



# **Stop Depending on the Kindness of Strangers**

Low interest rates and the Global Economy

**BRIAN STURGESS**

**With a foreword by Sir Martin Jacomb**

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# CONTENTS

Foreword by Sir Martin Jacomb

Summary

1. Introduction	1
2. The Economic Impact of Unconventional Monetary Policy	6
3. What Determines Interest Rates?	18
4. What is Causing Low Interest Rates?	30
5. Time to Grow-Up	44
References	50

## FOREWORD

Democratically governed market economies work better than any alternative, as we all know. However things have not been going well since the banking crisis. Several factors are at the root of this problem; but the principal cause of the failure of economies to get back to stability and success is the long continuation of low interest rate policies in force everywhere from the U.S., through the UK and Europe, to Japan.

Drastic interest rate reduction by central banks in the face of the 2007/8 crisis was the right response. A collapse was avoided. But the continuation of ultra-low rates for the last eight years has not achieved its intended result of renewing growth. It has done the opposite.

It is high time that the governments and central banks concerned got together and had a re-think. The idea that credit should be cheap, that savings are pointless, and that borrowing levels do not matter, is contrary to common sense. Harm is being done to individuals, to businesses and to the next generation.

Low interest rates are (in themselves) convenient for indebted governments. Recently however, in spite of this, and perhaps prompted by a few of us who have pointed out the damaging effects, voices of authority have begun tentatively to canvas a change of tack.

This paper analyses the issues in depth, and will, I trust, help persuade those in authority to decide on a fundamental change.

**Sir Martin Jacomb, January 2017**

*Sir Martin Jacomb is former Chancellor of the University of Buckingham, Chairman of Canary Wharf Group and Deputy Chairman of Barclays Bank.*

## SUMMARY

- Unconventional monetary policy – typified by very low interest rates and quantitative easing – was originally intended to be a short-term response to the financial crisis of 2007/8. Ten years later, it remains in place in all major Western economies.
- This may be politically convenient for those governments – such as in the US and the UK – which continue to run significant budget deficits, but its consequences have been severe:
  - It has exposed the global economy to great risks. When the next economic downturn occurs, central banks will have few options other than more QE.
  - It has failed to stimulate economic growth.
  - It has misallocated capital, and has encouraged ‘zombie capitalism’ and the rebuilding of corporate balance sheets ahead of productive investment.
  - It has failed to reduce deflationary pressures.
  - It has mispriced risk.

- It has obliged pension funds to invest in low-yielding government bonds, exposing them to significant risk should interest rates rise sharply in the future.
  - It has stimulated a boost in asset prices (particularly in share and house prices), thereby rewarding the already wealthy while punishing savers on lower incomes.
  - It has probably contributed to the widespread and deep-seated sense of unfairness that is prevalent in many of today's Western economies.
- It is time to grow up. The status quo cannot and should not continue, whether for economic or political reasons. Monetary policy should return to normal. This will expose today's politicians to difficult decisions, but failure to change direction will only, eventually, result in even greater pain. The small increase in interest rates by the Fed in December 2016 will hopefully be the first step in this process.
  - If the leading central banks signaled and then co-ordinated a gradual increase in bank rates, this will prevent the triggering of a currency war.
  - Unconventional monetary policy was introduced not by democratic governments, but by central banks. Decisions which affect the lives of billions of people have been taken by central bankers with little parliamentary scrutiny or consent. This suggests that the question of central bank independence should be revisited.

**“I have always depended on the kindness of strangers.”**

- Final words of Blanche DuBois as she is led off to the lunatic asylum in *A Streetcar Named Desire*.



# 1. INTRODUCTION

The global economy is experiencing a historically extraordinary period of low interest rates with only a few national exceptions.<sup>1</sup> Economists differ about the fundamental causes of this phenomenon, but one of the primary factors underpinning an environment of low and even negative bond yields, is the unconventional monetary policies which have been followed by central banks since the financial crisis. These policies, guaranteeing lower interest costs for financing government debt, are 'politically convenient' and this convenience is delaying a return to a normal environment of higher, healthier rates.

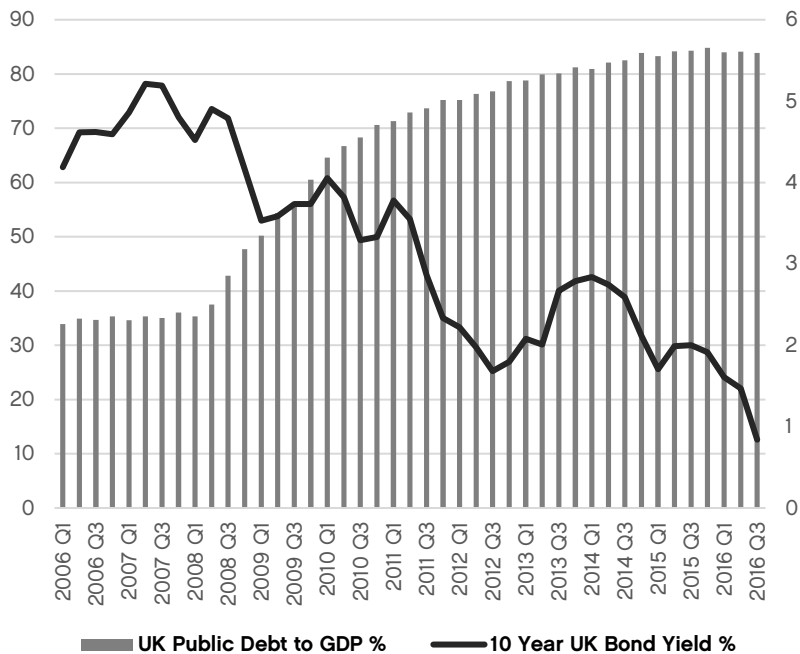
Nearly a decade after the financial tsunami of 2008, it is now apparent that low rates contribute to high and increasing levels of government debt by facilitating cheaper public borrowing. In

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<sup>1</sup> Some countries experiencing domestic problems including capital flight and high inflation have interest rates well above the global average level, On November 10 2016 the central bank policy rates set in Brazil, Russia and China were 14.0%, 10.0% and 4.35% respectively.

the UK, government debt as a percentage of GDP rose from 33.9 percent in Q1 2006 to reach 83.9 percent<sup>2</sup> by Q3 2016 while over the same period average nominal bond yields on 10 year government debt fell from 4.187 percent to 0.84 percent. See Figure 1.

**Figure 1 Bond Yields and UK Public Sector Debt**



Source: Bank of England, Debt Management Office

Similar patterns of rising debt and falling bond yields have occurred across the developed world, apart from in Germany. This means that supposedly independent institutions like the

<sup>2</sup> Excluding Public Sector banks.

Federal Reserve, the Bank of England, the Bank of Japan and the European Central Bank, whose powers influence the price of money for most of the world,<sup>3</sup> are following monetary policies that are closely aligned with the interests of politicians. Highly indebted governments can painlessly finance deficits while ‘kicking the can down the road’ thereby failing to reduce bloated and inefficient public expenditure levels. In contrast, conventional monetary policy, aimed at achieving low and stable inflation, created an effective straitjacket for governments.

A new norm, the practice of Quantitative Easing (QE), has replaced conventional monetary policy. QE involves the purchasing of government bonds and commercial paper on a massive scale, bolstering the prices of these assets and pushing down yields and market interest rates close to zero, and even into negative territory. What was originally intended as a short-term response by central banks to offset the negative impact of the financial crisis, now appears to be firmly established. As Richard Clarida, the global strategic adviser at Pimco, has claimed “QE begets QE”.<sup>4</sup> But this situation cannot continue. The adoption of Zero Interest Rate and Negative Interest Rate Policies (ZIRP and NIRP) means that, when the next downturn occurs, central banks will have few options other than more QE – although some have

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<sup>3</sup> The interest rates set by the G4 central banks cover polities accounting for around 55% of global GDP, but influence the rates charged by other central banks through international currency markets.

