U.S. Economic Policy in a Low-Interest Rate World

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Motivation

• Most defining feature of U.S. and global financial markets is the extremely low level of interest rates.
  • Monetary policy becomes quite asymmetric as lower bound greatly weakens stimulative MP measures.
  • Increases the potential for excessively risky behavior as investors search for means to maintain prior portfolio yields.

• Two subjects of paper:
  • Review U.S. monetary policy in the near term—why so hesitant?
  • Causes of the persistent low-interest rate environment
Near-Term Policy Dilemma

• Economy approaching full employment
• Strong desire to begin process of normalizing monetary policy with an initial small increase in the policy rate.
• However, inflation remains well-below the target rate, and most of the gains in reducing the gap between actual and full-employment output can be traced to poor supply-side performance.
  • Reduced estimates of potential GDP
  • Falling labor force participation
  • Low rates of productivity growth
Actual and Core Inflation

4-quarter percent change

Personal Consumption Price Index

Core Inflation
Weak Supply-Side Growth

Potential GDP
2007 estimate

Potential GDP
(2014 est.)

Real GDP

2004Q1 2006Q1 2008Q1 2010Q1 2012Q1 2014Q1
Slowing Productivity Growth

8-quarter annual rate of change
Concerns About External Economy

• Rising exchange rate and loss of trade competitiveness
  • Exchange changes particular large vis-à-vis two main competitors-Japan and European Union
  • Weak growth projections for major markets
• Quantitative easing and other unconventional forms of monetary appear to strongly impact exchange rates.
• The trade sector’s contribution to U.S. GDP growth has averaged -0.75 percentage points, compared to a total of only 2%.
Exchange Rates - Trade Weighted

Year/Quarter

Index

150
125
100
75
50


United States

China
Exchange Rates – Trade Weighted

Index

Year/Quarter

Euro

Japan
Persistently Low Interest Rates

• Nominal Interest rates have been declining for over a quarter of century.
  • Reflecting lower rates of inflation after 1980.
  • Now near zero for most G-7 economies

• Real interest rates were stable through the mid-1990s, but have been trending down over the past two decades

• Explore three primary explanations in the literature
  • Shifts in saving-investment balance
  • Shifts in mix of investment assets-shortage of safe assets
  • Secular stagnation
Short-term Interest Rate

Nominal Rate

Real Rate
Long-term Interest Rate

- Nominal Rate
- Real Rate
Saving-Investment Balance

• An equilibrium full-employment based framework that incorporates globally-integrated financial markets.

• Issue became prominent in the mid-2000s when Bernanke (2005) suggested excess saving in Asia as a primary cause of low interest rates in the United States.

• Difficult empirically because S-I should balance at global level. Also, we observe ex post rates not *a priori* plans.

• Major shift in global allocation of saving and investment
  • Growth of China
  • Decline of G-7
Changing Composition of Global Investment

Percent of World GDP

- G-7
- Other Advanced
- Other Developing
- China

Years:
- 1980
- 1985
- 1990
- 1995
- 2000
- 2005
- 2010
- 2015
Regional Trends

• Declining S-I rates in G-7
  • Reflects slower growth in labor force and TFP
  • Small net shift toward saving balance

• Other advanced economies
  • Sharp post-crisis fall in investment
  • Concentrated in Europe
  • Significant source of S-I surplus

• China
  • Recently leveling of high investment rate
  • Substantial reduction in S-I surplus since 2000

• Other Developing Economies
  • Stable investment rate with shifting saving
  • No longer large net borrower group
  • Lower petroleum prices should reduce saving of Gulf states
Saving-Investment Trends (1)
Saving-Investment Trends (2)
Saving – Investment Trends (3)

% GDP  China

investment  saving
Saving – Investment Trends (4)

% GDP  Developing Economies ex China

investment  saving
Shortage of Safe Assets

• Hypothesize a shift in investor preference between safe and risky assets (Caballero),
  • Drove up demand for safe assets (lower rate) and lower demand for risky assets (higher rate)
  • Illustrated by returns on bonds versus equities

• Contrast with fact that overall return to corporate capital has been trend free.
  • No evidence of a secular decline in the return to real capital
  • Matched by behavior of Tobin’s Q-ratio

• Theory implies a rise in the risk premium; yet
  • Not evident for emerging market debt, or
  • high-yield bonds versus investment grade

• Growth of government debt seems inconsistent with shortage of safe assets.
U. S. Nonfinancial Corporate Sector

Rate of Return
(right scale)

Tobin's Q
(left scale)

Year:

Values:
- Rate of Return: 0.0, 0.5, 1.0, 1.5, 2.0, 2.5, 3.0
- Tobin's Q: 0.0, 0.5, 1.0, 1.5, 2.0, 2.5, 3.0
Yield Spreads

Emerging market spread

BAA spread
Secular Stagnation

• A persistent tendency for aggregate demand to fall short of potential output
  • Term made popular by Alvin Hansen (1938), and reintroduced by Larry Summers
  • Focus on weak demand (investment) and high unemployment.

• Explicitly a disequilibrium perspective
  • No achievable rate of interest can equate saving and investment at full employment.
  • Low or even negative inflation and low nominal interest rates are also defining characteristics
Secular Stagnation(2)

• Similarities to supply-side causes of slow growth.
  • Slow growth due to demographic factors or reduced growth of TFP need not imply high unemployment, but
  • It is consistent with a low investment rate and low demand for funds.

• Hypothesis does not fit unemployment levels of Japan or the United States, but
  • Low unemployment was achievable only with extreme monetary ease.
  • US exchange rate is appreciating (strengthening economy), while it is depreciating for Japan.
Conclusion

• No single dominant explanation for the decline in market interest rates.
  • No uniform pattern of S-I imbalances
  • Data do not support notion of a shortage of safe assets
  • Strong returns on real capital are not confirming of a fall in the marginal efficiency of investment, but
  • Many US corporations are using cash flow to repurchase equities as opposed to investing in further growth.

• Global economy still marked by deficient demand
  • Low interest rates may be viewed as simply an indicator of underutilization of resources
  • Overall situation most resembles an extended, but temporary underemployment disequilibrium