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

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for
Nomura Foundation Conference on
THE EVOLVING GLOBAL FINANCIAL ORDER
NOVEMBER 11, 2015

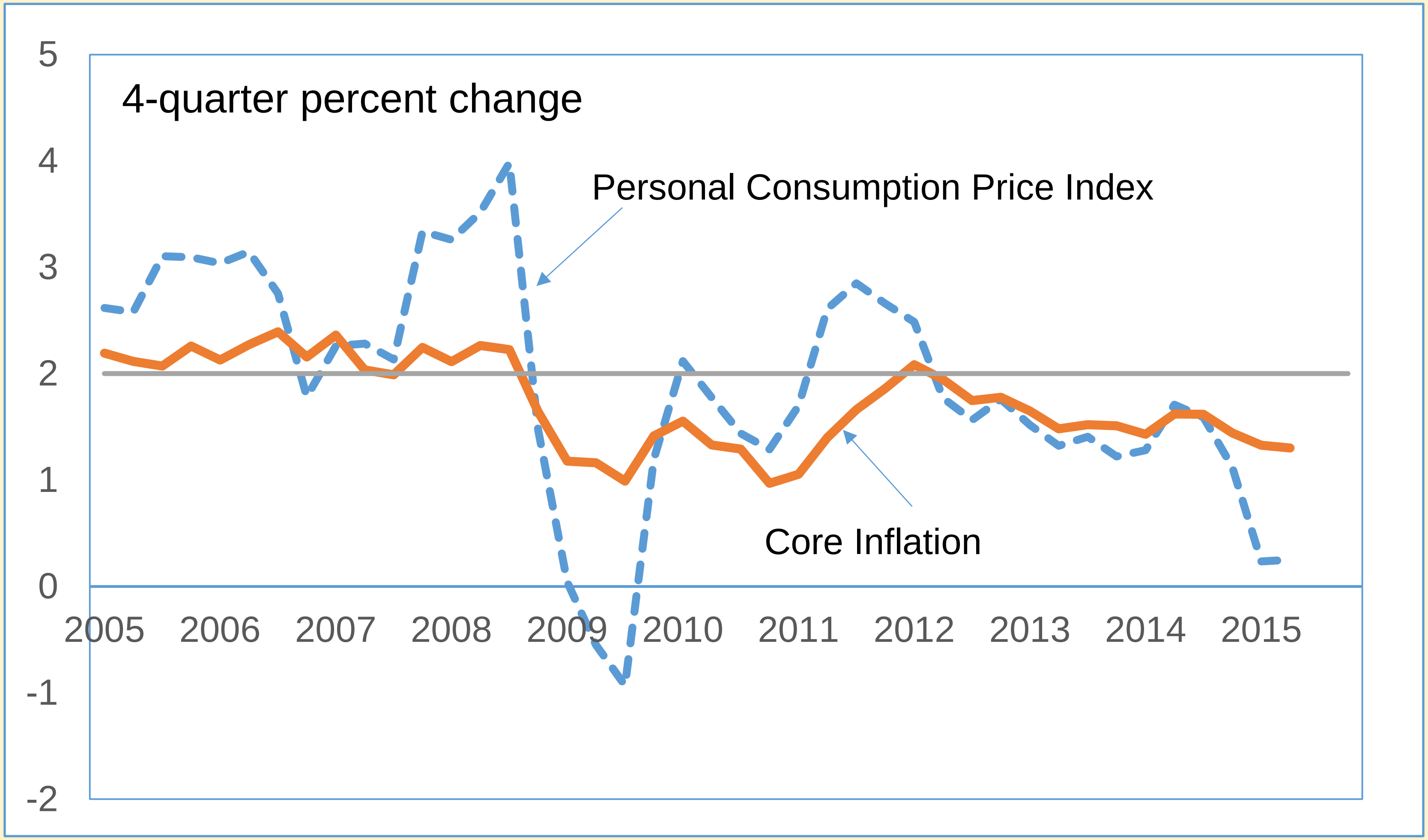
Motivation

- 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

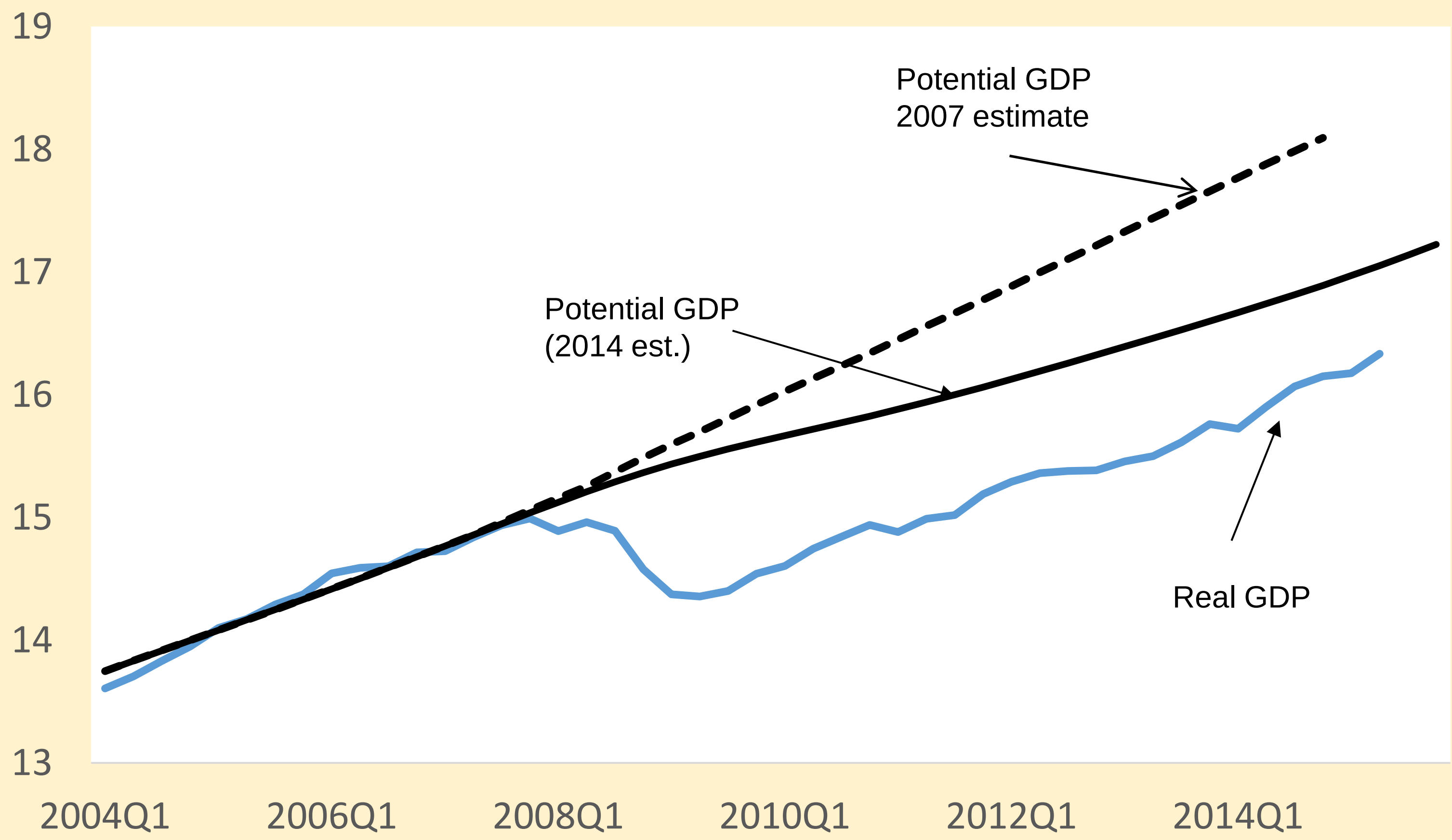
Near-Term Policy Dilemma

- 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 tbe traced to poor supply-side performance.
  - Reduced estimates of potential GDP
  - Falling labor force participation
  - Low rates of productivity growth