<sup>4</sup> Clarida (2014).

discussed the even more unconventional possibility of helicopter money.<sup>5</sup>

In place of ever more extreme descents into the unknown, central banks should quickly renormalise monetary policy. That would involve ending QE and allowing interest rates to rise steadily so that interest rates can carry out their proper functions. Failure to do so will leave the global financial system vulnerable to potential shocks such as the failure of the euro, or the fiscal stresses in the US resulting from the unfinanced spending plans announced by Donald Trump in his presidential campaign.

Unfortunately, as long as government borrowers can rely on the 'kindness of strangers',<sup>6</sup> there are few incentives for change. Furthermore, a low interest rate environment is also providing a disincentive for private borrowers to reduce their borrowing. The danger is that the longer it takes to return to normality, the greater the probability that a future financial shock will be as damaging

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<sup>5</sup> While the original idea of helicopter money describes central banks making payments straight to individuals, economists including Ben Bernanke have used the term 'helicopter money' to refer to a wide range of different policies, including the 'permanent' monetisation of budget deficits. Note that while Milton Friedman originally coined the term, he did so as a thought experiment, not as a policy recommendation; and that should it ever work, people would have to believe that it were a one-off event. Given that QE was also first introduced as a temporary measure, but now appears permanent, persuading people that it would never be used again would be "challenging".

<sup>6</sup> This phrase was used by Mark Carney, Governor of the Bank of England, in relation to how the UK would finance its large current account trade deficit post-Brexit. See: The Guardian, *Mark Carney fears Brexit would leave UK relying on 'kindness of strangers'*, January 2016.

as the fate awaiting Blanche du Bois.<sup>7</sup> However, unless normality is restored soon, or if a shock comes earlier, the extent to which central banks have been allowed by politicians to follow technocratic initiatives such as QE without the approval of, or even consideration of many legislatures, could lead to pressures that will threaten their newly won, but carefully guarded, independence.

The remainder of this paper is divided into four sections.

Section 2 analyses the severe negative economic impact to the global economy of the sustained low interest rate environment since the crisis. Section 3 considers the factors that determine the level of interest rates and describes secular trends in global rates in the developed world over the last three decades. Section 4 looks critically at the main explanations for why the trend in rates on government bonds has been downward both before and after the Great Financial Crisis, and assesses the extent which market rates have been held down below natural rates by secular trends or by deliberate central bank policies. Section 5 concludes.

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<sup>7</sup> “Whoever you are, I have always depended on the kindness of strangers.” is the final line of the 1947 play *A Streetcar named Desire*; spoken by the tragically delusional Blanche DuBois as she is being led off to the lunatic asylum. This is the first recorded use of the phrase.

## **2. THE ECONOMIC IMPACT OF UNCONVENTIONAL MONETARY POLICY**

The impact of unconventional monetary policies is unreservedly bad when used for too long. Following the 2008-09 crisis, they did have some short-term success, allowing a massive injection of liquidity which was then required to offset the negative effects of the crisis on bank's balance sheets and of a collapsing money supply.

But, since then, QE has failed to stimulate economic growth and is itself one of the principal causes of the economic malaise afflicting much of the developed world. While central bank actions are benefitting indebted governments and other private debtors who can more easily finance loans, serious problems are accruing which are holding back growth in the global economy and which threaten an impending crisis. For example, the IMF<sup>8</sup>

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<sup>8</sup> IMF (2016).

has warned recently that the rise of public and private global gross debt to a level of US\$152 trillion risks producing stagnating economic growth or even a recession. Debt has risen sharply during the period of low rates that have followed the 2008-09 financial crisis.

Zero and negative interest rates cause many damaging distortions. Risk is mispriced and capital is misallocated. Furthermore, the combined economic impact of QE programmes have failed to achieve their aims in the countries practicing them. In the US, QE was pursued in three blocks known as QE1,<sup>9</sup> QE2 and QE3 totalling US\$4.48 trillion, but these bursts of asset buying between 2009 and 2014 have all failed to return GDP growth to the economy's potential path by the end of 2016.

Neither has inflation returned to the Federal Reserve's target of 2 percent, but instead low rates have stimulated a boom in financial asset prices and have slowed down deleveraging. By the end of the QE3 programme in October 2014, US equity prices were trading at levels seen during the 1990s dotcom bubble and just before the financial crisis.

Similarly, continuing QE programmes by the Bank of Japan (BOJ) and the European Central Bank (ECB) have not stimulated growth nor effectively combatted deflationary pressures. Despite this, the Bank of Japan is showing no signs that its QE programme may be ended soon and is still purchasing around ¥80 trillion of

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<sup>9</sup> QE1 lasted between December 2008 and March 2010; QE2 lasted from November 2010 to June 2011 and QE3 was announced in September 2012 and ended in October 2014, ten months after the Federal Reserve began a tapering of the size of its monthly asset purchases.

government bonds and ¥6 trillion of equities per year. In the first week of December the ECB announced a decision to cut back the amount of bonds it buys monthly from €80 billion to €60 billion from March 2017, but at the same time it extended the programme by nine months to the end of 2017.

Far from failing to stimulate nominal GDP growth there is a strong case to be made that through distortionary effects on capital markets, on investment and savings preferences and distributional impacts, unconventional monetary policies depress growth. In addition, the existence of 'spillover' effects have also had damaging effects on many emerging economies beyond the countries practising QE. Nevertheless, despite the accumulating evidence that unconventional monetary policies including QE, Zero Interest Rate Policies (ZIRP) and Negative Interest Rate Policies (NIRP) do more harm than good, the Bank of England has restarted its QE programme. This has added to the government and corporate bond buying programmes of the Bank of Japan and the European Central Bank.

## **2.1 The Economic Consequences of Mr Carney**

On August 4 2016, Mark Carney, the Governor of the Bank of England, announced that the Bank's bond buying QE programme would be restarted after a hiatus of just under three years.<sup>10</sup> In

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<sup>10</sup> This decision may in time be seen to be as misguided as previous Bank of England catastrophic mistakes. In 1925 in a pamphlet entitled the 'Economic consequences of Mr Churchill', John Maynard Keynes condemned how the Bank of England encouraged the Chancellor of the Exchequer Winston Churchill to return sterling to the gold standard at an inflated exchange, thereby causing severe deflationary pressures on domestic prices. See: Keynes (1925).



total the Bank agreed to buy an additional £60 billion UK government bonds taking the total stock acquired since the start of the QE programme up to £435 billion. In addition the Bank announced it would purchase £10 billion of corporate bonds and that bank rate would be cut by 25 basis points to 0.25 percent. Prior to this decision by the end of 2015 through the Bank's Asset Purchase Facility, the Government effectively already owned 30 percent of its own debt.<sup>11</sup> The resumption of QE and its extension to the purchase of corporate bonds by the Bank of England implies that it has now entered a vicious spiral in which it must keep buying more debt to keep the interest paid by the Government low. The official rationale was to support growth in a post-Brexit environment of economic uncertainty,<sup>12</sup> but as monetary expert Tim Congdon has commented:<sup>13</sup>

“No good case whatsoever can be made for the latest round of Bank of England asset purchases, since money growth was positive at a satisfactory rate beforehand.”

The Prime Minister has also spoken out against the unconventional monetary policies carried out by the Bank of England. In her first closing speech as leader at the Conservative party conference in Birmingham in September 2016, Theresa May

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<sup>11</sup> Data from the Debt Management Office places the nominal value of total gilts at £1,427 billion so with the total stock of gilts acquired at £435 billion, not accounting for redemptions, this estimates the percentage of total gilts owned by the Bank of England at 30.47%.

<sup>12</sup> Bank of England (2016).

<sup>13</sup> Congdon (2016).

argued that the “emergency measures” necessary to combat the financial crisis of 2008 had created some “bad side effects.”<sup>14</sup>

“Because while monetary policy – with super-low interest rates and quantitative easing – provided the necessary emergency medicine after the financial crash, we have to acknowledge there have been some bad side effects. People with assets have got richer. People without them have suffered. People with mortgages have found their debts cheaper. People with savings have found themselves poorer. A change has got to come. And we are going to deliver it.”

