Persistent ultra-low interest rates: the challenges ahead

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It is a great pleasure and privilege for the BIS to co-organise and to participate in this symposium in honour of Christian Noyer.

Christian has served as a central banker in an era of unprecedented challenges. One major challenge was the establishment of the euro, to which Christian made a major contribution as Vice-President of the ECB.

Those were quite exciting days, but in retrospect they were really days of tranquillity. A far greater challenge for central banks, and for Christian as Governor of the Bank of France, has been the management of the various stages of financial and economic crisis since 2008.

The excellent presentations and discussions we have here today illustrate not only the complexity of this period, but also the amount of work that has been done to help understand the many puzzles and challenges – as François Villeroy de Galhau put it in his opening remarks[1] – and how to address them.

It is beyond doubt that the swift actions of central banks when the crisis first hit were crucial for preventing a financial and economic meltdown. As Christian himself has emphasised,[2] an important element of this crisis response was the close cooperation among central banks, through constant dialogue and, more concretely, cooperative actions such as the establishment of currency swap lines.

As the acute phase of the crisis is now well behind us, the key question becomes how central banks can best support the recovery, to make it not only more robust than what we have seen so far but also sustainable. This has proven to be a very challenging question. In the aftermath of the crisis, central banks have had to operate in uncharted waters, characterised by low growth, below-target inflation and unusually low interest rates – as well as financial fragility and rising debt.

In one of his speeches, Christian has highlighted the need to broaden the spectrum of views available to policymakers in order to avoid "groupthink" and "intellectual capture".[3] In this vein, the debates we have here today are important because there is not yet the necessary convergence of minds about the right analytical framework to use for understanding the new reality we face. Central banks have

1 F Villeroy de Galhau, "Ultra-low interest rates and challenges for central banks", speech at the Bank of France–BIS Symposium, Paris, 12 January 2016.

2 C Noyer, "Thoughts on the zero lower bound in relation with monetary and financial stability", speech at the Bank of France–BIS Symposium, Paris, 12 January 2016, and "Central banking – the way forward?", speech at the International Symposium of the Bank of France, Paris, 7 November 2014.

3 C Noyer, "Monetary policy – lessons from the crisis", speech at the Bank of France–Deutsche Bundesbank Spring Conference on "Fiscal and Monetary Policy Challenges in the Short and Long Run", Hamburg, 19 May 2011.

been working hard to update their analytical tools, and so have international organisations such as the IMF.

The BIS, as well, has played a part. Under the guidance of our Board, chaired by Christian until late last year, and in collaboration with the various Basel-based international committees, we have been promoting the exchange of views and cooperation in different areas.

Our own research has also been striving to better understand the phenomenon of low growth, low inflation and low rates – as well as its complex relationship with financial booms and busts (ie financial cycles). We have sought to contribute to the debates by bringing a perspective that is longer-term than the typical policy horizon. As such, we put less emphasis on the cyclical aspects of aggregate demand, and pay more attention to the more entrenched impediments to growth – factors that are slow-moving but whose effects cumulate over time. In particular, we focus on impaired balance sheets and resource misallocations. Since these impediments cannot ultimately be removed exclusively by expansionary monetary policy, prolonged monetary easing alone may not succeed in reviving economic dynamism. A combination of policies will be required.

And from this longer-horizon perspective, we see persistently low or negative interest rates – which are the result of not only central bank actions but also market participants' perceptions – as not a sustainable equilibrium, but rather at least in part a disequilibrium phenomenon. Let me briefly elaborate.

Why are interest rates so low?

In the BIS view, the recession that accompanied the Great Financial Crisis was not a typical postwar business cycle recession. Rather, it was a balance sheet recession, associated with the bust phase of the financial cycle.

Balance sheet recessions commonly coincide with permanent output losses and weak recoveries. The permanent output losses after the financial bust reflect, to a considerable extent, the fact that output growth was unsustainable during the preceding boom.

Two legacies of the boom require further analysis. One is the combination of a debt overhang and disruptions to financial intermediation. This is quite well known. A lot of work has been done in the wake of the crisis to improve the workings of the financial system.

The other, perhaps less well analysed so far, is the drag on growth that arises from the resource misallocations that occur during the credit boom. Recent BIS research using data from 21 advanced economies since 1979 finds evidence that credit booms undermine productivity growth, primarily through the misallocation of resources.[4] During periods of strong credit growth, workers shift to sectors with lower productivity gains, notably construction. This reallocation depresses aggregate productivity growth and thus potential output.

Importantly, even though the misallocations take place during the boom, their effects linger on and become much more impactful if a financial crisis materialises, as the economy then needs to shift workers away from the previously overextended sectors. Our analysis suggests that the magnitude of these effects is not negligible.[5]

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[4] BIS, *85th Annual Report*, Chapter III, June 2015; and, for more details, C Borio, E Kharroubi, C Upper and F Zampolli, "Labour reallocation and productivity dynamics: financial causes, real consequences", *BIS Working Papers*, no 534, December 2015.

