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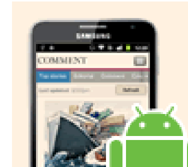

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FINANCIAL TIMES

What is the real rate of interest telling us?

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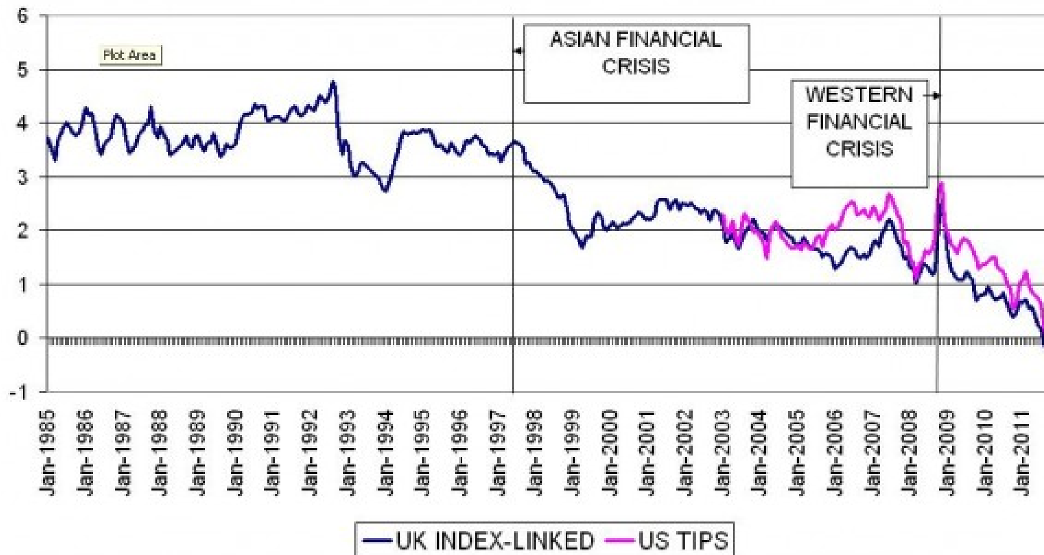
The real interest rate on US and UK government debt is currently near to zero (see chart 1). This is a remarkable fact. True, real interest rates were negative in the 1970s. But it is extremely unlikely that anybody bought bonds expecting this to be the case.

Now, however, the position is quite different. Both of these governments sell index-linked debt that delivers zero real returns. That is a demonstration of the fact that the world has a huge “savings glut”. Indeed, since savings must equal investment at the global level, it is only by its price – the rate of interest – that one can assess whether such a glut exists.
To put the same point in another way, the massive fiscal deficits being run by the UK and US are not, on this evidence, crowding anybody out of the market. It is far more plausible that these deficits stand between these economies – possibly even the world economy – and a slump. They are the least bad way available to offset the massive excess savings of the private and foreign sectors in these economies. The

only alternative would be strongly negative long-term real interest rates.



Fortunately, the fact that governments have been selling index-linked debt for a while helps illuminate not only where we are, but how we got here.
In an integrated global capital market one would expect a uniform real interest rate on safe assets.

The UK is a part of such an integrated global capital market. So, to a first approximation, one would expect the real interest rate on index-linked gilts to offer a reasonable approximation to the global real interest rate.

One can think of reasons for discrepancies across countries. One such reason would be the expectation of large appreciations or depreciations of the real exchange rate. Another would be captive savers: pension funds needing to match currencies of their assets and liabilities are an obvious example.

Happily, such reasons for discrepancies do not seem to be too significant, as is shown by the fact that the real yield on US Treasury Inflation-Protected Securities (TIPS) match those on UK index-linked gilts quite closely, since 2003. I will start then from the assumption that UK index-linked bonds give a reasonable approximation to the global real interest rate expected on safe and liquid securities.