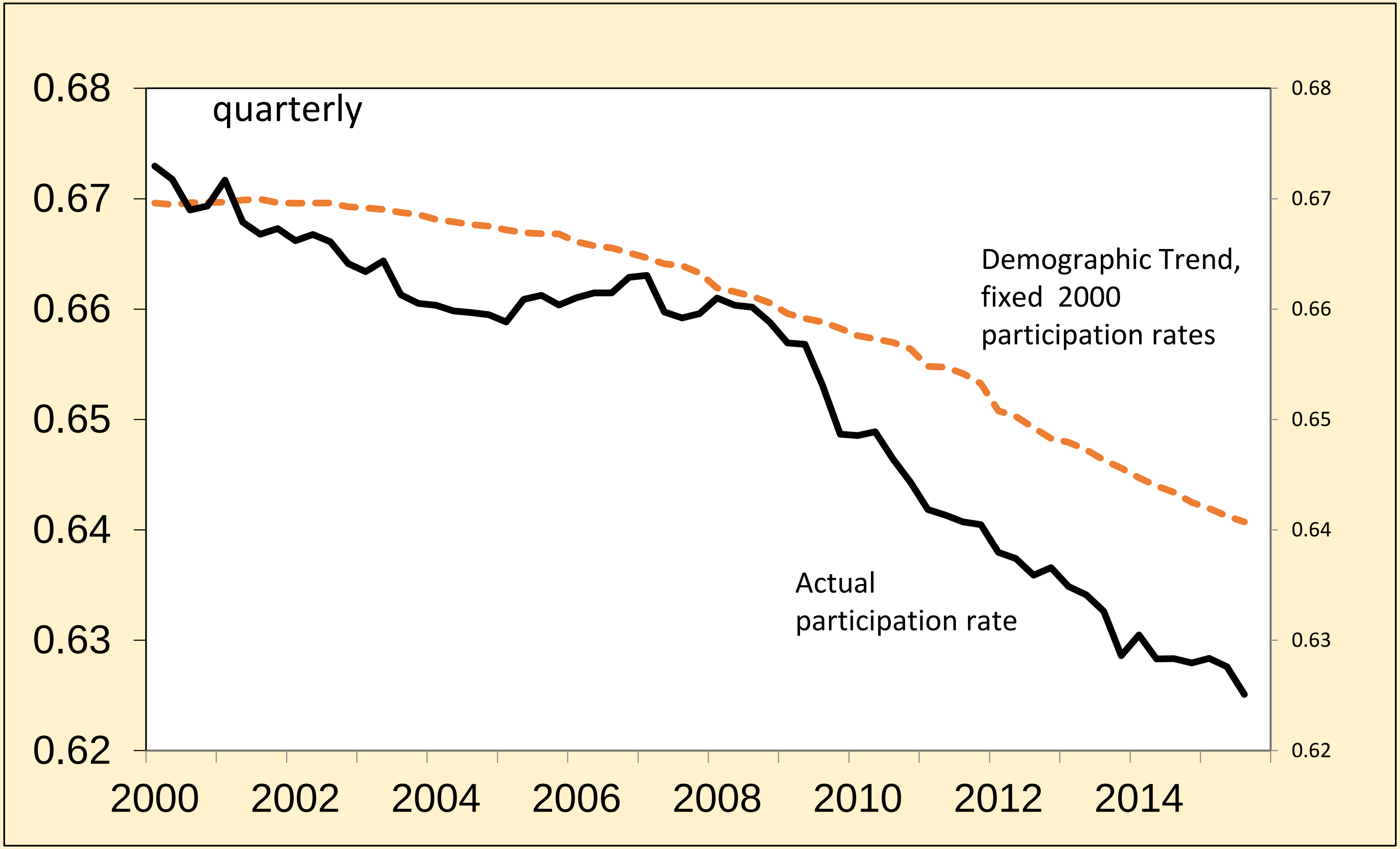
Actual and Core Inflation



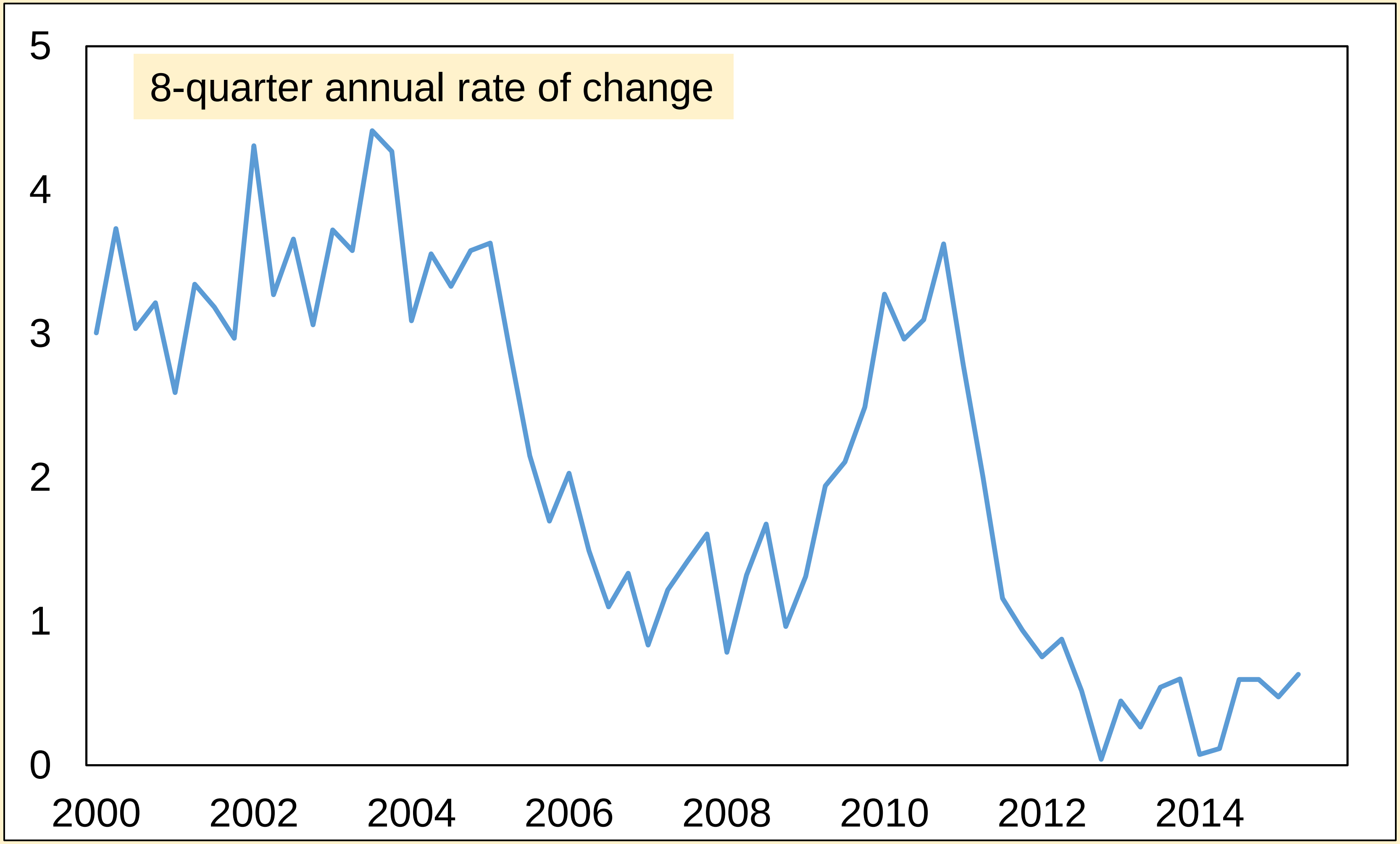
Weak Supply-Side Growth



Falling Labor Force Participation



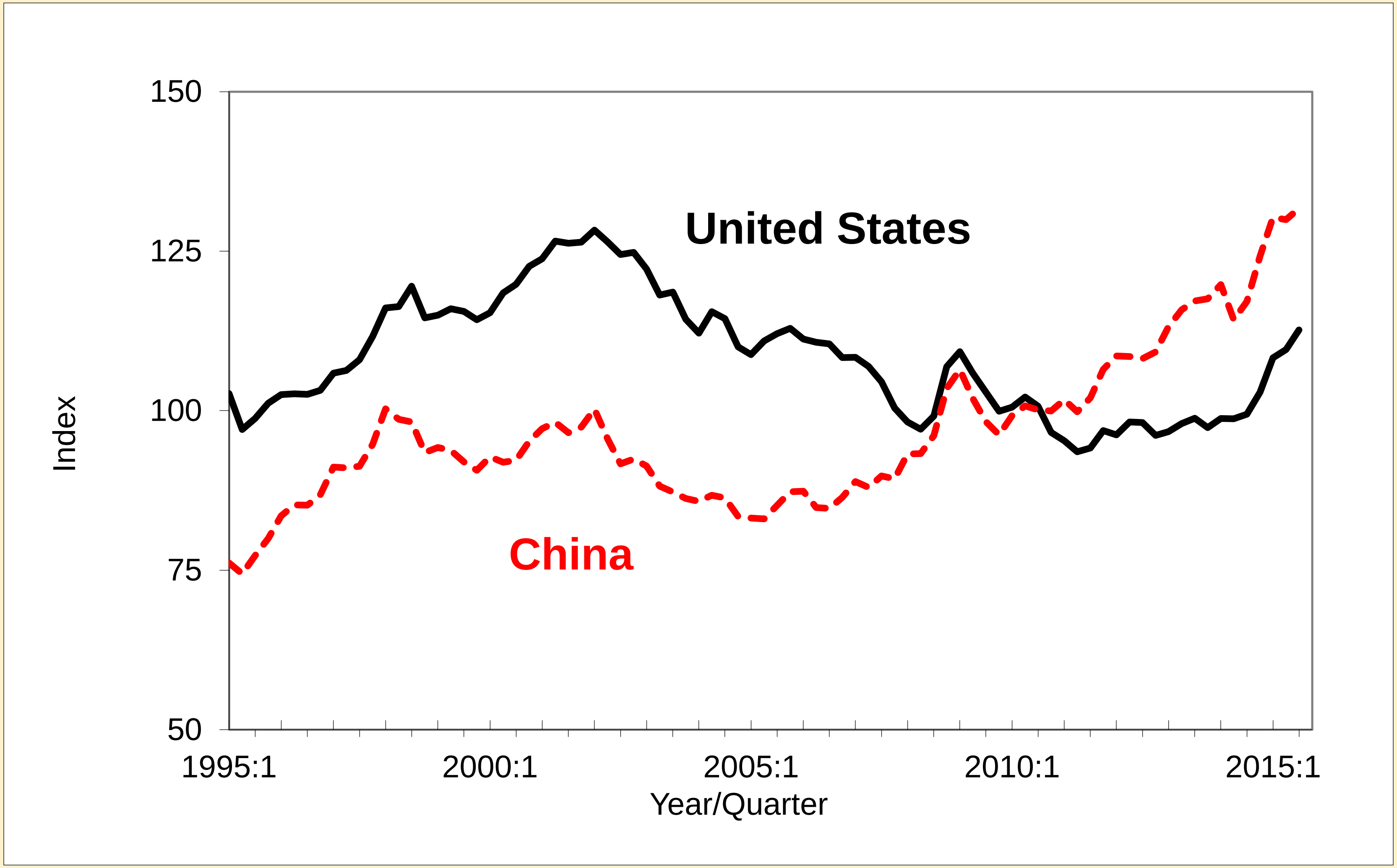