In contrast, in October 2014, the Federal Reserve announced that its bond-buying QE programme was over. And in December 2015, Janet Yellen chair of the Federal Reserve announced that the target range for the federal funds rate would be raised to 0.25 to 0.5 percent, the first rise since 2006. The Fed should have raised rates at its September meeting, but with the delay caused by the presidential election over, the Open Market Committee of December 13-14 made the decision to raise the target range again to 0.5 to 0.75 percent. Despite speculation that next year will see three further rises in rates, a *Financial Times* survey of economists estimated that the target range for the end of 2017 would still be only 1.0 to 1.25 percent.<sup>15</sup> However, with US 10 year bond yields rising from a low of 1.36 percent on 8 August to a

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<sup>14</sup> The Telegraph, *Mark Carney tells Theresa May to help savers suffering from low interest rates*, October 2016.

<sup>15</sup> Financial Times (2016).

current rate of 2.58 percent<sup>16</sup> the time for the Federal Reserve to grasp the nettle is now. But if the Federal Reserve has committed a sin of omission in 2016 by not raising rates quickly enough, the Bank of England has committed a sin of commission by reducing rates in the summer and failing to raise them at the last meeting of the Monetary Policy Committee of the year on December 16, held after the US rise.

## **2.2 Impact on Economic Growth**

The regime of low and negative market interest rates has had serious adverse global economic consequences. These were meant to entice companies and consumers to take more risks by raising consumption and investment. But none of the later QE programmes have succeeded in achieving their objectives. Neither Zero Interest Rate Policies (ZIRP) nor Negative Interest Rate Policies (NIRP) have been in any way stimulatory. Economic growth in most of the developed economies remains anaemic. Unfortunately, unconventional monetary policies, now seen as so necessary by so many central bank technocrats, may be having a negative impact on economic activity and growth. In a paper published in 2012, Michaelson and Walker<sup>17</sup> studying G7 data from 1950 to 2009 found that the expected relationship between real interest rates and annual real income growth rates, whereby higher real rates would be associated with lower real growth, did not operate at all levels of rates. Evidence of the normal negative relationship between real interest rates and economic growth assumed in the use of conventional monetary policy was found

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<sup>16</sup> Rate on 19 December 2016.

<sup>17</sup> Michaelson and Walker (2012).

to exist only as interest rates approached the zero bound, but after this the relationship reversed with zero and negative real rates being associated with lower growth. In other words ZIRP and NIRP could lower economic growth.

The statistically significant positive relationship found between negative real rates and lower growth does of course not indicate that one causes the other. It is also possible that the correlation found arises because low growth causes low and negative real interest rates as a result of monetary policy makers cutting rates in response to recessionary circumstances or economic shocks. But it is not difficult to explain why low and negative real rates send out economic signals that can lower economic growth. Fundamentally, in equilibrium the natural rate of interest that clears the market for savings and investment, also represents the price of capital. This is not observable, but if money market rates are kept down in the mistaken belief that the natural rate has fallen due to unconventional monetary policies, this will lead to mispriced risk – and will distort the return on capital, reducing the potential output of the economy and lowering productivity.

### **2.3 Impact on the Allocation of Capital**

A price of capital close to zero or even negative will have many long-term allocative effects. The mispricing of the cost of capital means that companies are more likely to undertake or continue projects that would not be profitable at normal rates of interest; or they may prefer to not invest at all and instead restructure their balance sheets.

Quantitative Easing was intended to provide liquidity into the financial system so that banks would lend to commercial customers and consumers stimulating expenditure and raising

investment. But banks profitability, already squeezed by additional regulations on capital requirements after the financial crisis, can be reduced by low policy and market rates of interest which would have a negative impact on lending.

The net impact of falling rates is not straightforward. Falling rates reduces the profitability on loans as there is a reduced spread between the policy rate and the rate the bank charges its customers – the interest margin. To the extent that banks are dependent on deposits for funding, zero and negative rates further afflict profitability since it is near impossible to pass negative rates onto customers. The spread between long-term and short-term rates also falls when interest rates are close to the zero bound. There is also evidence that for banks which finance their loans and investment by issuing debt or borrowing in wholesale money markets, the reduced cost occasioned by falling yields can raise interest margins. Data on the net interest margins of US banks and One Year Treasury yields from 1984 to 2010 analysed by the Federal Reserve Bank of St. Louis showed that for some short periods lasting a year or two, interest margins moved in the opposite direction to government bond yields as banks benefited from cheaper funding.<sup>18</sup>

The net effect of lasting QE programmes, however, is having a net negative impact on bank profitability, to a different extent in different countries. In the US, banking industry, profit margins are still being squeezed by low rates. According to the testimony of the Chairman of the Federal Deposit Insurance Corporation to Congress in 2016.

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<sup>18</sup> Wheelock (2016).

“During the 10 years leading up to the crisis, the average net interest margin for community banks was 4.0 percent. By 2015, after seven years of exceptionally low interest rates, the average community bank margin had fallen to 3.57 percent—a decline of 43 basis points. Non-community banks saw their margins fall even further, to just 3.0 percent in 2015. Margin pressure is likely to remain a challenge until interest rates rise to levels more in line with historical norms.”<sup>19</sup>

Although profit rates are protected by lower default rates when yields are low, capital is also misallocated as a result of banks allowing industrial customers and borrower to service what would be non-performing loans at higher interest rates. The number of so-called ‘zombie’ companies sitting on assets and talent is likely to be higher when interest are lower. One study based on a large database of UK companies predicts that a rise in base rates of 3 percent would significantly increase the number of companies falling into a high insolvency risk category. The author used a large company level panel data base of over 14 million company year observations (1998-2015) to model insolvency risk in relation to a wide range of firm level financial and non-financial variables including debt levels, macroeconomic conditions and the level of interest rates. Higher real interest rates, as would be expected, were found to have a positive and significant impact on insolvency risk in the sample, but this means that companies are

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<sup>19</sup> FDIC (2016).

surviving and using assets and credit that would be better served elsewhere with negative effects on growth and productivity.<sup>20</sup>

## **2.4 Distributional Impacts**

All monetary policies have distributional consequences. One of the more serious effects of the current regime is the financial repression of savers who earn low nominal rates of return below the level that would prevail without QE or ZIRP programmes. In contrast, these programmes allow borrowers, including the government, to benefit from low borrowing rates producing a transfer of resources from creditors to debtors. The greater the extent and the longer the length of time for which market yields are artificially held down by monetary policies below the rate of inflation producing negative real rates of return on safe government assets, the greater the size of the implicit stealth tax transferring resources from creditors to debtors. Negative interest rates reduce the real cost of servicing government debt and can reduce the real value of the debt outstanding, by the resource transfer or as has been the case, facilitate an expansion of debt. The same financial repression from a stealth tax can be accomplished by rising inflation, although this impacts on a larger set of groups than savers.

In either case financial repression can have a negative impact on economic growth by crowding out private productive investment in favour of the public sector. Furthermore, negative real interest rates arising from lower nominal rates by lowering the expected income received by retirees creates a perverse impact that saving can actually increase depressing demand since financial

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<sup>20</sup> Wilson (2015) p12.

assets do not produce the income planned at the time the savings were made. There are other negative distributional effects based on the use of cheap credit arising from low real rates which, instead of being funnelled into the purchase of investment or consumer goods, has arguably fuelled asset bubbles.

## **2.5 Impact on Pensions**

Low interest rates are causing severe problems for long-term investment institutions such as Life Insurers and defined benefit (DB) pension funds. These institutions have long-term liabilities, which they must match with long-term assets such as government bonds alongside riskier assets which will produce the returns sufficient to allow them to profitably meet outflows. Unfortunately, increased regulation of these institutions such as Solvency II European Directive which came into force in January 2016 has tended to push them into holding more safe assets such as government securities than they would have held under normal profit-maximizing conditions. But as bond yields have fallen, given the quantitative restrictions, these funds must invest more capital in these bonds to generate enough income to pay its members their guaranteed monthly pension or to meet other liabilities. This leads to the bizarre result that QE policies which have reduced the yield on bonds can lead funds to acquire more of these low-yielding assets. This again misallocates capital away from its most productive uses. Furthermore, if there is a return to inflationary conditions occasioning rapidly rising interest rates holders of fixed coupon assets such as government debt will suffer greatly from a sharp fall in market asset valuations.



