

## Will Rates Ever Rise Again?

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As investors digest the latest flow of very messy economic data, the key question they are trying to answer is “what will be a sustainable level of growth and inflation after the effects of the pandemic have subsided?” Both of these numbers have been declining for 40 years, and any investment outlook must ask what has changed since then? One way to analyze the dynamics ahead is to unpack the drivers of the natural real interest rate, what some economists call  $r^*$  (read as r-star). Much will depend on the success of the current fiscal programs coming from U.S. and European governments. They will have to be extremely effective at boosting productivity and stimulating demand in order to overcome the powerful structural factors.

The  $r^*$  is the interest rate that would support the economy at full capacity of utilization of available resources while keeping inflation low and stable.

Given its definition,  $r^*$  cannot be directly “observed in nature” and must be estimated—a process on which there is no clear consensus among economists. What has been clear, however, is that for all the recent talk about inflation, central banks—particularly in developed economies—have been finding it increasingly difficult to set policy rates compatible with the  $r^*$  that would be necessary to quell recessionary forces.

One reason for this is a phenomenon called secular stagnation, a concept created by Harvard’s Alvin Hansen in 1939 to describe the sluggish performance of the U.S. economy after the start of the Great Depression in 1929. In 2013, Larry Summers refreshed the concept to describe a circumstance in which changes in economic fundamentals, especially after the Global Financial Crisis, have shifted the balance between savings and investments. As policy rates have been near-zero and inflation has been low, central banks have been finding it harder to match real interest rates to an increasingly negative  $r^*$ .

Over the last four decades, structural drivers seem to explain persistently declining levels of  $r^*$ :

i) **Lower Rate of Population Growth:** this is one of the most important reasons behind an increasingly negative  $r^*$ , and, out of all drivers that could make  $r^*$  more negative over time, is perhaps the surest and most predictable one. For example, our simulations show that the U.S. fertility rate would need to increase by at least 30% for  $r^*$  to increase from around -2% to 1%—extremely unlikely given current trends. Conversely, immigration could serve as an important counterweight to lower fertility rates by attenuating the rate of decline of  $r^*$ , especially in countries where the population is already shrinking.

ii) **Lower Rate of Productivity Growth:** productivity has been declining for at least the past 40 years in most developed countries. For example, our simulations show that this is particularly severe in the U.K., where multi-factor productivity growth has contributed negatively to GDP growth since 2008. Still, this trend is not necessarily irreversible, as it could be the case that breakthroughs in artificial intelligence, clean energy, remote work technologies, etc., make productivity rates pick up in the near future.

iii) **Lower Labor Income Share, Higher Inequality, and Cheaper Capital Goods:** these are other relevant contributors to more negative levels of  $r^*$ . Essentially, this is because the more individuals derive their wealth not from labor but from capital gains, dividends, inheritances, etc.; or the more those with

higher income save relatively more than those with lower incomes; or the less savings are needed to finance a given level of investment, the lower aggregate demand will tend to be.

If the secular stagnation hypothesis is true, what should policymakers do? While the debate is still open, some alternatives have already been proposed:

i) **Unconventional Monetary Policy:** since conventional monetary policy becomes less effective when nominal interest rates are stuck at the zero lower bound, central banks could rely on unconventional tools such as quantitative easing (central bank purchase of a definite volume of longer-term securities to increase the money supply and encourage lending and investment), forward guidance (central bank communication and assurance about its likely future course of monetary policy), and yield curve control (central bank purchase of as many longer-term securities as necessary to achieve specific interest rate targets) to increase interest rates. Yet history seems to suggest that the more one uses these types of policies, the less effective they get.

ii) **Higher Inflation Targets:** raising the central bank's inflation target could raise nominal interest rates; this would grant policymakers more room to lower interest rates again in the future when needed. However, if a central bank fails to achieve a new inflation target that is too ambitious, it may lose credibility. Furthermore, central banks could risk getting trapped in an endless monetary accommodation even when economic activity is strong.

iii) **Fiscal Policy:** an expansionary fiscal policy could in principle raise  $r^*$  and take the economy out of a secular stagnation state if it stimulates aggregate demand by reducing excess savings. On the other hand, if a fiscal expansion fails to address the economy's savings glut, then it will not help jump-start  $r^*$ .

To give a few examples, an expansionary fiscal policy could fail to increase  $r^*$  if people: a) do not use their extra fiscal proceeds in productive ways (because there are not enough good investment opportunities out there or perhaps they prefer to speculate, leading to asset bubbles); b) avoid consuming more today and increase savings because they anticipate higher taxes in the future; or c) start to believe that the government will use the extra money on superfluous things (instead of investing in long-run structural levers such as infrastructure, education, etc.). This latter point is particularly important when we take into account that any policy that changes people's expectations about the future money supply (or more generally the future-interest rate reaction to the central bank's actions) will influence aggregate demand today.

In this context, what should investors do given the possibility that the economy is trapped in a secular stagnation state, and the menu of tools currently available to central banks?

The first thing to ask is whether the fiscal stimulus packages in the developed countries will structurally raise  $r^*$ .

1) We should expect  $r^*$  to increase if we see government spending in the U.S., Europe, and elsewhere that a) boosts productivity, and b) stimulates spending... . In this case, we have to judge the effectiveness of the new programs.

2) If we take the view that most of the money will be wasted and mainly leave governments with higher debts and more likely to tax future incomes and profits, then we should expect  $r^*$  will fall. We will know that this is the case if inflation rates remain very low in the period following the next couple of years.

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Our calculations suggest that the current package is not enough to drive  $r^*$  higher for long. Depending on our assumptions about the size of the output gap (the difference between actual GDP and GDP if the economy operated at full capacity), the structural forces in the U.S. will likely keep  $r^*$  between -0.9% and -2.2% in the long run. This is because should inflation prove to be more permanent and higher than currently expected, while that may end up being a blessing in disguise, the Fed's quick reaction to a few months of high inflation sprints make it unlikely that inflation will remain high enough for long enough to enable monetary policy to efficiently track our estimated  $r^*$ . We believe that this is one of the reasons that markets have been increasingly pricing lower yields despite the realization that fiscal policy will be more expansionary.

In summary, COVID-19 and subsequent massive fiscal stimulus packages not only produced short-run volatility but also may have caused longer-run structural changes in the economy—and our views on that depend on  $r^*$ . This is because if we believe that the recent fiscal expansions will more than compensate the negative forces of secular stagnation, then we should expect higher inflation and higher policy rates in the long run. However, if we think that the fiscal expansions will fail to fundamentally address the global saving glut problem and that the secular stagnation forces will eventually prevail, then we have more reasons to believe that despite potential short-run fluctuations, policy rates and inflation rates will tend to decline in the long run.

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