Slowing Productivity Growth



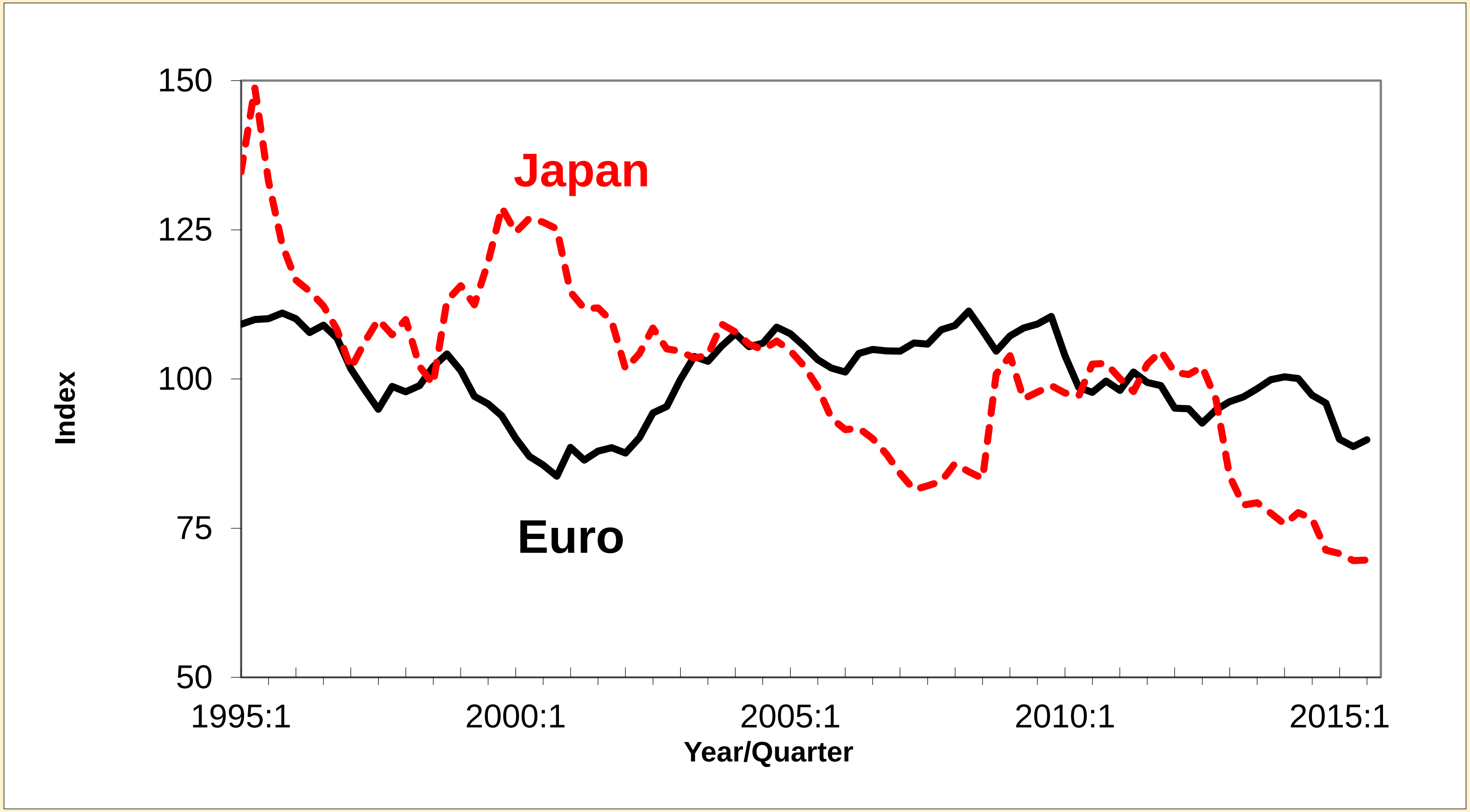
Concerns About External Economy

- 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



