How long can the low interest rate environment last?

Agustín García / Alejandro Neut

The low interest rates in developed economies are a symptom with multiple causes, some structural and others cyclical, which taken together suggest we'll see very gradual rate hikes. In fact, it could take up to a decade to see policy rates converge at around 3.5-4.0%, way below the 5% benchmark rate seen prior to the global crisis.

The structural factors are nothing new and several have been pushing rates lower for more than a quarter century, whether it be to boost credit supply (savings) or lower demand (investment). We should point out that some have already faded or are being removed, as is the case with the higher savings seen in emerging markets (tied to development via export policies) or baby boomers who are about to enter retirement. But there are several factors that are changing the rules of the game and will only recede if they are actively dealt with, such as low productivity growth, the relative slowdown in the active population and inequality. Lastly, there are causes that raise major uncertainties, giving rise to more technical discussions, such as the reduction of the term premium in long-term benchmark rates.

As for the cyclical factors, these are closely linked to a glut of private debt, which caused the global crisis of 2008. The correction has been painful and very slow, but it is making headway and the process is expected to go forward in an orderly fashion. This cautious optimism is driven, mainly in Europe, by the continued normalization fostered by an accommodative and highly reactive monetary policy, which will tighten very gradually and keep an eye out for any setbacks in the forecast recovery.

We should applaud the concern shown by monetary authorities, and appreciate the fact that their inflation targets are aligned with those of the economic recovery. But we should also point out that they face significant risks: the deleveraging of China has yet to take place, the paradigm of globalization is still being questioned by extreme and disruptive positions, which are gaining popular support, and monetary authorities themselves are currently in uncharted waters, as the lack of support from fiscal/structural policies has forced them to implement measures that have side-effects that could cause financial instability. That's why it is of capital importance to remain vigilant on several fronts (financial, behavior of economic agents, political).

In the Eurozone the ECB faces a particularly urgent challenge. There are practically no more tools in the monetary policy toolbox after implementing negative rates and unconventional asset purchases. Among the risks that these extreme policies have engendered are catastrophic events such as the drying up of liquidity on markets with government purchased bonds, the creation of bubbles related to the incorrect valuation of risks, the sudden collapse of deposits, which already offer depositors zero return and mean losses for the banking sector, and the loss of central bank credibility, which given their limited room for action may lead them to take riskier measures.

In light of this scenario, over the medium term one of the keys is to continue developing macro-prudential policies that ensure the stability of the financial sector. While over the longer run authorities should consider whether or not structurally lower nominal rates require precautionary reforms that prevent central banks from quickly losing room to maneuver when faced with adverse cycles in the future. One possibility is to increase the inflation target in order to keep nominal rates higher to gain more space to act. Another possibility would be to implement digital currency, which eliminates the obstacle posed by reducing rates into negative

territory.

However, successful monetary policy doesn't take other authorities off the hook, given that there is room for structural reforms that are aligned with boosting productivity, and also for expansive fiscal policy (like the Juncker plan) that spurs growth with fiscal multipliers greater than one.

In short, low or negative interest rates are here to stay for a long time, so economic agents must adapt to this new environment.

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