In the UK, actuarial consultants Lane Clark and Peacock (LCP) in their annual Accounting for Pensions Report<sup>21</sup> calculated that the combined pension deficit of the 56 companies in the FTSE 100 that disclosed a deficit at their 2015 year-end was £42.3 billion. Following the recent cut in base rate and the extension of the QE programme by the Bank of England, pension scheme deficits have increased. By 9 August, LCP estimated that FTSE 100 companies had pension deficits totalling £63bn, up from £46bn at the end of July. It has been estimated that the Bank of England's decision to cut rates in August 2016 raised the pension liabilities of the FTSE100 companies by £17 billion in one month.<sup>22</sup> In the US the pension plans of S&P 1500 companies are estimated to have a total shortfall of US\$562 billion as of the end of July 2016 which has been growing as yields have fallen since the onset of QE and ZIRP. Unfortunately, while QE programmes have reduced yields they have bolstered bond prices so these deficits are being "filled" by purchasing government debt which will fall raising the deficits as interest rates return to normality.

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<sup>21</sup> Lane Clark and Peacock (2016a).

<sup>22</sup> Lane Clark and Peacock (2016b).

## **3. WHAT DETERMINES INTEREST RATES?**

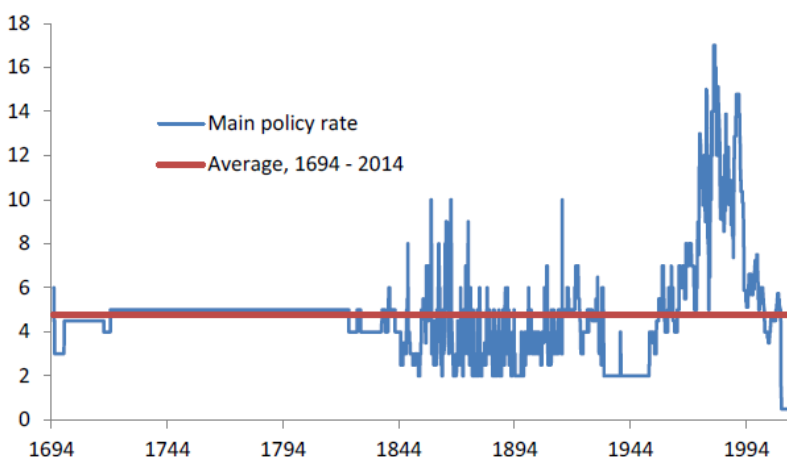
Interest rates are the cost of holding money in the sense that the opportunity cost of storing wealth in cash is the income foregone from not holding interest bearing assets. There are many rates of interest, ranging from those earned on safe government bonds of differing maturities to the usurious rates often charged on non-secured pay-day loans. In order to understand what determines market interest rates and to get a feeling for how high or low rates are, it is necessary to consider three crucial concepts: policy rates (the interest rates set by central banks), money market rates and the theoretical idea of the natural rate of interest.

### **3.1 Policy and Money Market Rates**

Policy rates, both nominal and real (adjusted for inflation), are at an unprecedentedly low level throughout the developed world. For the UK, David Miles, a former member of the Bank of England monetary policy committee, has calculated that the Bank's base rate, currently at 0.25 percent, is well below its historic average between 1694 and 2014 of 4.8 percent since. During that period,

it has ranged from 0.25 percent to 17 percent. (See Figure 2) With the Consumer Price Index showing prices rising by 1.0 percent in September 2016, the current short-term inflation adjusted real rate of interest was therefore negative at minus 0.75 percent compared to its estimated historic real rate of around 2.8 percent.<sup>23</sup>

**Figure 2 Bank of England's main policy rate 1694 to 2014**



*Source: Bank of England*

Short-term interest rates are set by central banks. They influence a whole series of market interest rates charged on government debt of varying terms and on corporate and private loans across the economy. In the UK, the Bank rate is the rate of interest charged to banks for secured overnight lending. It is set by the Monetary Policy Committee and is regarded as the key rate for

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<sup>23</sup> Based on a long-term inflation estimate of 2 percent per annum.

the operation of monetary policy as it affects the price of credit and the demand for, and supply of, money in the banking sector and in the wider economy. In this context, before the financial crisis, the setting of short-term interest rates by central banks had two main functions as pointed out by Mervyn King:

“The first is to ensure that in good times the amount of money grows at a rate sufficient to maintain broad stability of the value of money, and the second is to ensure that in bad times the amount of money grows at a rate sufficient to provide the liquidity – a reserve of future purchasing power-required to meet unpredictable swings in the demand for it by the private sector.”<sup>24</sup>

In other words, central banks could ensure price stability while also being prepared to act as a lender of last resort in order to support the financial system in times of crisis. To facilitate these aims, the role for conventional monetary policy using short-term policy rates such as bank rate in the UK or the Federal funds rate in the US has traditionally been to nudge interest rates up or down if necessary to depress or stimulate demand; or to drop rates sharply if the stability of the financial system is threatened as the Bank of England and the Federal Reserve did in response to the severity of the financial crisis in 2008-09.

Throughout the developed world nominal policy rates are at or near to historic lows.<sup>25</sup> Real policy rates are negative in all countries experiencing consumer price inflation. Since policy

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<sup>24</sup> King (2016) p163.

<sup>25</sup> In December 2015 the Federal Reserve raised rates for the first time since 2006.

rates influence market rates, low policy rates means that the cost of safe long-term borrowing as evidenced in the market yields of 10 year government securities is also very low (close to zero in the case of Japan). Policy rates and long-term bond rates across the G7 countries as of December 3, 2016 are shown in Table 1.

**Table 1 G7 Countries Policy and Bond Market Rates November 2016**

	<b>Policy Rate</b>	<b>10 Year Bond Rate Nominal %</b>	<b>Inflation % *</b>	<b>Real Policy Rates %</b>
<b>US</b>	0.50	2.32	1.6	-1.1
<b>Japan</b>	0.00	0.02	0.2	-0.2
<b>Germany</b>	0.00	0.27	0.8	-0.8
<b>UK</b>	0.25	1.42	0.9	-0.7
<b>Canada</b>	0.50	1.58	1.5	-1.0
<b>France</b>	0.00	0.71	0.5	-0.5
<b>Italy</b>	0.00	1.99	0.1	-0.1

Source: *The Economist* November 26, 2016, Central Bank data<sup>26</sup>

Traditionally, in addition to setting the policy rate, central banks have also manipulated banking reserves and the supply of money by buying and selling government bonds or commercial

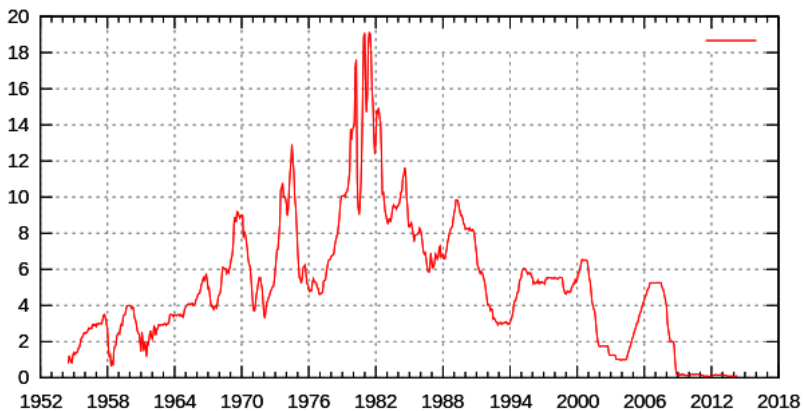
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<sup>26</sup> global-rates.com, *BoJ overnight call rate – Japanese central bank’s interest rates, 2016.*

paper through what is termed 'open-market' operations to inject or remove liquidity from the financial system.

