Mojmír Hampl: Outlook for global interest rates

Speech by Mr Mojmír Hampl, Vice Governor of the Czech National Bank, at the Official Monetary and Financial Institutions Forum (OMFIF) Roundtable for Public Sector Asset Managers, London, 30 January 2018.

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My contribution to today's discussion on global interest rates will focus on the equilibrium real rate of interest. The equilibrium rate, which determines the development of interest rates in the long run, has decreased around the world by about 4 percentage points since the 1980s, as documented, among others, by the influential studies of Holston, Laubach, and Williams (2017) and Rachel and Smith (2017).

Very recently, it seems to me, the process has started to reverse, but any progress toward a higher rate is likely to be slow. Equilibrium values do not change abruptly. Seven principal reasons have been identified for the decrease in this parameter observed in the past:

The first is a decrease in growth expectations caused primarily by the Great Recession and the ensuing process of de-leveraging. Gloomy prospects depress demand for capital and, in consequence, also the equilibrium interest rate. Currently, however, notions of secular stagnation are losing steam, and growth expectations have slowly been recovering to pre-crisis levels. It is perhaps useful to remind ourselves that secular stagnation has been declared many times in the past – by Malthus, after the Great Depression, and during the 1970s and 1980s – only to be refuted by continued growth.

Second, we have seen a steady decrease in dependency ratios, which has stimulated excess savings and therefore lowered the equilibrium rate. This trend, too, will reverse soon, as the increase in the share of the elderly population will outpace all other population groups. Dependency ratios around the world will rise, which will buoy the equilibrium rate.

Third, inequality has risen in past decades, again adding to the increase in the mean savings rate. But note that we are now observing a decrease in (at least) wage inequality in many countries, including the Czech Republic. Inequality, broadly defined, has decreased in most countries around the world since the crisis (World Bank, 2016). I believe that the discussion on inequality tends to be overly pessimistic.

Fourth, more and more developing countries have been getting fully integrated into the world economy, releasing their supply of savings into global markets and giving rise to the notion of a "savings glut". I see no reversal here, which means that this factor will continue to depress the equilibrium real rate of interest.

Fifth, the relative price of capital goods has been decreasing. In consequence, capital has become cheaper relative to labor. This is reducing the total demand for capital (when counted in nominal terms) and thus lowering the equilibrium rate. Again, this trend is likely to continue.

Sixth, we have witnessed a preference shift away from infrastructure projects, which is again reducing the demand for capital. In many countries, environmental regulations have made it difficult to invest in infrastructure. As with the previous two factors I see no signs of a reversal in this trend.

Seventh, recent decades have produced a rising spread between the return on capital and the risk-free rate, which is depressing the risk-free rate even further. Obviously, this phenomenon is connected to risk aversion and can be expected to reverse, at least partially, in response to the current wave of strong confidence in global growth prospects.

In summary, I see reasons for modest optimism concerning growth in the equilibrium rate. The factors contributing to this new trend will include an increase in growth expectations, a rise in dependency rates, a halt to the increase in inequality, and a decrease in risk aversion. The equilibrium rate will be kept from rising swiftly, however, by a continuing savings glut, a decrease in the relative price of capital, and muted investment in infrastructure projects.

These prospects also hold more specifically for the Czech economy, for which we at the Czech National Bank currently forecast the equilibrium real 3-month interest rate to stand at around 1%. Adding the 2% inflation target, this translates to a nominal interest rate of 3% in normal times. Given that the Czech economy is currently doing much better than in normal times, we have room to increase our short-term rate even without a substantial rise in the underlying equilibrium rate.

References

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