CRS INSIGHT

Low Interest Rates, Part III: Potential Causes

March 15, 2019 (IN11074)

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Interest rates have been unusually low by historical standards since the 2007-2009 financial crisis, as discussed in CRS Insight IN11044, *Low Interest Rates, Part 1: Economic and Fiscal Implications*, by Marc Labonte. This Insight discusses various theories of why rates have been low.

Nominal Versus Real Rates

Part of the reason why *nominal* interest rates (the stated rate familiar to most people) have been low is because inflation has been low since the crisis. Because inflation erodes the value of the return to an investment, it is common to adjust interest rates for inflation. Even when this adjustment is made, the resulting *real* interest rates are still low by historical standards, as discussed in Part 1. The rest of this Insight focuses on explanations of why real rates have been low.

Low inflation may also be affecting real rates. Investors and households may now expect that inflation will remain low in the future. If they perceive there to be less risk of future inflation, they may demand less compensation to protect against inflation risk, resulting in lower real interest rates. The fact that real rates were high in the 1980s after inflation became high permits inference that this phenomenon may now be working in reverse.

Potential Causes

As Part I discussed, both short-term and long-term interest rates have been low since the crisis. The Federal Reserve's monetary policy decisions are the main determinant of short-term interest rates, as discussed in CRS Insight IN11056, *Low Interest Rates, Part 2: Implications for the Federal Reserve*, by Marc Labonte. If the Fed were keeping rates artificially low, however, inflation would be expected to rise, but it has not. Moreover, monetary policy has much less influence on long-term rates, suggesting some broader economic forces are at work.

Economists have identified two trends in particular that could explain why rates fell to unusually low levels during the crisis. First, an increase in risk aversion caused a "flight to safety"—there was relatively more demand for safer assets such as Treasury securities, driving down those rates, and less demand for riskier assets with higher rates. If a higher percentage of total credit is extended to lower-risk borrowers, then average interest rates would be lower. Some have argued that new financial regulations after the crisis could also be limiting the availability of credit to higher-risk borrowers (which would require a higher interest rate to match that risk). Second, firms and households reduced borrowing (called *deleveraging*) during the crisis after having become overextended. This decline in demand would put downward pressure on interest rates. In contrast, the federal government increased its borrowing at the same time as it increased the budget deficit in response to the crisis, and this would be expected to put upward pressure on interest rates.

Because of the depth of the financial crisis and the sluggishness of the initial recovery, low rates were unsurprising in the early stages of the recovery. But risk aversion and deleveraging would presumably be temporary factors. More puzzling is why interest rates have remained low as the recovery has strengthened. Economic growth has accelerated since 2017, and unemployment has been below 5% since 2016. Nevertheless, based on market data, investors expect low interest rates to persist.

Real interest rates represent the price at which savers are willing to lend funds to borrowers, and they are generally determined by market supply and demand. They can fall because the supply of saving rises or the demand for borrowing falls. Business investment, which relies on borrowing, has been low in this expansion. Low investment may be related to the long-term decline in productivity growth and economic growth, which could also be pushing down rates. One reason economic growth is lower is because of the aging population; higher savings by the baby boomers, as they enter an age where their savings rate peaks, could also be pushing down rates.

As discussed in Part 1, interest rates have also been low abroad in recent years. Low economic growth and aging effects are more pronounced abroad than in the United States. Global economic conditions could push down U.S. interest rates through international capital flows. If interest rates are lower in the rest of the world than in the United States, economic theory predicts that foreigners would buy U.S. assets, placing downward pressure on U.S. interest rates and upward pressure on the dollar. Both the increase in the value of the dollar since 2014 and the large U.S. current account deficit (which is equal to net foreign capital inflows) support this theory.

One prominent explanation for low interest rates worldwide is the "global savings glut," in which former Federal Reserve Chairman Ben Bernanke posits that the supply of savings has outpaced investment demand in the last decade in both advanced and emerging economies. Notably, many emerging economies have saved through official reserve accumulation of U.S. securities, particularly Treasury securities, by foreign governments or central banks. Official holdings of Treasury securities increased from $0.9 trillion in 2003 to $4 trillion in 2018. However, all of the increase in official holdings had occurred by 2012, and holdings have hovered around $4 trillion since.

Former Treasury Secretary Larry Summers has combined the decline in interest rates with many of the causes laid out above into an overall explanation of economic conditions in which he calls secular stagnation. A key implication of his theory is that persistently low interest rates are a sign that the private economy cannot generate sufficient, sustained economic growth on its own.

Future Prospects

The explanations discussed above suggest that low interest rates could potentially reverse if or when these phenomena reverse. For example, baby boomer retirements and the resultant drawdown of their retirement savings could put upward pressure on interest rates. The continuation of the U.S. economic expansion could put further upward pressure on rates. Growth could pick up or savings could fall in the rest of the world. In response to improving economic conditions, investors could become less risk averse. Alternatively, were the U.S. or world economy to reenter a recession, cyclical forces would likely push rates temporarily lower.