

The
Economist

Free exchange

A natural long-term rate

Central banks ignore this century-old observation at their peril

Oct 26th 2013 | From the print edition

WHEN Federal Reserve officials released their latest round of economic projections last month, they included a striking revelation. Three years from now, the Fed reckons, America will be back at full employment with a jobless rate very close to its long-term level of about 5.5%. Yet monetary policy will still be exceptionally easy, by historical standards. Fed officials reckon the federal-funds rate will be just 2% by the end of 2016, zero in real terms. In previous decades, real rates ranged from 1% to 5% when unemployment was that low.

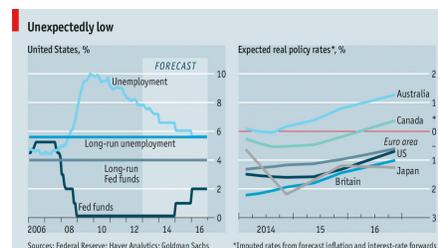
Depending on whom you ask, such a prolonged period of negative or zero real rates is proof that the Fed is either dangerously irresponsible or admirably resolute. Both interpretations imply that the Fed is in control. But the truth is more subtle. The central bank may tweak rates from month to month but, in the long run, deeper factors determine the “natural” rate of interest, and the central bank defies them at its peril.

Over a century ago Knut Wicksell, a Swedish economist, drew the distinction between the financial rate of interest that borrowers actually pay and the natural rate of interest that was determined by the return on capital. If the financial rate is below the natural rate, businesses can reap unlimited profits by borrowing as much as they can and ploughing it into high-returning projects. Eventually, though, all that additional spending pushes up prices, money and credit, and eventually, financial interest rates.

Wicksell saw financial rates as those set by banks competing to make loans. That job is now performed by central banks. They still think in Wicksellian terms: the natural rate prevails when the economy is at full employment. Set the policy rate above the natural rate and the economy tips into depression. Set it below, and inflation results—or, some worry, speculative credit booms.

The natural interest rate is often assumed to be constant. The Taylor rule, a popular monetary-policy formula, tends to incorporate a real rate of 2%. But, according to Wicksell, the natural rate is “never high or low in itself, but only in relation to the profit which people can make with the money in their hands, and this, of course, varies. In good times, when trade is brisk, the rate of profit is high, and, what is of great consequence, is generally expected to remain high; in periods of depression it is low, and expected to remain low.”

Although the Fed’s critics think it is holding financial rates well below the natural rate, this is at odds with plenty of other evidence. If investors thought today’s low rates were unsustainable, bond yields would be much higher, to reflect the likelihood of higher short-term rates in a few years’ time. To be sure, bond yields have been held down both by the Fed’s promise to keep rates low near zero, and its purchases of long-term bonds. Yet bond yields are just as low, if not lower, in countries with less explicit commitments. Economists at Goldman Sachs have plotted market expectations of short-term interest rates against consensus inflation forecasts to derive expected real policy rates for several major markets. The results show that real policy rates are projected to be even more negative in Japan and Britain in three years’ time than in America, and just as negative in the euro zone. Even in Australia and Canada, whose central banks avoided large-scale bond buying, real rates will still be unusually low.



Dominic Wilson of Goldman Sachs argues that this simply reflects a belief that big economies will operate below potential for several years. Healthier countries such as Australia must also keep policy rates low to avoid unwanted currency appreciation.

But in a speech in March, Ben Bernanke, the Fed's chairman, argued that something else is at work: "the low level of expected real short rates may reflect not only investor expectations for a slow cyclical recovery but also some downgrading of longer-term growth prospects."

Indeed, despite profit margins near record levels and rock-bottom interest rates, business investment has been sluggish, recently peaking at just above 12% of GDP; it topped 14% in the late 1990s. This could reflect expectations of weak sales, and less of a payoff to new investment: annual productivity growth has slowed to 1% since the recovery began, half its long-run average. Households may also be less eager to borrow against future income since they don't expect that income to rise much.

A new saving glut

Weak investment is not the only thing pressing down on the natural rate; ample saving is doing the same. Before the crisis Mr Bernanke credited a "global saving glut" originating in China and other emerging markets with holding down long-term interest rates. Although China's current-account surplus has shrunk in the past five years, Goldman Sachs reckons that the proportion of emerging-market populations in their prime saving years (aged 35-69) is climbing, and won't peak until 2032. Although governments acted as borrowers of last resort in the years immediately after the crisis, most are now whittling back their structural deficits, a process likely to continue for several years, freeing more savings.

All this suggests that policy rates, low as they seem, are not out of line with their natural level. If the Fed were to tighten, demand and investment would sink, and, as Mr Bernanke warned in March, "perversely serve to extend the period of low long-term rates". Shortly after that speech, he inadvertently proved his own point. When he said the Fed might soon slow quantitative easing (QE, buying bonds with newly printed money), bond yields shot up and investors began pricing in much quicker increases in short-term rates than the Fed had intended. The housing market has since weakened and job growth has slowed. This is not all due to higher bond yields. Nonetheless, the Fed has since put off the date when it slows QE, and low real rates look likely to be around even longer.

[Economist.com/blogs/freexchange](http://www.economist.com/blogs/freexchange) (<http://www.economist.com/blogs/freexchange>)

From the print edition: Finance and economics