Opinion **Markets Insight**

Today's ultra-low interest rates are anything but 'natural'

Policymakers who have cut rates repeatedly should not be let off the hook so easily

In the beginning of the last century, central banks had to adjust rates according to the rules of the international gold standard © AFP via Getty Images

Lotta Moberg YESTERDAY

It is impossible to miss that central banks have cut interest rates at an unprecedented pace. A common view is that economic and demographic factors are forcing central bankers to move in this direction. This is a misunderstanding. Policymakers should not be let off the hook that easily.

Average interest rates in developed markets have been in steady decline over the past 30 years. This seemingly secular trend has inspired a plethora of theories about what drives it, from trade flows and productivity, to life expectancy and demographic shifts. Depending on your choice of timeframe, you can indeed see such factors moving with interest rates in the past few decades.

However, two variables moving in the same direction for a while does not mean their relationship is causal. Three years ago, Claudio Borio and his colleagues at the Bank for International Settlements published a paper suggesting that over the longer term, movement in interest rates are rather connected to changes in monetary regimes, such as a shift from the gold standard, or toward inflation-targeting. That suggests that central banks do indeed have a role to play in our current interest rate environment.

Moreover, it is clear that central bankers have political incentives to cut rates and keep them low. In economic downturns or market crashes, rate reductions can quickly save the day. In normal times, rate increases risk bringing about the next crisis. Few central bankers want to be blamed for contributing to a recession.

Why, then, did central bankers hold off from forcefully suppressing interest rates until the past 30 years or so? It mostly comes down to constraints. In the beginning of the last century, central banks had to adjust rates according to the rules of the international gold standard. Central bankers faced similar constraints during most of the Bretton Woods era after World War Two, which created a collective currency regime based on the US dollar and gold.

The only period similar to today was between the mid-1940s and the mid-1950s, the early years of Bretton Woods. Against the formal rules of the agreement, several countries maintained capital controls until the mid-1950s. This allowed them to keep rates low despite fairly high inflation.

During this period, several central banks held real rates negative for an extended length of time. This so-called financial repression was an effective way for governments to finance and repay their huge war debts. Outside of this period and our current environment, real interest rates were not negative for extended stretches in the previous century.

When the Bretton Woods agreement broke down in the 1970s, the world saw a gradual adoption of floating exchange rates, after which inflation-targeting took hold, pioneered by New Zealand in 1990. For the first time in a long while, central banks had free rein to cut rates as long as they could claim to be adhering to their mandates. No exchange rate-targeting or gold standard rules were holding them back.

While the previous round of negative real interest rates was used to repay war debts, this time around governments are mainly using low rates to argue for more borrowing. There is method to this apparent madness. The case for bigger debts is the erroneous — but often made — claim that central bankers are not determining rates as they are simply following the "natural rate of interest." They have to cut rates because that natural rate is falling.

The concept of the natural rate was defined by Swedish economist Knut Wicksell, as "the rate of interest which would be determined by supply and demand if no use were made of money and all lending were effected in the form of real capital goods".

You often hear the claim that central banks must follow the natural rate downwards to avoid imposing interest rates that are too high to support normal economic growth. However, the models used for measuring the natural rate rely on macroeconomic variables such as output gaps — which in turn depend on interest rates. This interdependence between interest rates and output makes it hard to account for rates being suppressed below the natural rates for decades.

If you plot the path of interest rates going back to the 12th century, there has been a gradual decline and it is quite likely that the natural rate has decreased thanks to factors such as economic integration and increased longevity.

However, there is nothing natural about the fall in rates that we have seen in much of the developed world since the 1980s. The US, for one, has seen rate cuts with each crisis since the stock market crash of October 1987.

Between crises, rates have been raised a little, before being slashed again to new lows. This pattern appears to follow a political imperative of avoiding market downturns and recessions. That is anything but natural.

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