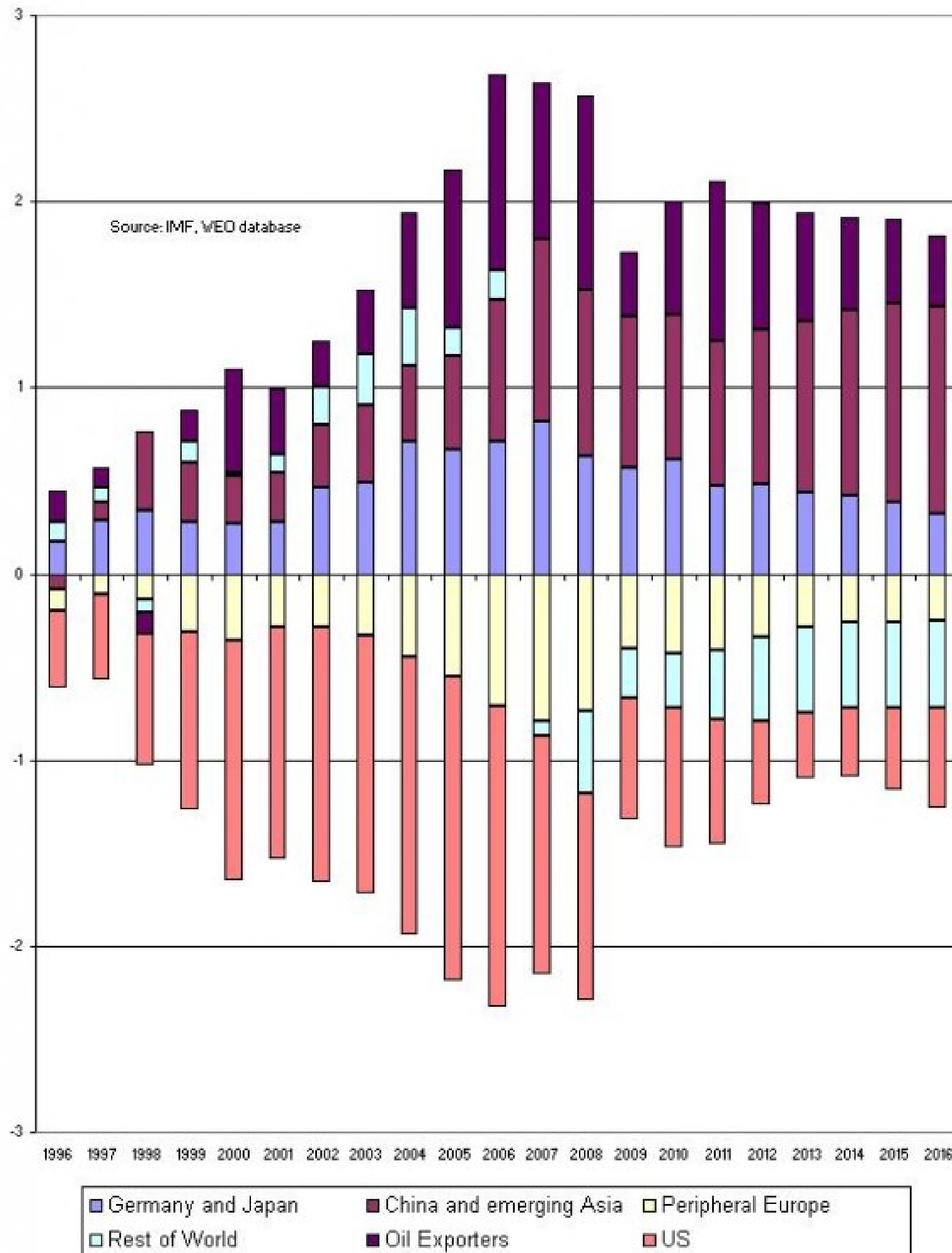
We can then clearly see that the last 27 years breaks down into three clear sub-periods: from January 1985 to January 1998, the real interest rate averaged 3.7 per cent; from January 1998 to August 2007, it averaged 2.1 per cent; and then since August 2007, when the financial crisis began, it has fallen steadily, to below zero, with a brief interruption during the period of high panic from October to December 2008.

What explains these huge changes in one of the most fundamental prices in the global economy?

One possible explanation for the massive decline in real interest rates between the first and second sub-periods — a collapse in global economic growth — can be ruled out: according to the International Monetary Fund, global economic growth, measured at market exchange rates, averaged 3.1 per cent a year between 1985 and 1997 and again between 1998 and 2007.

The obvious explanation for the collapse in the safe real rate of interest after 1997 then is the emergence of an ex ante "savings glut", an idea famously proposed by Ben Bernanke, now chairman of the Federal Reserve, in 2005 ("The Global Saving Glut and the U.S, Current Account Deficit", March 10 2005,). Initially this glut was caused by a collapse in the demand for investment after the Asian financial crisis. That was then followed in the 2000s by the fall in investment propensities in developed countries, after the bursting of the stock market bubble in 2000, rising excess savings of China and the shift in global income to the high-saving oil exporters (this last itself partly itself a result of China's rapid rise).The result of these huge shifts in ex ante savings propensities was far lower real interest rates after 1997. Indeed, on average, they were little more than half their level in the 1985 -1997 period. As I argued in my book, Fixing Global Finance (Johns Hopkins University Press and Yale University Press, 2009), the Asian financial crisis transformed the global macroeconomic environment. The emerging world as a whole became a huge net exporter of capital, with the US and "peripheral Europe"

emerging as net importers (see chart 2).