In the financial crisis of 2008-09 the collapse in the supply of money as a result of the contraction of banks' balance sheets was so severe that both price and quantitative instruments were used in tandem.

**Figure 3 Federal Reserve Funds Rate 1954 to 2015 (%)**



Source: *Federal Reserve*

In a series of rapid stages as the financial crisis unrolled, the Federal Reserve cut the funds rate from 4.75 percent on September 18 2007 to 0.25 percent on December 16 2008. The Bank of England similarly slashed bank rate in several moves

from 5.75 percent on 5 July 2007 to 0.50 percent by 5 March 2009. (See Figures 2 and 3).<sup>27</sup>

The European Central Bank (ECB) reacted to the crisis after some delay but eventually followed the Bank of England and the Federal Reserve in reducing policy rates. The price to financial institutions of fixed rate weekly refinancing was not adjusted downwards by the European Central Bank until October 5, 2008 when it moved from a variable rate tender of 4.75 percent to a fixed rate of 3.75 percent. As the crisis developed this rate was adjusted down in stages to 1.00 percent by May 13, 2009, but after that further changes have moved out of step with other central banks policy rates and instead have reflected the internal problems of the Eurozone.

After a long period of time of slow growth, high corporate and sovereign debt and falling prices, the Bank of Japan had already held interest rates at very low levels for some time and therefore had less room to loosen monetary policy. The relevant policy rate is the uncollateralised overnight call rate.<sup>28</sup> This was reduced

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<sup>27</sup> The federal funds rate is the *interest rate* at which *depository institutions* lend reserve balances to other depository institutions overnight, on an *uncollateralized* basis. *Reserve balances* are amounts held at the *Federal Reserve* to maintain *reserve requirements*. The interest rate that the borrowing bank pays to the lending bank to borrow the funds is negotiated between the two banks, and the weighted average of this rate across all such transactions is the federal funds effective rate. The Federal Reserve uses Open Market operations to make the effective rate follow the funds rate.

<sup>28</sup> This is the interest which is charged when banks which are part of the system provide one loans with a short maturity of 1 day.

from 0.50 percent to 0.30 percent on October 31 2008; and then to 0.10 percent on December 19.

With nominal interest rates close to the zero lower bound, new instruments were added to the world's central bankers' toolkits. Rather than accept the Keynesian idea that such near zero interest policies (ZIRP) rendered monetary policy ineffective because of the liquidity trap,<sup>29</sup> both the Bank of England and the Federal Reserve also tried to expand the supply of money directly through Quantitative Easing (QE).<sup>30</sup> This involved buying paper assets and pumping liquidity directly into the banking system. The Bank of England bought £375 billion and the Federal Reserve acquired US\$2.7 trillion of bonds representing around 20 and 15 percent of GDP respectively.<sup>31</sup>

Most economists agree that the first round of QE was a success in that it saved the global financial system and prevented a repeat of the Great Depression of the 1930s, although there is also a legitimate view that recovery in the supply of bank money

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<sup>29</sup> A liquidity trap is a situation in which injections of cash into the private banking system by a central bank fail to decrease interest rates and hence make monetary policy ineffective.

<sup>30</sup> According to Joyce *et al* (2012), the term QE was first used to describe the policy tried by the Bank of Japan in order to drive up asset prices and eliminate deflationary forces. It involved purchasing government securities from the banking sector to boost cash reserves in the hope that this would stimulate lending and spending.

<sup>31</sup> King (2016) p183.



was also constrained by the contradictory impact of excessive regulations.<sup>32</sup>

But what was an emergency response now appears to have become the “new normal”. QE, in its various guises around the world, is highly convenient for indebted governments; and there appears to be little consideration of how to return to a state of normality. But QE is having serious long-term economic and distributional effects which politicians and central bankers will, one day, have to deal with.

### **3.2 The Natural Rate of Interest**

To argue that central banks are setting policy rates too low for too long, and supporting these rates with extensive bond buying programmes, presupposes knowledge of what rates should be. The level and term structure of domestic interest rates are influenced by the rate setting and open market operations activities of central banks, but rates are also subject to market forces. The theory of the determination of interest rates owes an enormous debt to the work of the Swedish economist Knut Wicksell<sup>33</sup> as recognised by Keynes in his *Treatise on Money*. According to Keynes:

“Wicksell conceives of the existence of a ‘natural rate of interest’ which defines as being the rate which is ‘neutral’ in its effect on the prices of goods, tending neither to raise them or lower them.”<sup>34</sup>

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<sup>32</sup> Hanke (2012).

<sup>33</sup> Wicksell (1898)

<sup>34</sup> Keynes (1930) p176.

Keynes defined Wicksell's natural rate "as the rate at which saving and the value of investment are in equilibrium" and noted that "the market rate cannot be continually held even a little below the natural rate unless the *volume of bank money is being continually increased*."<sup>35</sup> In contemporary monetary theory, the equilibrium rate of interest that should clear markets for savings and investment – balancing supply and demand – is the neutral or safe real rate of interest (the nominal rate plus expected inflation) with reference to dynamic considerations based on economic growth. Once upon a time, before the world entered the 'low rate never-never land' that exists today, whether or not conventional monetary policy was 'tight' or 'loose' – used to be measured in relation to this hypothetical "neutral interest rate" or the rate prevailing when an economy is growing at its trend rate with low inflation. This is the rate at which savings are being invested in such a way as to keep the economy on a sustainable growth path.

This rate is neither constant nor directly observable. It depends on many factors such as the stance of fiscal policy, the level of government indebtedness, the state of asset markets and the term premium built into the slope of the yield curve. But the conventional wisdom was that in normal conditions it was always going to be positive and always several percentage points greater than zero. According to Janet Yellen, current Chair of the Federal Reserve, writing in 2005:

"Research suggests that the neutral real rate is probably somewhere in a 1.5 percent to 3.5 percent range. To get

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<sup>35</sup> Keynes (1930) p177, author's italics.

to a neutral nominal rate, we have to add in expected inflation. That probably takes us to a neutral nominal range of around 3.5 percent to 5.5 percent at this point.”<sup>36</sup>

What a difference a decade makes. The neutral rate of interest is unobservable, but many monetary economists attempt to estimate it by looking at the spot rates on index-linked long-term government bonds since the safe rate is the rate a central bank will pay, and the premium is based on inflation targets and the market’s long-term inflation expectations. In the UK the Bank Rate or safe rate is the rate of interest paid on reserves held by commercial banks at the Bank of England. The safe real rate then is the return on inflation-proof bonds such as those that have been issued by the UK and many other countries for some time.

The data from index-linked bonds demonstrates the global trend in developed economies of falling real interest rates. In the UK, thirty year data from the Bank of England shows a steady decline in the spot forward real rate 10 years ahead based on index linked gilts from the mid-1990s to the present day. (See Figure 4)

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<sup>36</sup> Federal Reserve Bank of San Francisco, *What is neutral monetary policy?*, April 2005.

**Figure 4 Estimate of the real risk-free UK interest rate 1985-2014**



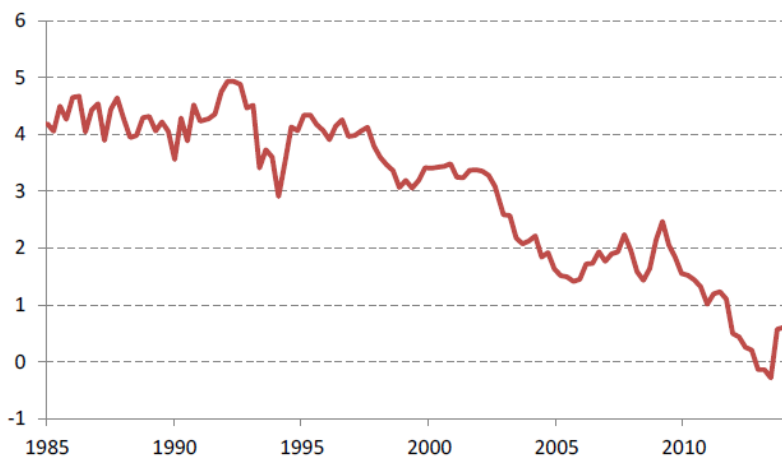
Source: Miles (2014)

In fact, real interest rates as measured by the yield on safe government bonds appear to have been declining right across the developed world for two decades. Figure 5 shows estimates of the real interest rates from the yields on inflation protected bonds since 1985 based on data for G7 countries (excluding) Italy calculated by ex-governor of the Bank of England, Mervyn King and David Low of New York University.<sup>37</sup>

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<sup>37</sup> Low and King (2014).

