



BANK FOR INTERNATIONAL SETTLEMENTS

Persistent unusually low interest rates. Why? What consequences?

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Themes and takeaways

- One Annual Report (AR) theme
 - Why have interest rates been so low for so long?
 - Are they equilibrium (natural) rates?
 - If not, what might be the consequences?
- Takeaways
 - They are not necessarily equilibrium rates
 - Consistent with “good” medium-term outcomes
 - They raise material risks for the global economy
 - Financial instability and chronic weakness
 - They raise doubts about the “separation principle”
 - Monetary policy (MP) for (near-term) output and inflation
 - Macroprudential policy (MaP) for financial stability

Structure of remarks

- What is the relationship between market and equilibrium rates?
 - Prevailing view and Annual Report perspective
- Why are rates below equilibrium costly? A mechanism
 - Financial booms – resource misallocations – productivity nexus
- What are the consequences ...
 - ... for the interpretation of the long-term decline in interest rates?
 - ... for the global economy?
 - ... for policy frameworks?

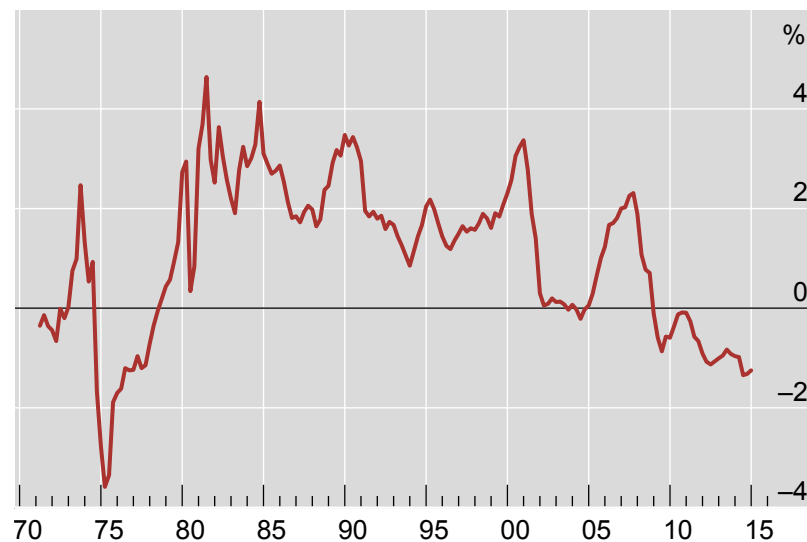
When are market rates equilibrium (natural) rates?

- Market rates have been ultra-low for very long (Graph 1)
- They are determined by central banks and market participants
- Standard view: behaviour of inflation signals disequilibrium
- AR view: financial imbalances can also signal disequilibrium
- If low rates ...
 - ... contribute to financial instability ...
 - ... and financial instability causes huge economic costs ...
- ... it is not reasonable to regard them as equilibrium rates
 - To think otherwise reflects the deficiencies of current models
- Central banks' task is to set policy rates at equilibrium level
- If so, this undermines the separation principle
 - Also, MP has a role to play in preventing financial instability

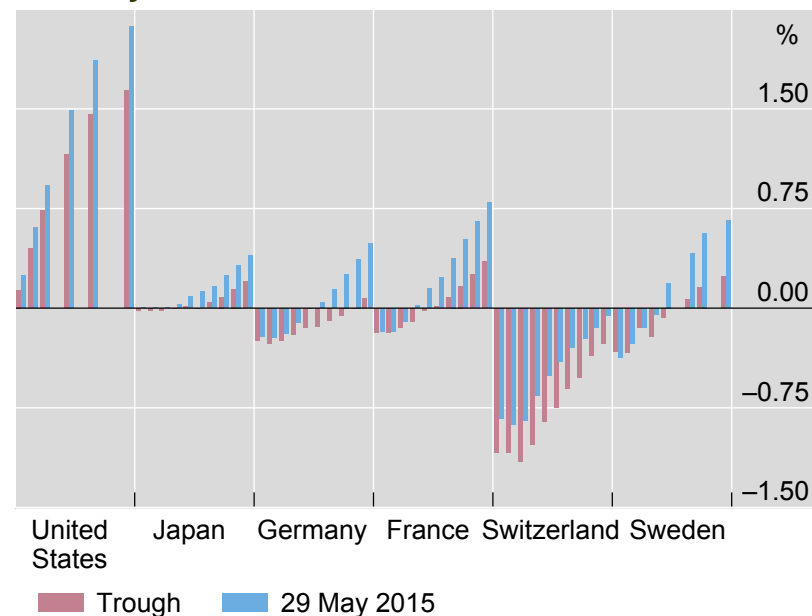
Interest rates have been exceptionally and persistently low

Graph 1

G3 real policy rates¹



Bond yields²



¹ Nominal policy rate less consumer price inflation excluding food and energy. Weighted averages for the euro area (Germany), Japan and the United States based on rolling GDP and PPP exchange rates. ² Yield per maturity; for each country, the bars represent the maturities from one to 10 years.