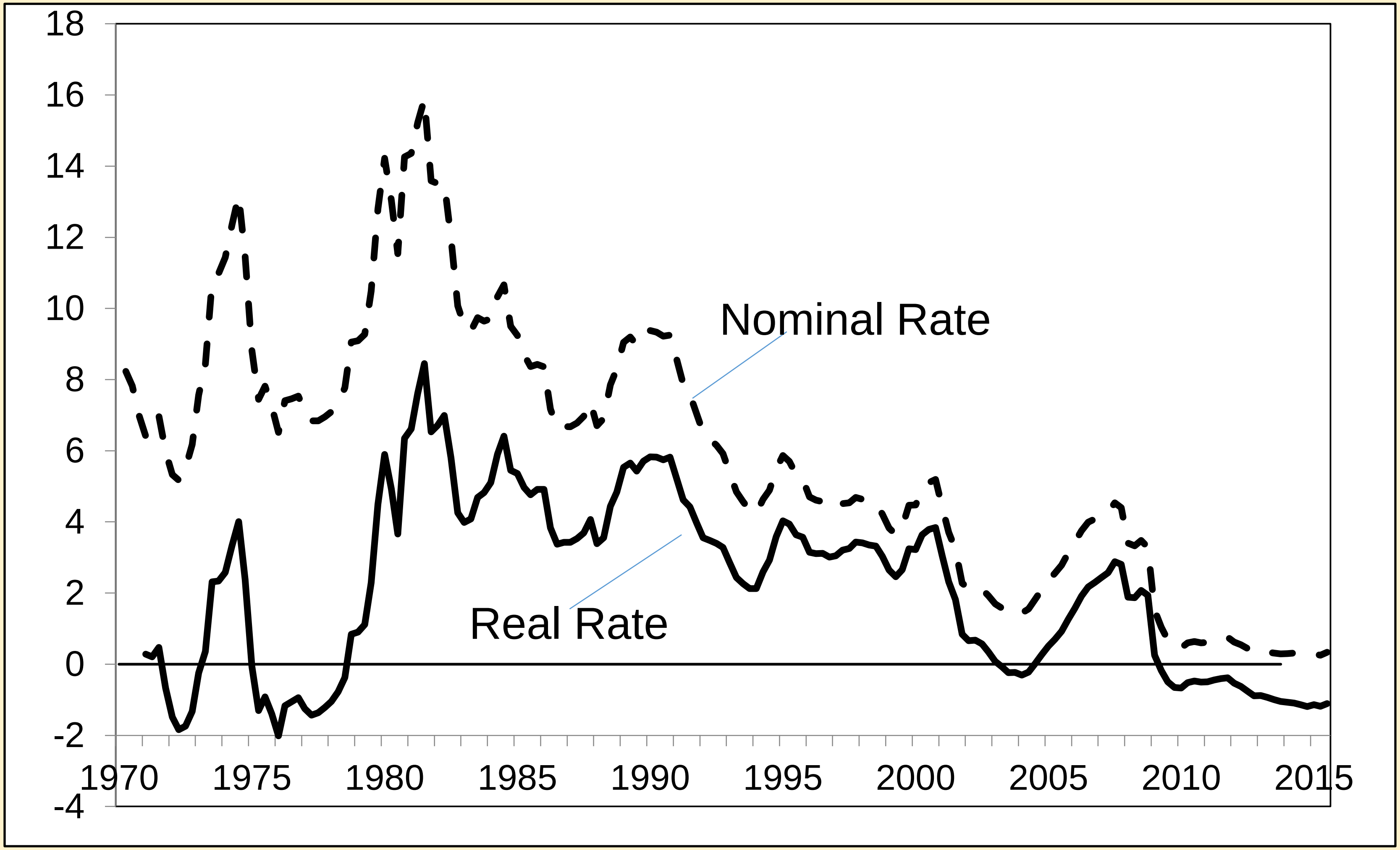
Exchange Rates – Trade Weighted



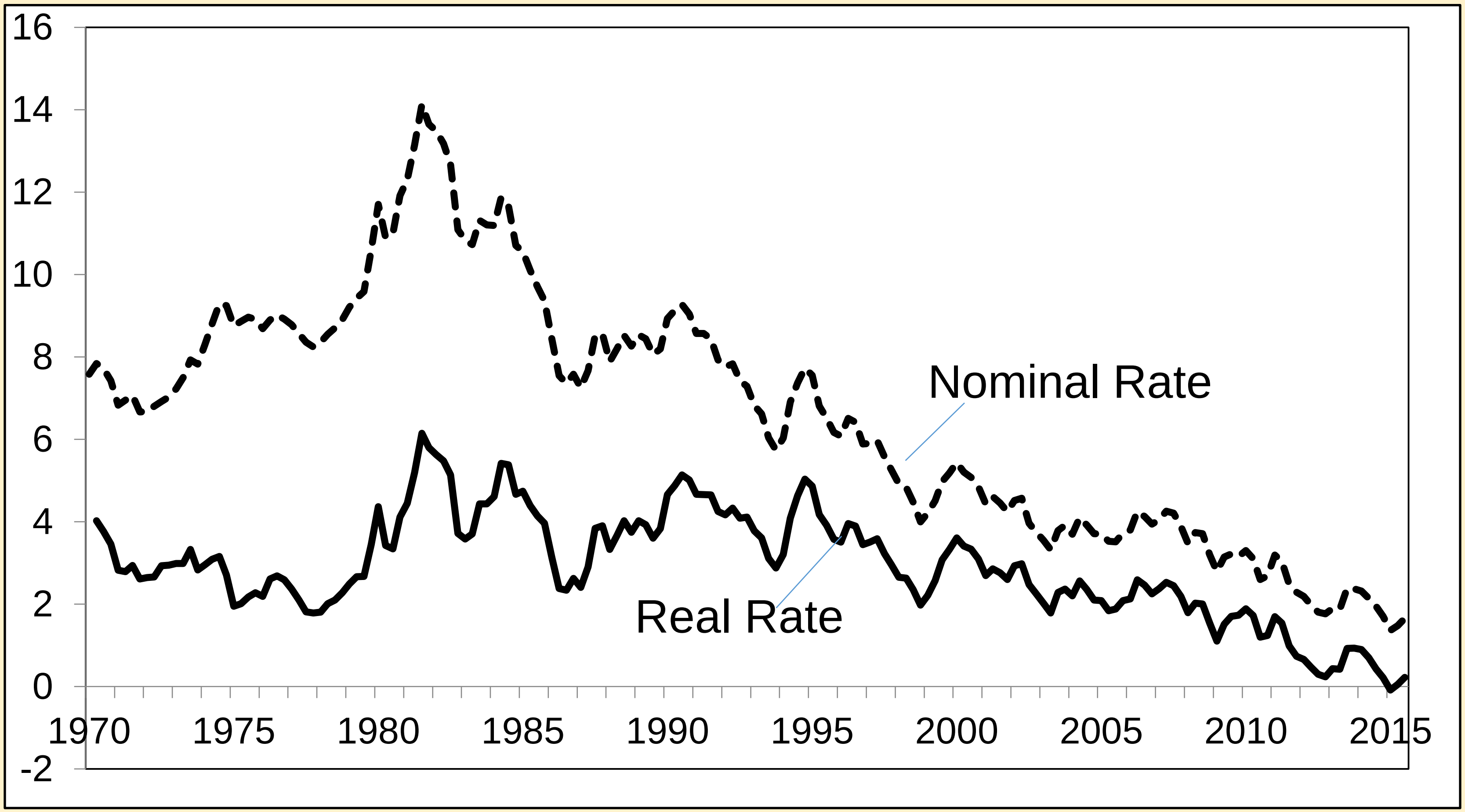
Persistently Low Interest Rates

- 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