[5] For a typical credit boom, the estimated loss of productivity growth is about 0.25 percentage points every year as the boom proceeds, while it is of the order of 0.5 percentage points per year after a financial crisis occurs.

What does all this imply for interest rates?

Clearly, monetary policy is essential in a crisis for stabilising the financial system and the macroeconomy. But in the wake of a balance sheet recession, where weak demand may not be the only problem, monetary easing cannot be the only answer.

If we accept that some deeper, often country-specific, impediments to growth are at work, then the appropriate policy response needs to include measures such as determined balance sheet repair and structural reforms to facilitate resource reallocations. A resilient financial system and flexible economy make monetary policy more efficient. Moreover, relying too much on the support from monetary policy may, over time, weaken the incentives for other actors to address the underlying problems through repairs and reforms. If this reliance persists, low rates could become self-validating. This is a key concern.

There are other concerns as well. As mentioned by a number of speakers today, a prolonged period of very low interest rates can have unintended consequences in the financial sector: erosion of interest margins for financial institutions, incentive for excessive financial risk-taking, asset price inflation, etc.

There can also be consequences in the real sector. For example, as people in ageing societies worry more about their retirement, persistently low interest rates may increase precautionary savings and weaken consumption. Analogously, funding deficits in corporate pension plans may constrain companies' capacity to make new investments. These effects warrant further investigation.

Furthermore, there are spillovers and spillbacks. Persistently low interest rates in the core advanced economies have spilled over to other economies less affected by the crisis. These spillovers work through various channels: from investors' search for yield and co-movements in global bond markets to policy reactions to avoid large interest rate differentials. These spillovers can fuel the build-up of financial imbalances in the receiving economies. Rapidly rising property prices, expanding credit and increasing indebtedness, including in foreign currency debt, point to such imbalances. When these economies enter the late stages of the boom, their vulnerabilities may spill back to the originating economies.

Challenges ahead

What are the challenges ahead?

As mentioned by Stan Fischer, quantifying the trade-offs is a challenge.[6] Part of the difficulty in assessing the costs and benefits of alternative policies is that the traditional analytical frameworks do not take enough account of the endogenous build-up of financial imbalances, which may accumulate slowly but then assert themselves quite powerfully. As such, these frameworks tend to underestimate the influence of monetary policy on the financial cycle. They also tend to underestimate the international dimension, in the form of policy spillovers and spillbacks.

This suggests that we need to develop better analytical frameworks that can allow us to study the interaction between finance and macroeconomics. In addition to taking a long-term perspective, this effort will require two things.

One is to think holistically. A holistic approach to macroeconomic and financial stability will involve a suite of policies: prudential, macroprudential, monetary and fiscal policies – and no less importantly, structural reforms. Since the interest rate determines the universal price of leverage in a given

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6 S Fischer, "Monetary policy, financial stability, and the zero lower bound", remarks at the Annual Meeting of the American Economic Association, San Francisco, 3 January 2016.

currency, monetary policy is a key factor in the financial cycle. A holistic approach would call for a monetary policy that responds more symmetrically to the financial cycle to help contain financial imbalances. Fiscal policy, for its part, should ideally create some additional fiscal space during financial booms in order to have enough capacity to address financial busts. All this will have to be complemented with a greater degree of attention to the slow-moving factors that sap productivity. Such drags on long-term growth tend to be not visible during financial booms, but become apparent during the busts.

The other requirement is to think globally. An important element for greater global financial stability is a better appreciation of cross-border spillovers in the conduct of national policies. Importantly, thinking global is not incompatible with central banks' domestic mandates – consider it a kind of enlightened self-interest. In improving our collective understanding of how spillovers and spillbacks work, central bank dialogue and cooperation are essential ingredients.

Conclusion

Let me conclude by noting that, in confronting and tackling these challenges, we would be well advised to follow Christian's example and his work – always inspired by pragmatism, inclusiveness, cooperation and good governance. Indeed, Christian has been a key player in crisis management, in endeavours to improve policy frameworks and in strengthening central bank cooperation.

Christian, you have worked steadily and effectively for the collective good of this community. As BIS Chairman, you gave direction and guidance in times when central banks faced unprecedented challenges. Under your chairmanship, many initiatives that are crucial for the BIS itself and for its collaboration with central banks and other institutions came to fruition. We have to build on to this work and to nurture the close cooperation among central banks in order to successfully meet the challenges of the future.

In closing this symposium, I would like to thank the Bank of France for inviting the BIS to be a part of this special event and for the excellent organisation. Many thanks also to the speakers. But most of all, I want to thank you, Christian. We as a community owe you an enormous debt. It is a debt of gratitude – the only type of debt we won't mind having more of! We wish you all the best in your future endeavours.