Sources: Bloomberg; national data.

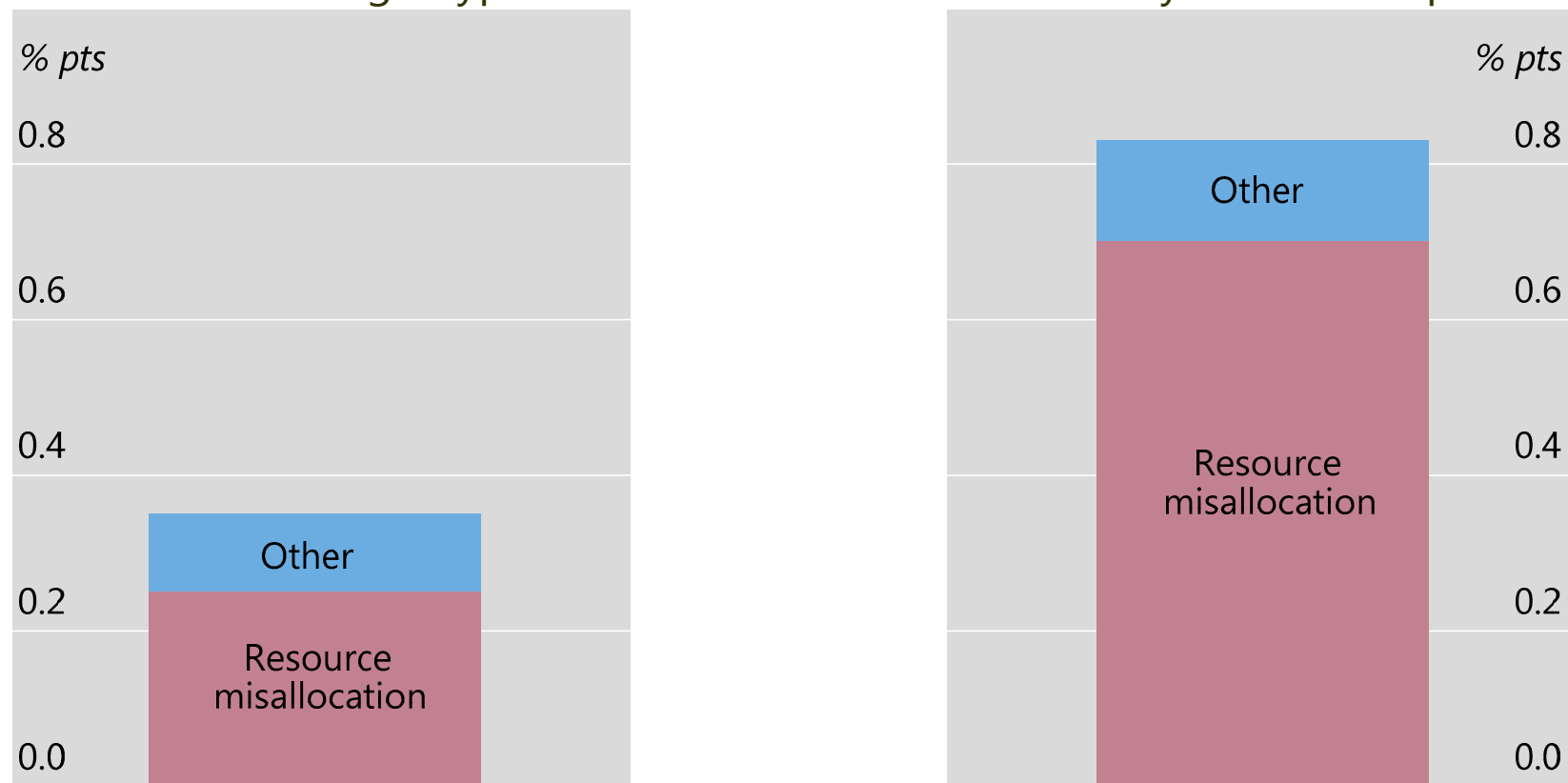
Financial booms, resource misallocations and productivity