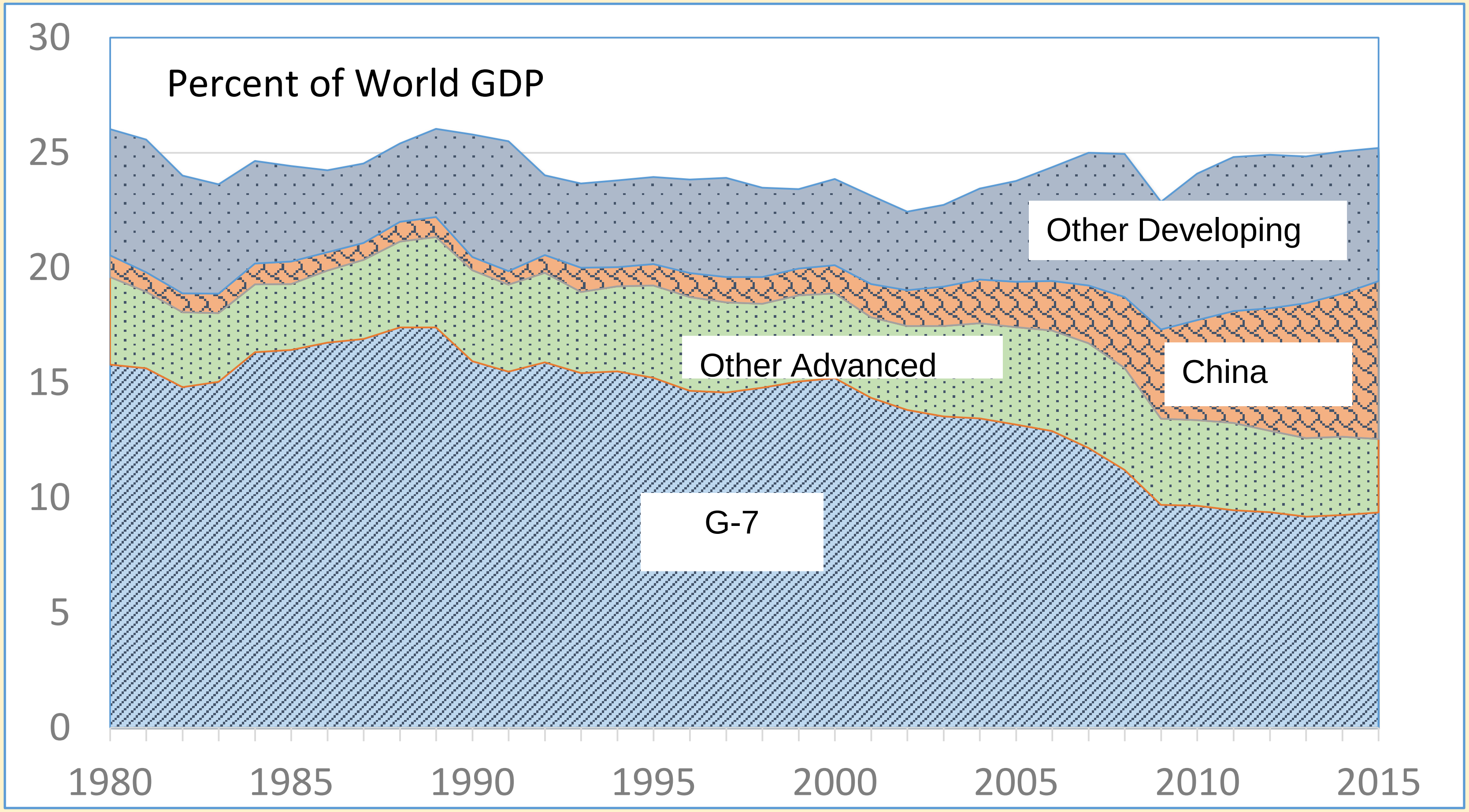
Long-term Interest Rate



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

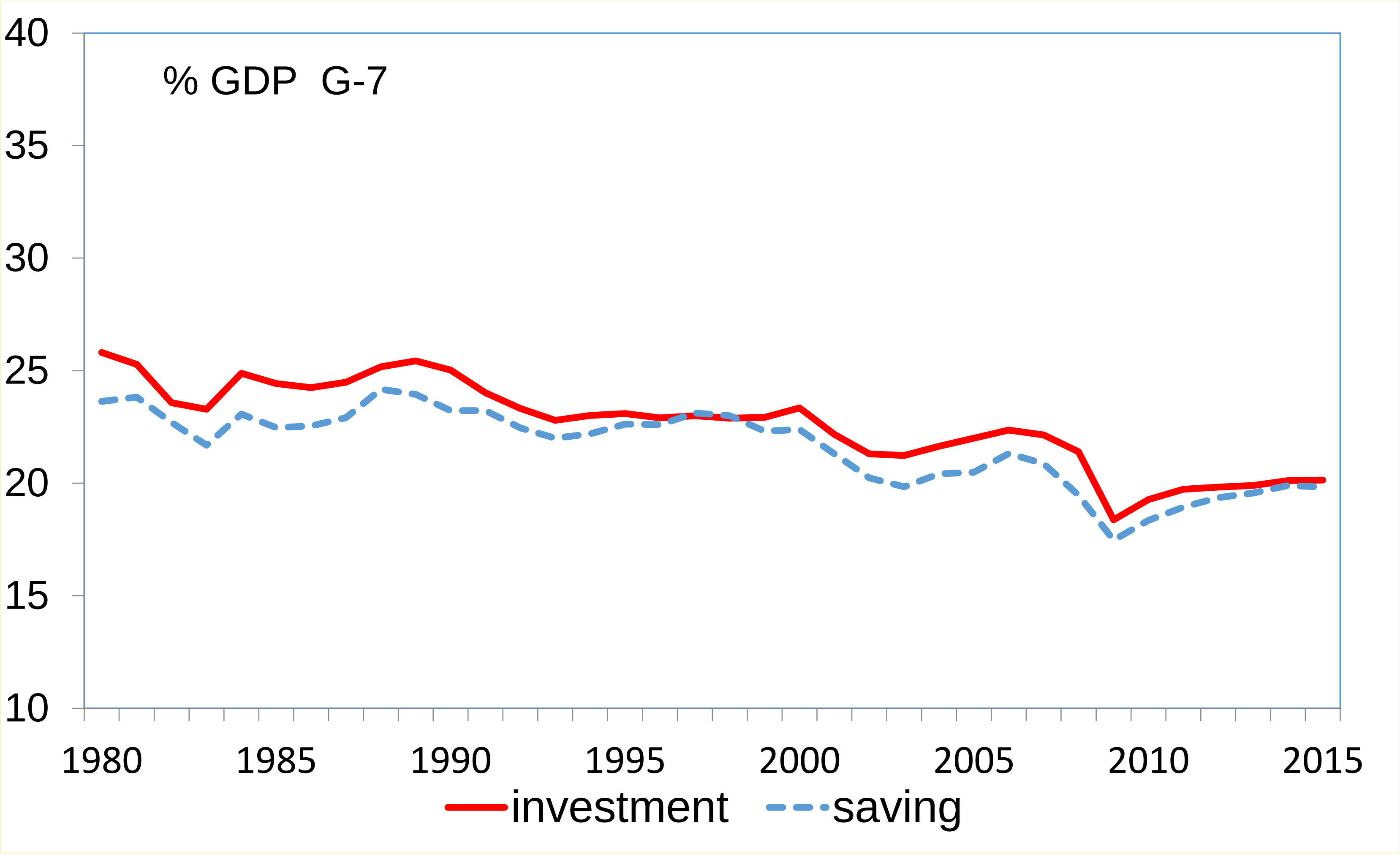
Changing Composition of Global Investment



