.

² Eichengreen, B. (2015), "Secular Stagnation: The Long View." *American Economic Review*, pp. 66-70.

³ Bernanke, B. S. (2005), "The Global Saving Glut and the U.S. Current Account Deficit." The Sandburg Lecture, Virginia Association of Economists, Richmond, VA, March 10.

- 4) The fourth possible explanation is the more controversial one. The idea is that the pace of scientific and technological inventions has slowed down, since the golden XX century of electricity and ICTs, and will never recover, causing a corresponding permanent scarcity of high-return investment opportunities. Robert Gordon is a supporter of such a pessimistic view.⁴

Personally, I don't believe in this fourth factor: the innovative capabilities of humankind have always caught philosophers and economists by surprise. But the other three factors are serious and deserve to be addressed.

Let me now briefly touch upon some policy implications.

Nearly eight years after the onset of the financial crisis, global growth is disappointing on average, but with a high variance across countries and regions. The U.S. recovery is continuing at a sustained pace, while growth in the euro area and Japan is currently still modest, though expected to pick up. Emerging economies' growth will decline for the fifth year in a row in 2015, although these economies will continue to increase their share of global GDP.

Against this outlook, monetary policy stance across major economies may become asynchronous in the coming months, when the Federal Reserve will actually start the announced normalization process.

The big question is: how much transitory are the transitory factors explaining the current low interest rate environment? What will happen when monetary policy normalizes? Or will the structural factors prevail and keep real and nominal interest rates low forever, or at least for a very long time?

On the first point, Reinhart and Rogoff,⁵ among others, have shown that in the aftermath of financial crises economic recessions tend to be more severe than in typical business cycle recessions and the recovery takes longer. Credit cycles last longer than business cycles. But eventually they come to an end, once households' and corporates' balance sheets have been repaired. And that poses the problem of how and when normalizing monetary policy.

On the second point, a challenge relates to possible spillover effects on emerging-market economies of changes in the monetary policy stance in advanced countries. Large capital flows went to emerging-market economies in the last years, in search for yield, putting upward pressure on asset prices and exchange rates in those economies. They might suddenly reverse when monetary conditions change in advanced economies. The risk is that the process becomes disorderly, with impaired liquidity in certain markets or asset classes, rapidly diffusing contagion to other correlated asset classes. These risks call for clear and effective communication strategies by central banks, while the authorities in emerging economies should further strengthen policy buffers and further advance structural reforms.

Another delicate policy challenge regards the relation between monetary and fiscal policies. The combination of high public debt—accumulated in many advanced economies in response

⁴ Gordon, R. (2012), "Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds." National Bureau of Economic Research, Working Paper 18315.

⁵ Reinhart, C. M. and Rogoff, K. S. (2009), "This Time Is Different: Eight Centuries of Financial Folly." Princeton, New Jersey: Princeton University Press.

to the financial crisis—and very low interest rates has strengthened the interdependencies between the two policies. Exceptionally low nominal interest rates have contained debt servicing costs, and that's good news; the flip side is that fiscal positions are highly exposed to changes in the monetary policy stance, especially if changes are abrupt.

Finally, what if the current low interest rates were the new long-run equilibrium? In this case I would see serious challenges for monetary policy management. Central banks might more often encounter the zero lower bound on nominal rates, which would imply less room to maneuver the policy rate to counteract deflationary shocks. The economy would be less resilient to negative shocks. Central banks might have to increasingly resort to what we call unconventional policies. But we do not know how effective these tools are as a normal business cycle stabilizer, and what macroeconomic risks they might entail.

Let me conclude signaling another risk. Economic policies became exceptionally accommodative after the financial crisis in order to save the world from another Great Depression. Financial panic was destroying households' and corporates' confidence and curtailing aggregate demand, so macroeconomic policies, both fiscal and monetary, had to fill the gap, as long as needed. The phase of very low nominal interest rates has been necessary, and still is necessary in many areas of the world including the euro area, in order to support growth, fight deflation risks and sustain employment. But low growth, and the ensuing low interest rates, risk feeding on themselves if allowed to linger for too long: households may eventually feel compelled to save more, because they see, for instance, their insurance policies and retirement schemes at risk of not being fully honored. At the same time, low growth implies low return from real investment, and this creates perverse incentives to search for yield taking risk on board; this may jeopardize financial stability.

One main lesson comes from these considerations. The most effective and long-lasting solution to tackle the declining trend of real interest rates is to act forcefully and preemptively to support growth. Support remains necessary from the demand side; but in the longer run it must come from the supply side, by identifying and implementing those reforms that, encouraging investment, may boost productivity and support job creation. We need to prove Robert Gordon's prophecy wrong. The consequent increase in potential economic growth would raise the real interest rate and push nominal interest rates into a safer territory.