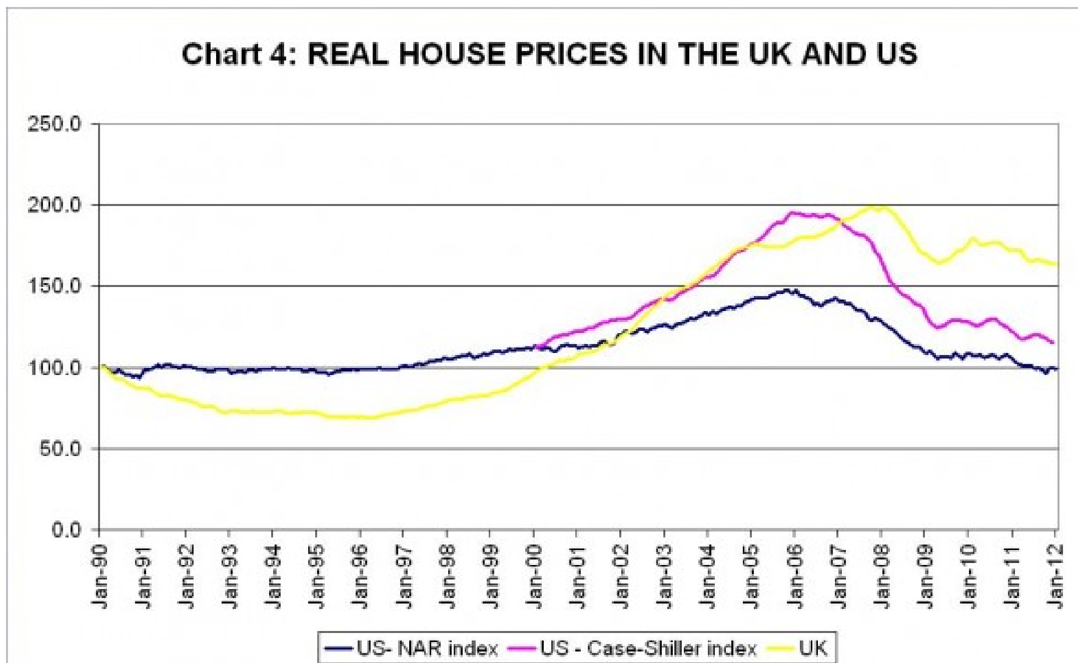
The surpluses of the emerging world did not result from purely private behaviour.They were exacerbated by deliberate policy. One such policy was sterilisation of intervention in foreign currency markets (that is, a policy of offsetting the monetary impacts of such intervention). In the 2000s, the most

important of the emerging countries pursuing that policy was China whose foreign currency reserves rose from a little over $100m at the time of the Asian crisis to $3tn in 2011.

Meanwhile, the capital importing countries tolerated – or even encouraged an offsetting expansion in private credit and leverage. That is how global demand and supply was balanced in the 2000s, prior to the crisis.

More precisely, the collapse in real interest rates in the aftermath of the Asian financial crisis caused what the late Hyman Minsky called a "displacement". Thus the reduction in the price of savings raised the price of long-lived real assets, above all housing, setting off the well-known house price bubbles and credit booms in a number of developed countries.

The coincidence between the fall in the real rate of interest in 1997-99 and the beginning of the bull market in housing in the US and UK is indeed remarkable. The collapse in real interest rates also helped exaggerate an already impressive bull market in equities, which topped out, at extraordinarily overvalued levels, in 2000.



Thus the world of the pre-crisis savings glut had two fundamental characteristics: a long bull run in housing and low returns on safe real assets. This was the "ideal" environment for an expansion of property-backed leverage on an exceptional scale.

That property-backed leverage then went into reverse as soon as house prices started to decline, which they did, in the US, in 2006. The subsequent collapse of the over-leveraged financial system and cut-backs on construction and household spending in affected economies generated a deep recession.

That collapse then led to an even bigger ex ante savings glut and so to a further decline in the real interest rate on safe assets to the depressed levels we see today.

That is the third period shown in the first chart: the period of the "contained depression". In this period, real interest rates have been low for fundamental reasons.

It is the savings glut that delivers the negligible real returns savers now hate. What, after all, is the value of risk-free savings in a "savings glut" world? Zero.

When will we know that the world economy has recovered from the extraordinary conditions of today. My answer would be that this will be when the real rate of interest on safe securities (if any are indeed left by then) is around 3 per cent. Until that happens, policy is trying to stave off disaster.

What would cause such a shift? The most important contribution would be a move to a world economy in which the countries with the best investment opportunities – the emerging countries – became very large net capital importers, as the emerging countries of that time (the US, for example) were in the late 19th century. A huge

investment boom in the high-income countries would also help a great deal. But I cannot see that happening in current circumstances.

The advanced countries, as a group, need to become large net capital exporters. Will that happen? I strongly suspect not.

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