**Figure 5 Estimate of the real risk-free 'world' interest rate**



Source: Low and King (2014)

## **4. WHAT IS CAUSING LOW INTEREST RATES?**

There are three main competing, although often overlapping, macroeconomic explanations as to why the global natural real rate of interest may have fallen over the last 20 years:

- the Global Savings Glut theory proposed by Ben Bernanke;
- the Secular Stagnation theory proposed by Lawrence Summers; and
- the Debt Supercycle theory proposed by Ken Rogoff.

Each of these are discussed critically in turn in this section.

### **4.1 Global Savings Glut**

Ben Bernanke, chairman of the Federal Reserve, stated his concern in 2005, two years before the financial crisis, about the “significant increase in the global supply of saving – a global saving glut – which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term

real interest rates in the world today”<sup>38</sup> The implication was that, if investment is inadequate to absorb a rise in preferred saving, the equilibrium rate of interest has to fall. In an international context, the cause of the excess of savings over investment was linked to policies by many emerging economies to build up international currency reserves and to the existence of large trade surpluses resulting from the export-led economic growth strategies of countries like China.

Since the financial crisis some of these influences that were due to global imbalances have moderated in such a way as to indicate that the equilibrium rate of interest should start to rise. Chinese growth has slowed down and the economy has started rebalancing away from export-led growth, the oil price has been low for some time and the build-up of foreign currency reserves in emerging market economies has been slowing. In contrast, Bernanke<sup>39</sup> notes that a new source of the ‘savings glut’ has been contributed to the global economy from the significant increase in the collective current account balance of the euro zone with Germany becoming the world’s largest net exporter of both goods and financial capital.

## **4.2 Secular Stagnation**

Lawrence Summers, former US Treasury Secretary, first advanced the hypothesis in 2013 that persistent low interest rates indicated the risk that the developed world had entered a period of secular stagnation.<sup>40</sup> The idea of secular stagnation is not new and was

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<sup>38</sup> Bernanke (2005).

<sup>39</sup> Bernanke (2015).

<sup>40</sup> Summers (2013a).

proposed by Alvin Hansen,<sup>41</sup> an early American follower of the ideas of Keynes, in the 1930s.

Hansen argued that a combination of slowing population growth and technological progress was leading to feeble growth, a lack of investment opportunities and an accumulation of saving. Summers<sup>42</sup> has resurrected this theory and according to this perspective in the period after the financial crisis most of the world is facing an indefinite future of lower per capita real income caused by a deficiency of demand. A period of secular stagnation, already experienced in two lost decades in Japan, is faced by the global economy after the stimulus to world economic growth given by the rise of China has faltered.

Summers argues that a number of factors are at work which will depress investment demand. First, the growth in the working age population in the developed world is slowing and is unlikely to speed up over the next 20 years. – which will reduce the demand for equipment, the demand for new housing and the need for new commercial and industrial real estate.

Second, whereas the application of new technologies in previous decades from the 1950s onwards saw a rise in capital-intensive economic technologies, the shift away from manufacturing to less capital-intensive services has changed desired investment rates. The rise of the digital economy has intensified these trends meaning some economic activities need virtually no capital at

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<sup>41</sup> Hansen (1938).

<sup>42</sup> Summers (2013b).



all.<sup>43</sup> Offices can be smaller since people are likely to spend more time online working at home. E-commerce reduces the demand for shopping malls, for hotels, and for cars. There are many other factors at work that have reduced the demand for capital and the amount of capital needed per unit of output pulling down labour productivity. As Summers has concluded:<sup>44</sup>

“All of this taken together makes it highly plausible that we have seen a very substantial and structural increase in saving and decrease in investment resulting in low rates, resulting in a tendency toward economic sluggishness. In important respects this is the deep cause of the financial crisis.”

### **4.3 Debt Supercycle**

The argument that weak economic growth and low market rates post 2008 has been caused by the lingering aftermath of a ‘debt supercycle’ is associated with the writings of Kenneth Rogoff.<sup>45</sup> Growth will return, according to this theory, after the negative impact of an excessive debt build up subsides following a period of deleveraging. Based on an intensive long-term study of debt cycles Rogoff has argued that the debt supercycle view is highly relevant to the current state of the global economy. In a recent book based on the proceedings of an IMF conference he writes:<sup>46</sup>

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<sup>43</sup> Summers (2013).

<sup>44</sup> Summers (2016).

<sup>45</sup> Lo and Rogoff (2015).

<sup>46</sup> Rogoff (2016) p19.

“The run-up to and aftermath of the 2008 global financial crisis has unfolded like a garden variety post-World War II financial crisis, with very strong parallels to the baseline averages and medians that Carmen Reinhart and I documented in our 2009 book, *This Time Is Different*.”

Unfortunately, the necessary deleveraging process has not happened in this debt supercycle. That is because of a number of factors including:

- the unconventional monetary policies followed by central banks while maintaining policy rates well below equilibrium rates;
- the impact of the lingering Eurozone crisis;
- the low incentives for governments to reduce their borrowing requirements; and
- the difference between policy rates and what can be called the credit surface.

This is keeping growth sluggish and observed long-term bond rates down. Furthermore, Rogoff notes that current low policy rates and low market rates reflected in government bond yields do not reflect the higher rates faced by small and riskier borrowers who are squeezed out of credit markets by tighter banking regulation and the preference to serve low-risk borrowers such as governments and cash-rich corporations. This causes a bias between the unobservable true economic interest

rate and the real rate on government bonds used as a proxy. According to Rogoff:<sup>47</sup>

“My guess is that the true real interest rate is higher, and perhaps this bias is larger than usual. Correspondingly, true economic inflation is probably considerably lower than even the low measured values that central banks are struggling to raise.”

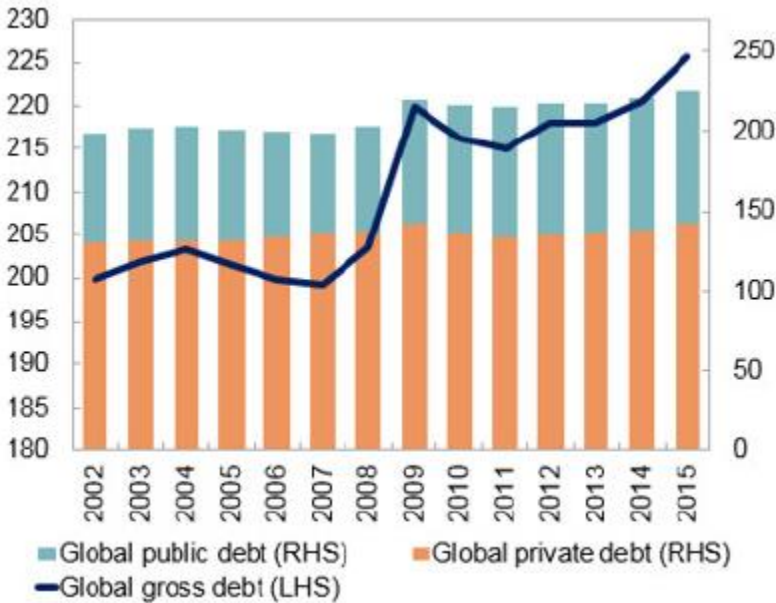
Data on the level of non-financial sector global debt shows not only a lack of progress in deleveraging since the financial crisis, but a greater indebtedness. In its Fiscal Monitor of October 2016, the IMF<sup>48</sup> has warned that private and public debt in the global economy standing at US\$152 trillion, or 225 percent of world GDP has reached a historic high and this is causing a major headwind to a return to global economic growth while raising the risk of another financial crisis. (See Figure 6).