- Financial boom-busts do not cause damage just through demand
- They also have a sizeable impact through supply
- Three findings of BIS research (Graph 2)
 - Financial booms sap productivity growth as they occur ...
 - ... mainly through resource misallocations ...
 - ... that have an even larger impact if a crisis occurs later on
- Three implications
 - Money is not neutral
 - Misallocations cause another form of hysteresis
 - Misallocations weaken the effectiveness of demand management
 - Premium on balance sheet repair and structural policies

Financial booms sap productivity by misallocating resources

Graph 2

Annual cost during a typical boom and over a five-year window post-crisis



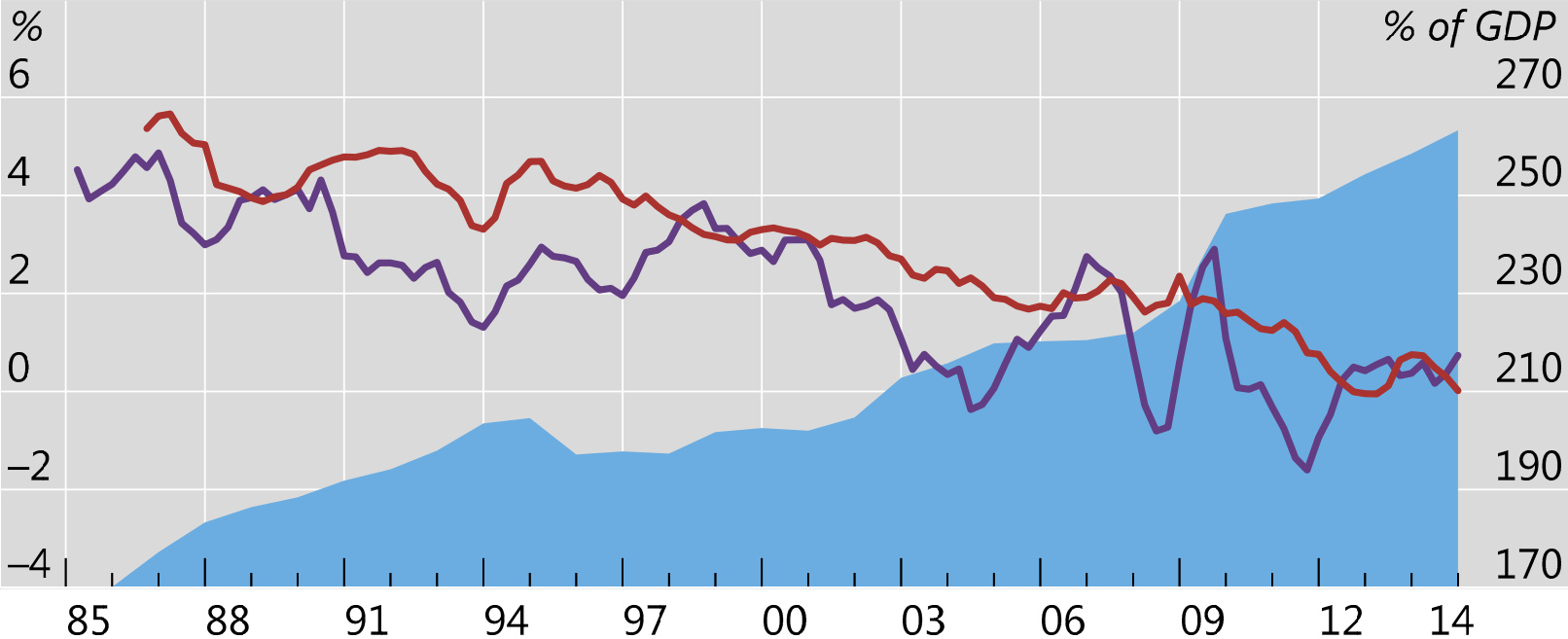
Estimates calculated over the period 1980–2010 for 22 advanced economies. Resource misallocation = annual impact of labour shifts into less productive sectors during the credit boom on productivity growth as measured over the period shown. Other = annual impact in the absence of reallocations during the boom.
Source: BIS calculations.

Why have interest rates declined over time?

- Complementary explanation: in part a disequilibrium process
- Reflection of asymmetrical MP over booms and busts
 - Downward bias in interest rates and upward bias in debt
 - Debt trap? (Graph 3)
 - Running out of ammunition over time
 - Harder to raise rates without causing damage
 - Too low rates in the past are one reason for lower rates today

Interest rates sink as debt soars

Graph 3



Lhs:

— Long-term index-linked bond yield¹

— Real policy rate^{2, 3}

Rhs:

■ Global debt (public and private non-financial sector)³

¹ From 1998, simple average of France, the United Kingdom and the United States; otherwise only the United Kingdom. ² Nominal policy rate less consumer price inflation. ³ Aggregate based on weighted averages for G7 economies plus China based on rolling GDP and PPP exchange rates.