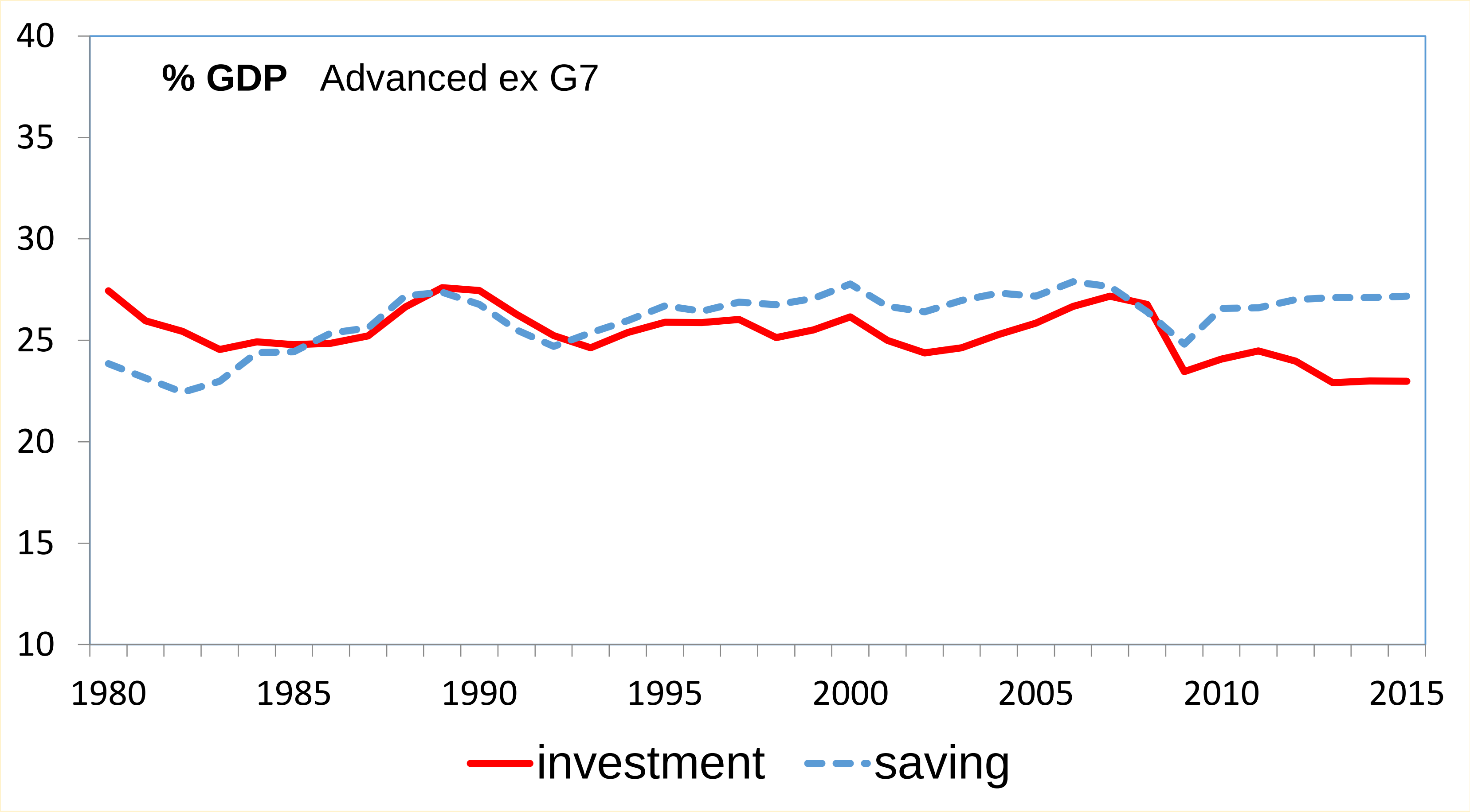
Regional Trends

- 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

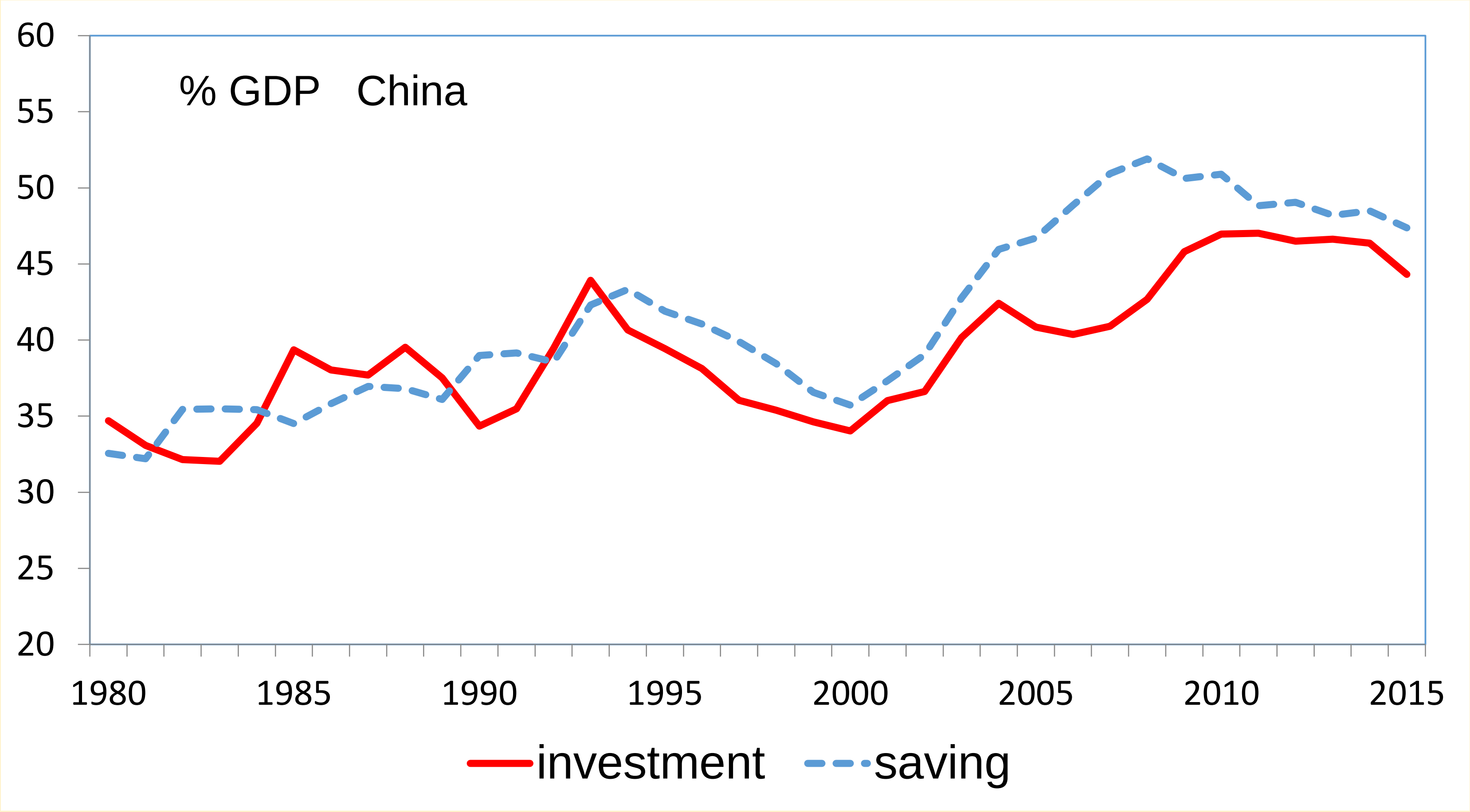