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<sup>47</sup> Rogoff (2016) p23.

<sup>48</sup> IMF (2016).

**Figure 6 Global Private and Public Debt % of GDP<sup>49</sup>**



Source: IMF (2016)

Of course, it is not just the size of debt that matters. Globally, net debt is zero since the world's citizens, governments and corporations do not have a liability with Mars. The significance of debt depends on its distribution across private and public sectors, its division across the world and the use made of it whether it has been borrowed to finance consumption, productive investment or for speculation. According to the IMF's database two thirds of global debt, or US\$100 trillion consists of liabilities of the private sector which add to risks when they reach excessive levels. Resolving this debt overhang in a period of low

<sup>49</sup> Weighted average.

growth and low inflation will not be easy particularly when unconventional monetary policies keep down the cost of servicing both private and public debt.

#### **4.4 An Assessment**

None of the above explanations are completely convincing alone in understanding why the estimated equilibrium natural rate of interest has been falling globally over the last 20 years. A recent paper published by the Bank of England suggests that a large number of secular forces may have combined to cause declining long-term interest rates, Estimates of the size of the main influences are shown in Table 2. After analysing the secular trends that could have had a major impact on the global neutral rate the authors conclude:<sup>50</sup>

“When combined, lower expectations for trend growth and shifts in desired savings and investment can account for around 400bs of the 450bs decline in global real rates seen over the past thirty years.”

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<sup>50</sup> Rachel and Smith (2015) p51.

**Table 2 Contributory Causes of Low Interest Rates**

<b>Secular Cause</b>	<b>Impact on Global Real Rate (Basis Points)</b>	<b>Cumulative Impact (Basis Points)</b>
<i>Deterioration in outlook for trend growth</i>	100	100
<i>Shift in Savings schedule due to demographic changes</i>	90	190
<i>Higher inequality</i>	45	235
<i>Preference shift to higher saving following Asian Crisis</i>	25	260
<i>Fall in the investment due to decline in relative price of capital goods</i>	50	310
<i>Preference shift away from public expenditure projects</i>	20	330
<i>Increase in spread between risk free rate and the return on capital</i>	70	400
<i>Unexplained</i>	50	450

Source: Rachel and Smith (2015)

This suggests that most of the decline in long-term real rates, around 300bs, was due to shifts in preferences within a global savings-investment framework. Although the authors admit the

inherent uncertainty in their calculations stating that the “confidence intervals around estimates is clearly very wide,” around 50bs of the fall is unaccounted for. There are several possibilities to explain the authors’ results. Either the calculations of individual effects are underestimated or there are missing variables or the entire framework is wrong. Ignoring the latter for the moment, the authors discuss a number of explanations of the missing 0.5 percent, but the most interesting one is their admission that the market measures of real rates they are using, derived from long term government bond yields, are distorted.

This is the argument made by Rogoff that the data used to estimate the neutral rate of interest is biased downwards and the bias occurs because of the operation of monetary policy. Decisions on policy rates will always distort prices in the government debt market resulting in markets rates that are above or below the unobservable neutral rate. Bond prices in this market are determined by the demand and supply of safe assets and given the rising levels of public sector deficits in most advanced countries with the exception of Germany since 2009, bond prices should have fallen and yields should have risen. Instead the demand for safe assets has been reinforced by post-crisis regulatory changes and continuing central banks QE programmes which distort market rates.<sup>51</sup>

The original proponents of unconventional monetary policies were aware that very loose monetary policy carried significant risks in terms of currency depreciation, stimulating asset price

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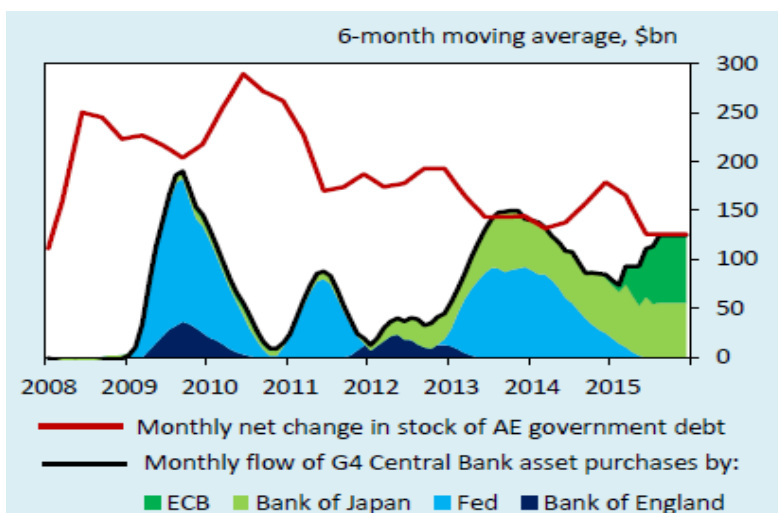
<sup>51</sup> A study by Joyce *et al* (2011) estimated that the Bank of England’s £200 billion of asset purchases lowered 10 year government bond yields by around 100 basis points.

bubbles and higher inflation. But at the time they were initiated these side-effects were considered to be risks worth taking given the economic dangers of a global drying up of liquidity and a consequent deep and prolonged recession in the aftermath of the global financial crisis. But that was in 2009 when the Federal Reserve and the Bank of England began their quantitative easing programmes. At the end of 2016, although inflationary pressures have not yet appeared in the developed world, ultra-low and negative interest rates have become not a solution but arguably part of the problem.

QE has indeed begat QE. Several of the largest central banks have embarked on unconventional policies to meet different perceived domestic needs. By 2015, the demand for Advanced Economies (AE) government debt resulting from government bond buying programmes by the ECB and the Bank of Japan alone was sufficient to acquire all public debt coming onto the market from the G4 economies. (See Figure 7)



**Figure 7 Supply of Public Debt and G4 central bank asset purchases**



Source: Rachel and Smith (2015)

The Federal Reserve has ended QE, but it hesitated to return interest rates to normality in the face of market tantrums<sup>52</sup> and the political impasse before the 2016 November presidential election. But as is shown in Figure 7, the Bank of Japan and the European Central Bank have continued with an extensive series of QE initiatives that have more than made up the difference

<sup>52</sup> Research by Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School for the 2016 version of Global Investment Returns by Credit Suisse looking at data from the US and the UK suggested that central banks have a habit of reacting to market tantrums. They found evidence that interest rates increases were postponed when stock market volatility is high which may encourage risky behaviour by investors.

caused by the reduction in asset purchases of the Federal Reserve and the Bank of England.

The Bank of Japan announced it would consider an asset buying programme in October 2010 with the aim of depreciating the Yen and stimulating inflation. This has been extended in stages without any noticeable impact on economic activity. In July 2012 Mario Draghi, President of The European Central Bank (ECB), announced in London that “*within our mandate, the ECB is ready to do whatever it takes to preserve the euro.*”<sup>53</sup> Then six years, after the original QE programmes of the Bank of England and the Federal Reserve, the ECB began acquiring sovereign and corporate bonds. Its balance sheet is expected to balloon to 35 percent of Eurozone GDP by 2017,<sup>54</sup> according to estimates by Bank of America Merrill Lynch. The ECB has been responding actively to deflationary fears within the Eurozone by QE and loosening monetary policy through rate reductions at intervals despite the fact that the source of deflationary pressures arise from the existence of the inflexible euro itself.

It is most likely that the fall in market rates seen after 2009 has had little to do with secular trends, but is more due to the impact of QE policies by central banks. The role of misguided monetary policy in creating the 2008-09 financial crisis has been outlined in a recent analysis by John Taylor. According to his explanation of the Great Financial Crisis, the Federal Reserve had departed in 2003 from the

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<sup>53</sup> Speech made at Global Investment Conference in London, 26 July 2012. See: Bloomberg, *Deutsche Bank Thinks Draghi's Gone Over to the 'Dark Side'*, November 2016.

