

HOW LONG CAN INTEREST RATES REMAIN LOW?

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Globalisation has globalised low interest rates

We live in extraordinary times. Real interests are negative, have been negative for several years and the forward guidance from central bankers suggests that they believe they are going to stay that way for several years to come. Yet this is a very unnatural state of affairs: the long run interest rate should roughly approximate the growth rate. Assuming that this is about two per cent then that too is roughly what the long run interest rate should be.

There are good reasons for thinking that this long run rate will eventually re-impose itself. Economic growth is ultimately driven by technology pushing out the supply curve. Big technology shifts – the coming of the railways, cars, electricity and the internet – have triggered growth spurts in the past, and there are lots more to come, with graphene, 3D printing, big data, smart grids, new generation solar and genetic applications just some examples of things we already know about.

HOW WE GOT TO NEGATIVE REAL INTEREST RATES

The causes of our current extraordinarily low interest rates lie deep in the great boom of the late twentieth century, spurred in part by the arrival of the new information technology. It not only spawned great new companies like Microsoft, Apple and Google, but as a generally pervasive technology, it changed everything

else as well – a bit like the way railways transformed the role of markets as suppliers and consumers were brought into ever-closer contact, and the way electricity brought light, power and appliances into factories, offices and homes.

An irrational exuberance took hold: the future looked dramatically better than the past, and because there would be so much growth, why save when you could borrow and get a slice of the expected golden future?

As the late twentieth century boom got going, debt-financed consumption replaced prudent savings. Banks lent on the promise of the golden future that borrowers were certain would be around the corner. Governments resorted to ever greater deficit financing on the hope that the growth in tax receipts from that growth would pay back the loans. That borrowing in turn sucked in the savings from the one part of the world which still forced down consumption. China channelled its savings into US Treasury bills, which paid for the demand for China's exports, and in turn fuelled China's phenomenal growth. China's low costs also helped to keep the lid on inflation.

In this 'Goldilocks' economy, politicians, and indeed professional economists, convinced themselves that the business cycle had been abolished and the wise use of fiscal

policy would steer the economy on a stable path. Yet the underlying fundamentals had not been altered as much as this irrational exuberance suggested. Whilst there had indeed been a technology-induced boom, the underlying growth rate turned out to be much lower than expected and the business cycle had not been abolished. After the party, there would be a nasty hangover as the debts that had been amassed could not be supported by the underlying economic performance.

An accident was waiting to happen and as the economies of the developed world started to skid, the policy response made it worse. The crash of 2000 was met with a large dose of Keynesian and Monetarist medicine. Interest rates headed towards zero (and negative in real terms) and George Bush's tax cuts in the US and Gordon Brown's public expenditure splurge in the UK further added to demand.

What followed was textbook economics. The asset bubble in 2000 became significantly worse – and, in particular, a housing bubble sustained by subprime lending took off. This became unsustainable – as these things always do – and came crashing down to earth in 2006 when interest rates inevitably started to rise.

Governments can carry on getting away with low interest rates until inflation really gets a hold

DEFAULTING ON THE DEBT

The consequent credit crunch and banking crisis which unfolded in 2007 reflected the fact that the enormous debts in both the private and public sectors were no longer credible. The credit crunch played out into a sovereign debt crisis. In the US and the UK, now that interest rates were already close to zero in nominal terms, rather than explicitly defaulting on the debt, both governments resorted to printing money. In the Eurozone, they tried German discipline with internal devaluation.

We have been here before – after both World Wars when governments found themselves with debts beyond their capacities to pay. After the First World War, Germany resorted to the printing presses to pay for reparations demanded by the French, who in turn faced demands from the US to pay for their war loans. In the process, the German professional middle classes had their savings wiped out and this contributed to the Nazi disaster. Understandably, Germany has good historical reasons for its ‘sound money’ approach to the Eurozone crisis.

After the Second World War, debt was written off in part, but in the UK the debt-to-GDP ratio was over

240 per cent (compared with less than 90 per cent today). The solution then was low real interest rates, but with the banks forced to hold government debt and – crucially – capital controls. Financial repression paid off the debt, aided by the economic growth of the 1950s.

The final example of unsustainable government debt came at the end of the 1970s, when low growth and the union-pressurised Labour government induced a wage-driven inflation spiral. Margaret Thatcher inherited an economy with over 10 per cent inflation, which quickly accelerated to a peak of 22 per cent in 1980. Inflation ‘solved’ the problem – indirectly writing off the government’s real liabilities.

WHAT HAPPENS NEXT?

These past episodes and a bit of economics tell us a lot about what is likely to happen next. The facts are simple: the debts are not going away. Indeed they are getting bigger – in the UK and the US, and indeed in much of Europe too. These debts are greater than the capacity of economic growth to pay them off anytime soon. The result is that there will have to be further defaults. Inflation makes this a lot easier – at three per cent per annum it would be halved in real terms in a decade. But it only works if that

There is every prospect of a sustained period of low interest rates for at least a couple more years

inflation rate is above the interest rate – and debt is not index-linked.

Put another way, suppose governments were now to raise interest rates to something like normal – say two per cent real. Two things would follow. First, government interest charges on debt would rise sharply making it much harder to reduce the debt and the deficits. That is the problem for Italy and Greece, where real interest rates have been more than two per cent. Second, real assets would fall in value – especially houses. Think what a mortgage rate of say five per cent nominal, plus a margin of two per cent, would do to house prices.

A moment’s reflection tells us that keeping interest rates low is more of an election-winning strategy than adjusting back to long-run normalcy. It suits politicians to keep rates very low and central bankers panic about the consequences to the fragile banking sector of a shock of rising real interest rates. It is easier to keep the printing presses going for a bit longer in the US, and to hold to negative interest rates in both the US and the UK, than to face up to the painful fact that the great late twentieth century boom has left the major economies with debts they cannot hope to repay.

HISTORY HAS NOT BEEN ABOLISHED

So how long can they keep up the fiction? Governments have the power to expropriate their citizens as long as they cannot leave and they cannot run away with their money. Even though there was a lot of capital flight from Germany in the period between 1918 and the final collapse in hyperinflation in 1923, the Weimar regime still managed to render its debt worthless. If a government wants to, it can radically alter the terms of the equation between savers and borrowers.

One big difference is that although there are few capital controls in the major Western economies now, money can run from a default-minded government. Indeed, in a proper panic – such as the run on Northern Rock – the possibility can quickly become the reality. Yet there is a difference this time around. Although the money can run, there isn’t anywhere obvious for it to run to. The US, still the world’s largest economy, can borrow with impunity at very low interest rates despite having a very high debt burden; the Chinese and the Japanese have the problem – with \$1.5 trillion US Treasuries each. The euro is not much better and sterling is in a similar place. Even Switzerland no longer looks that attractive. Globalisation has globalised low interest rates.

As long as this remains true and there is little prospect of a capital flight from the dollar, euro or sterling, governments can carry on getting away with low interest rates for the foreseeable future. Until that is, inflation really gets a hold. Three per cent inflation is a gentle way to default. 10 per cent is not. Add in a return to economic growth (which raises tax revenues), and there is every prospect of a sustained period of low interest rates for at least a couple more years. But history has not been abolished: the credibility of the dollar, euro and sterling has taken a bashing and other countries, like China, may gradually gain the credibility that these Western countries have been losing.



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