Saving-Investment Trends (1)



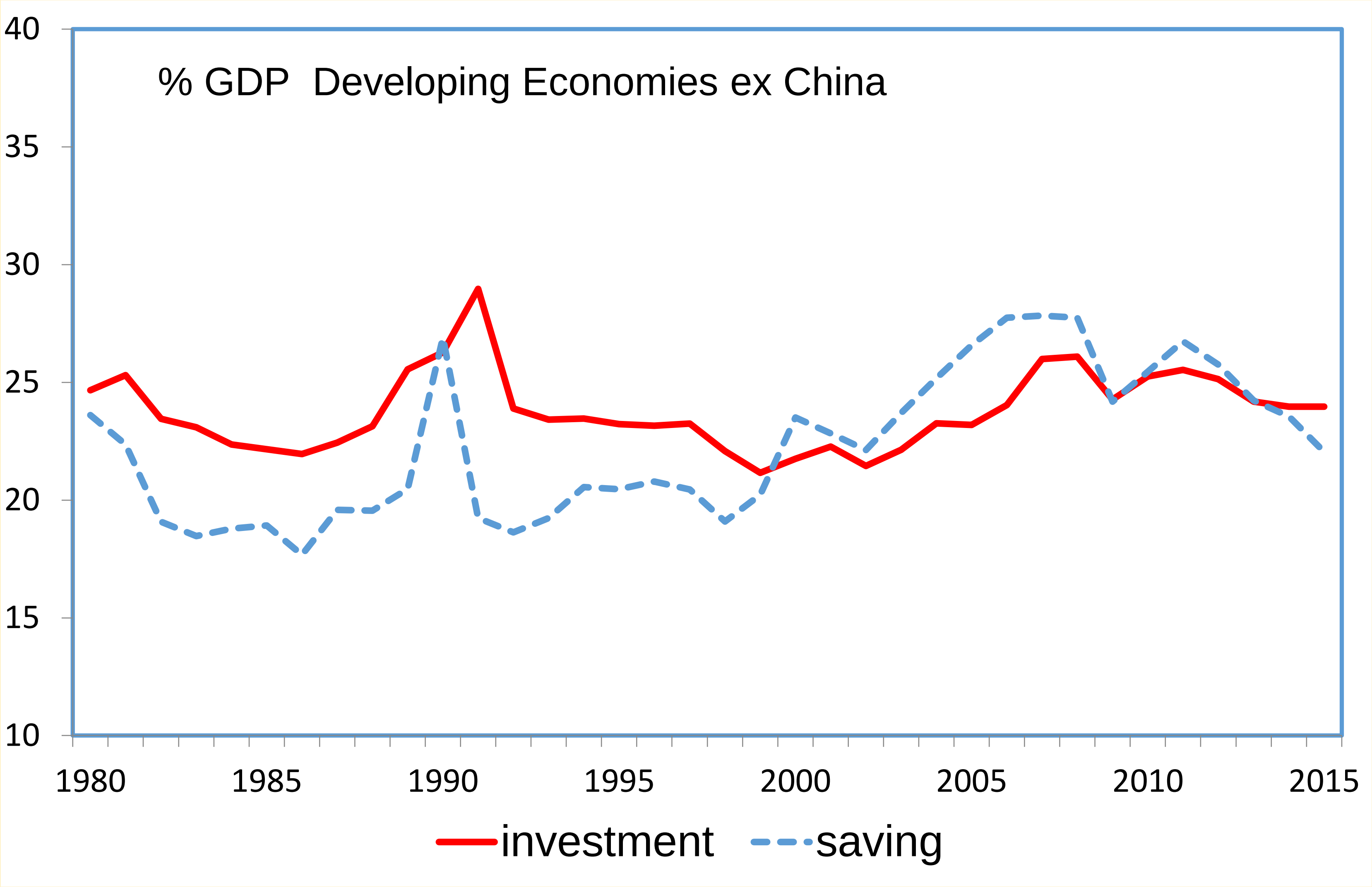
Saving-Investment Trends (2)



Saving – Investment Trends (3)