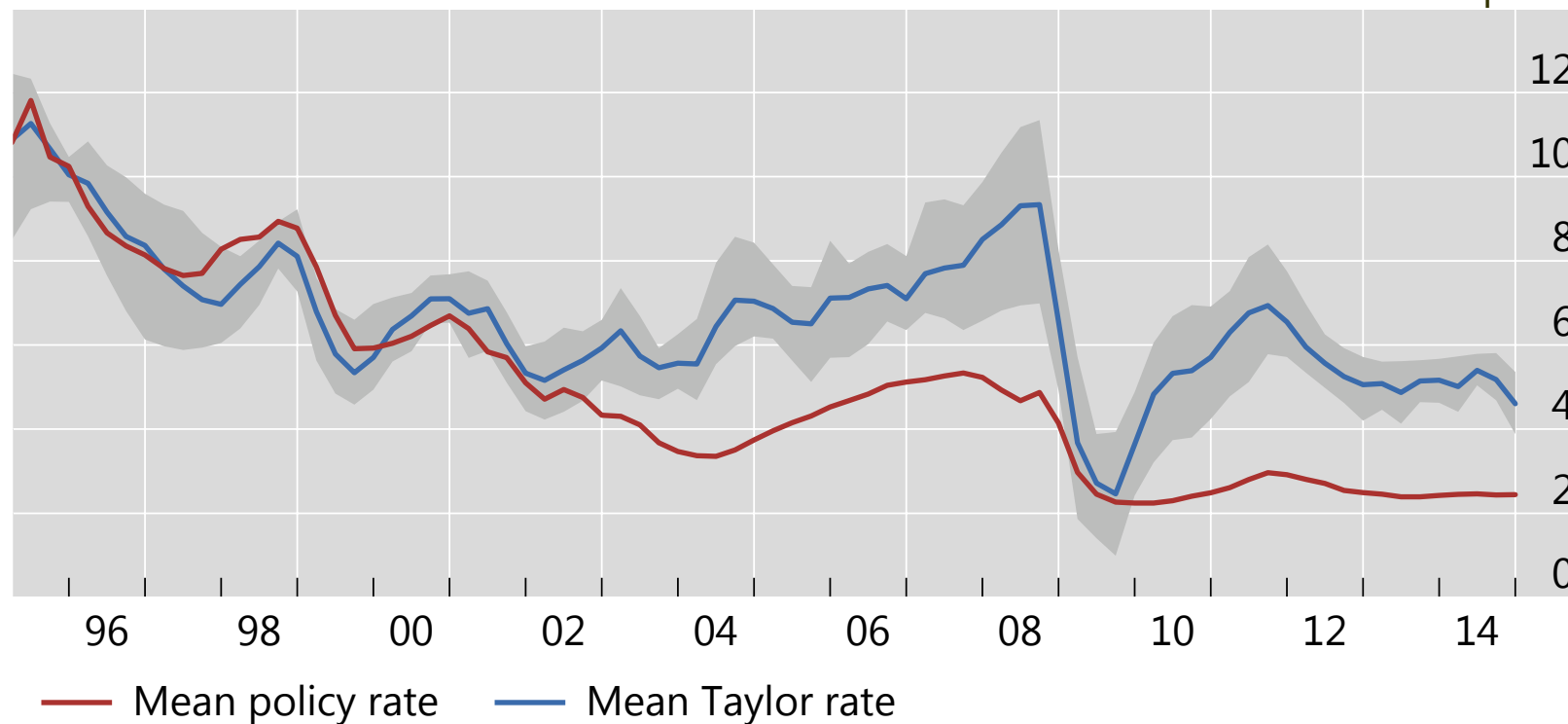
Sources: IMF, *World Economic Outlook*; OECD, *Economic Outlook*; national data; BIS calculations.

Two further consequences

- There is an important global dimension to all this
 - Successive crises need not occur in the same country
 - In part as easing begets easing across countries
 - Signs of unusually accommodating global monetary conditions (Graph 4)
 - The international monetary and financial system is key
 - Troubling signs that this may be happening
- Imprudent to rely on MaP alone to restrain financial imbalances
 - Financial booms are too powerful
 - And the reach of MaP is too limited
 - It needs the support of MP

Unusually accommodative global monetary conditions

Graph 4



Weighted averages. For details, see BIS, *85th Annual Report*, Graph V.3.