<sup>54</sup> Financial Times, *Happy Mario Draghi day: four charts after 'whatever it takes'*, July 2016.

rules-based monetary policies that had produced what has been called the Great Moderation by reducing the federal funds rate to 1 percent (it had been 5.5 percent in 1997) when the inflation rate was around 2 percent producing a negative real rate and maintaining it at a low level during 2003-2005. He argues:

“In my view this policy change brought on a search for yield, excesses in the housing market, and, along with a regulatory process that broke rules for safety and soundness, was a key factor in the financial crisis and the global recession.”<sup>55</sup>

Similarly mistakes are being made now about the neutral rate of interest. The Bank of England study quoted above assumes that the long-term secular trends outlined above will continue and that this will keep the global neutral rate at a low level “perhaps settling at or slightly below 1% in the medium to long-term.”<sup>56</sup> If this assessment is used to guide the Governor, it has profound implications for the future misconduct of monetary policy. Indeed, the authors concluded that the implication for monetary policy in the face of any future shocks was similarly to administer more of the medicine that has not worked so far.

“Of course, short-term interest rates are not the only instrument in a central bank’s arsenal. With a persistently low global neutral rate, policymakers may become more reliant on unconventional policy measures – such as quantitative easing (QE).”<sup>57</sup>

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<sup>55</sup> Taylor (2016) p136.

<sup>56</sup> Rachel and Smith (2015) p51.

<sup>57</sup> Rachel and Smith (2015) p56.

## 5. TIME TO GROW-UP

Unconventional monetary policies pursued by central banks have produced an unprecedented historic period of low policy, and money market, interest rates across the developed world and in many emerging economies. Supporters of these policies argue that low interest rates and the massive asset-purchasing programmes needed to support them are necessary to stimulate economic growth, to combat deflationary pressures and to prevent another financial crisis until global debt levels are back to manageable proportions.

Unfortunately, while low yields could have allowed governments and indebted individuals the space to reduce debt levels by more severe, but shorter austerity programmes through the relief of low servicing costs, they have had the opposite effect. Low yields have acted as debt stimulants and instead of having a global economy with lower levels of debt and stronger growth to allow rates to return to normal levels, we have the opposite. Despite the evidence that long-term use of monetary stimulants always leads to a catastrophic financial melt-down, the world still needs to deleverage and public deficits need to be cut, but

populist political revolts are going to make the interest rate and fiscal medicine harder to administer.

The adoption of ZIRP or NIRP, instead of traditional loose short-term expansionary monetary policies, would have been justified on the grounds that the long-run real neutral rate of interest, which is unobservable, has fallen in recent decades. There is undoubtedly some evidence that this has happened, but the reasons advanced to explain such a drop are not totally convincing as to scale and causal contribution. The neutral rate refers to the real economy and to global investment and saving and this must be distinguished from the level of policy rates which influence through the banking system money market rates of interest. Furthermore, the rate of interest often used to estimate the real neutral rate, the long-term yield on 10 year government bonds minus expected inflation will have been biased downwards, especially after the massive QE programme carried out by central banks since 2009 which has impacted primarily on money market rates.

Haruhiko Harudo, the governor of the Bank of Japan has cited Peter Pan's insistence on the power of imagination to permit flight as an inspiration for what his monetary policy QE programmes are meant to do for Japan. But it is perhaps time for all proponents of QE programmes to grow up from "Never Never Land". The unconventional monetary policies pursued by central banks since the financial crisis have not promoted growth nor have had a significant effect on deflationary pressures, but they have had serious negative impact effects which may be causing reduced investment, misallocated resources and anaemic economic growth

All QE appears to have succeeded in doing is allowing indebted governments to 'kick-the-can' down the road, and to fund their fiscal deficits without taking effective action to address the balance of government expenditure between unproductive consumption and productive infrastructure investments. Similarly low interest rates have not stimulated private productive investments to any meaningful extent, but instead have encouraged investment in financial instruments and real estate, thereby pushing up private sector debt and asset values while deferring necessary deleveraging. This problem is especially serious in the Eurozone, the US, Japan and the UK, but the spill-over effects means that the flow of liquidity from QE into risky short-term speculative investments has spread to countries like Brazil, India and China and other emerging markets as investors hunt for yield.

As the recent rise in US long-bond yields has demonstrated, more and more QE is fighting market tides. QE has been used by Japan to push down the value of its currency, but as the recent Federal Reserve action in December has shown, a failure by central banks to act in a coordinated fashion and raise rates in tandem will lead to painful currency and interest-rate adjustments. The longer the BOJ, the ECB and Bank of England fight against market trends, the worse the eventual consequences when the tide bursts through the asset buying dykes.

Normalisation of monetary policy should therefore no longer be delayed. And the recent rise in long-bond yields, caused by the anticipated impact of the expenditure and tax cutting programme of president elect Donald Trump, creates the perfect opportunity. The day after the election 10 year bond yields in the

US jumped by 20.3 basis points to 2.07 percent as bond prices fell on inflation fears.<sup>58</sup> The Federal Reserve increased rates by 0.25 percent and needs to steadily raise interest rates in 2017 in line with the rise in long-term bonds. Similarly, the Bank of England needs to rapidly reverse its perverse policy moves made in August and the ECB and the Bank of Japan must collectively end QE to prevent triggering off a currency war.

It would of course be more powerful if the world's leading central banks acted in unison. As Sir Martin Jacomb has written:

“It should seem obvious by now that the low-interest-rate policy is not working. Does anyone really think that reducing the bank rate from a half to a quarter percent is going to make any positive difference? And yet central banks persist. Any would-be scientist knows that if an experiment on given facts yields an undesired result twice, it is pointless trying a third time. Instead of persisting with a policy that is not effective, central banks should give a clear message of a return to normality.

The central banks of the US, the Eurozone, Japan, Canada and the UK should agree to raise rates by enough to signal a real change — and this needs to be done-simultaneously so as to eliminate the risk of an attempt to achieve competitive devaluation by delay.”<sup>59</sup>

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<sup>58</sup> According to Dow Jones data this was the biggest single day move since 5 July 2013.

<sup>59</sup> Jacomb (2016).

The failure of unconventional monetary policy and the damaging effects of low rates brought about by technical decisions has also had consequences for the health of democracy in the West. It is no coincidence that the rise of “populism” has occurred simultaneously with the introduction of QE and very low interest rates. For, as we have seen, these policies have meant that house prices and share prices have risen substantially, disproportionately benefitting the already well-off; whereas those without such assets have enjoyed no such good fortune.

All around the world, these policies have been introduced not by democratic governments but by central banks. Decisions which affect the lives of billions of people have been taken by a handful of technocrats with hardly any real parliamentary scrutiny or consent. This suggests it may be time to revisit the question of central bank independence. To take the case of the Bank of England, independence is not a hallowed part of the operation of economic policy in the UK. Independence was only agreed in 1997 and embodied in legislation a year later.<sup>60</sup> The legislation states that the objectives of the Bank of England shall be: (a) to maintain price stability, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment. The principle of central bank independence was based on inflation being the main enemy of price stability, with targets being set and monitored – independence was not granted in order for the Bank of England to embark on unprecedented and unsupervised monetary experiments inflating the size of its balance sheet. The recent

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<sup>60</sup> Bank of England Act, 1998. See: [legislation.gov.uk](http://legislation.gov.uk), *Bank of England Act 1998*, 1998.



disagreements between Theresa May and Mark Carney, governor of the Bank of England and the question marks that have arisen over the future position of Federal Reserve chair Janet Yellen, demonstrate the political pressures building up as a result of central bank interest rate policies.

The status quo cannot and should not continue, whether for economic or political reasons. It is time for a significant change, and for monetary policy to return to normal. This will expose today's politicians to difficult decisions. But failure to change direction will only, eventually, result in even greater pain.

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