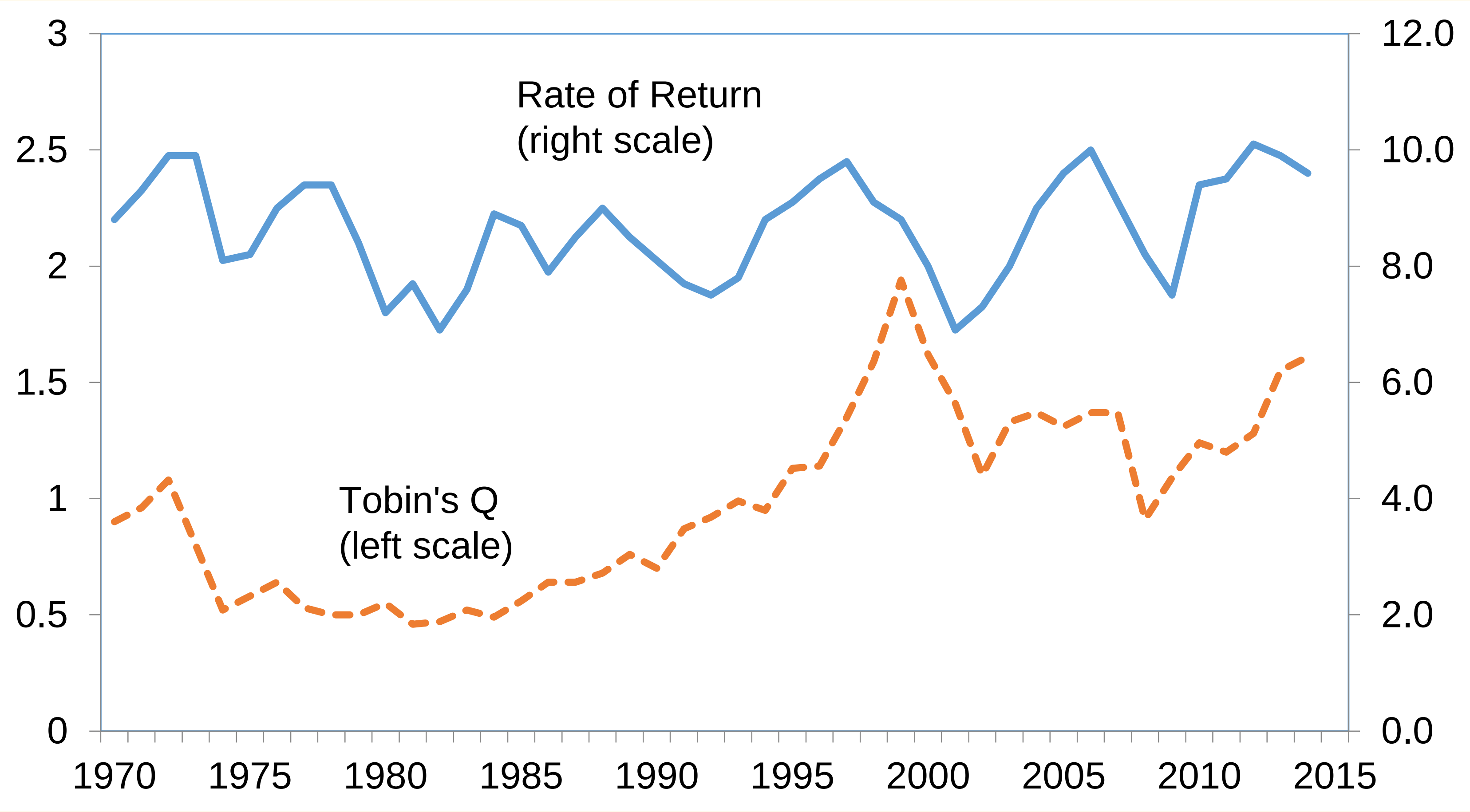
Saving – Investment Trends (4)



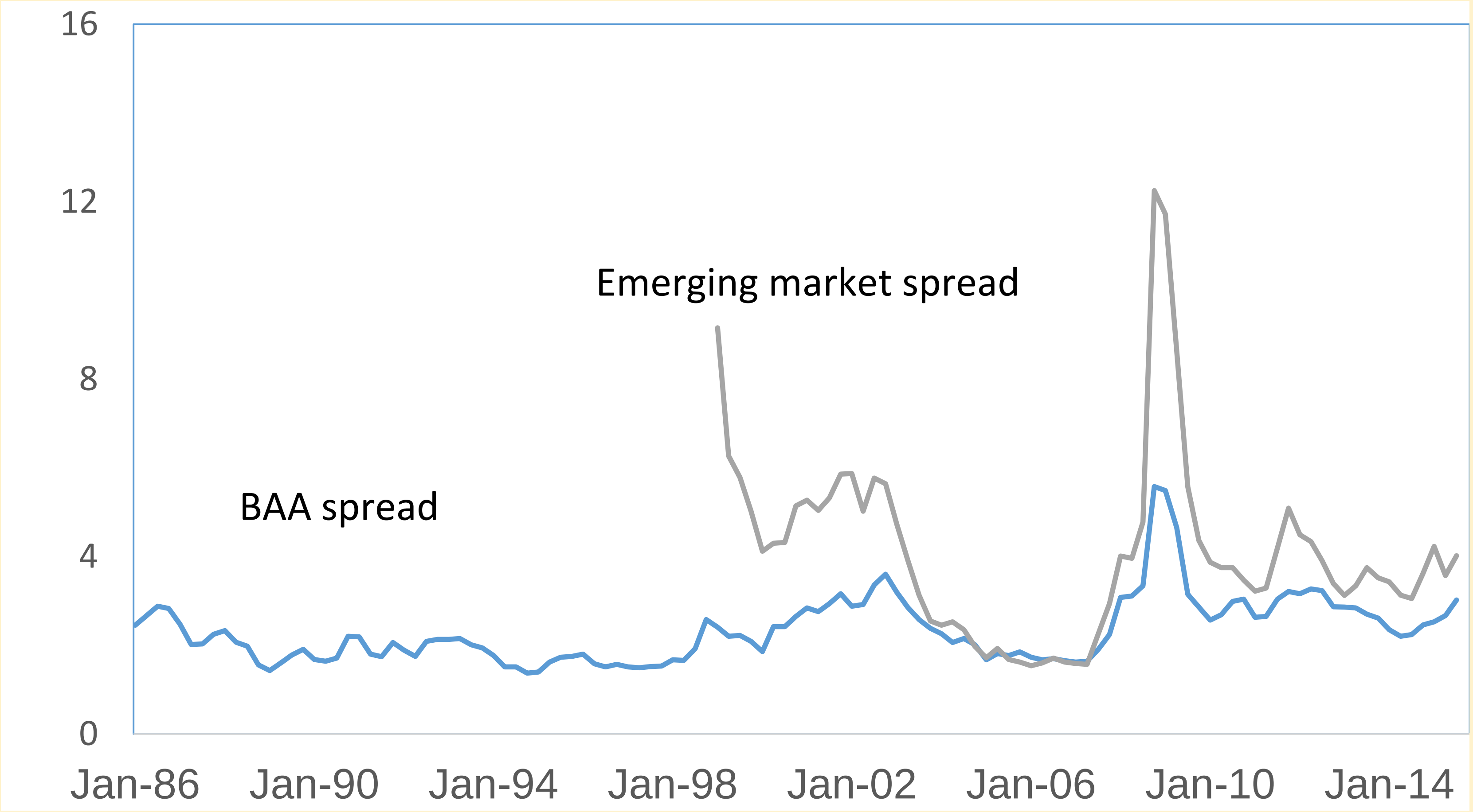
Shortage of Safe Assets

- 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



Yield Spreads



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