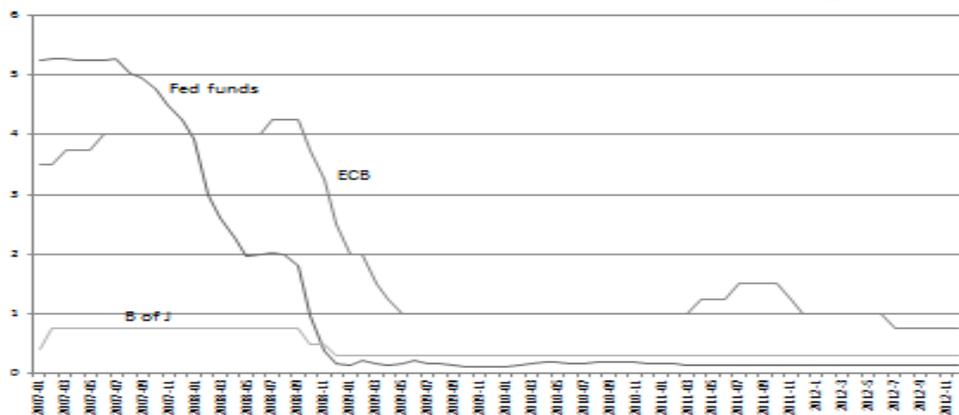


## The Interest Rate Conundrum: Interest Rates Are Too Low

By Brian Fabbri (February 2013)

The present aggressive and unconventional monetary policy carried out by the US Federal Reserve, the ECB, and the Central Bank of Japan has created a distortion in global financial markets. Money is plentiful and practically costless. Interest rates throughout the world are too low. Central bankers worried about deflation and high unemployment rates have lowered interest rates to unprecedented levels in all developed economies and some developing economies. The central bankers frustrated by a prolonged period of insufficient economic growth have undertaken additional unconventional measures to stimulate growth such as purchasing longer maturity credit instruments. Aside from transferring these credits from the private balance sheets of banks to the central banks' balance sheets, they have also driven longer term yield levels down to unimagined levels and shrunk credit spreads to unprecedented levels.

### Central Bank Rates Approaching Zero

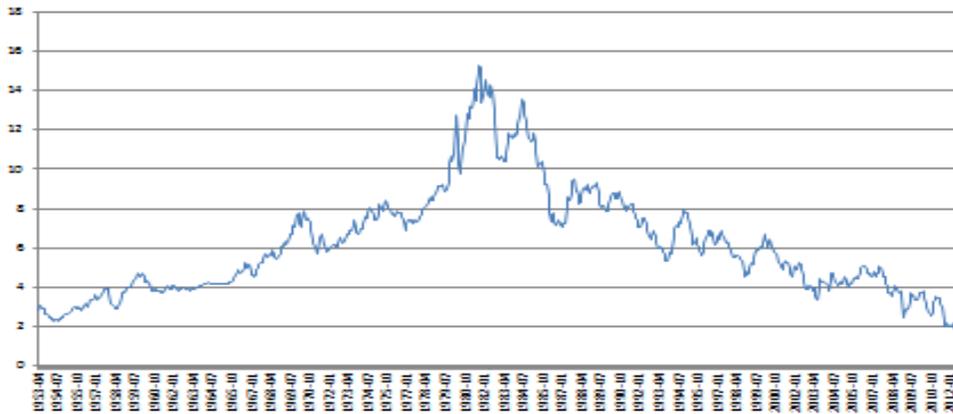


Source: Bank of Japan, European Central Bank, Federal Reserve, Fabbri Global Economics

In the past, financial market participants couldn't wait for central banks to begin lowering their policy rates. It was like a bell sounding that the rally in financial market assets had begun. Recently financial market participants took courage from the decisions made by central banks to purchase their own governments sovereign bonds. This pushed sovereign yields down further and also supported all competing financial assets such as: federal agencies, mortgage backed bonds and corporate bonds. Bond investors rejoiced. Most

recently market participants are taking additional courage from central bank commitments to keep policy rates low for long periods into the future.

## The Rise and Fall of 10-Year Treasury yields



Source: Federal Reserve H15, Fabbri Global Economics

### What have these aggressive monetary policy decisions done to financial markets?

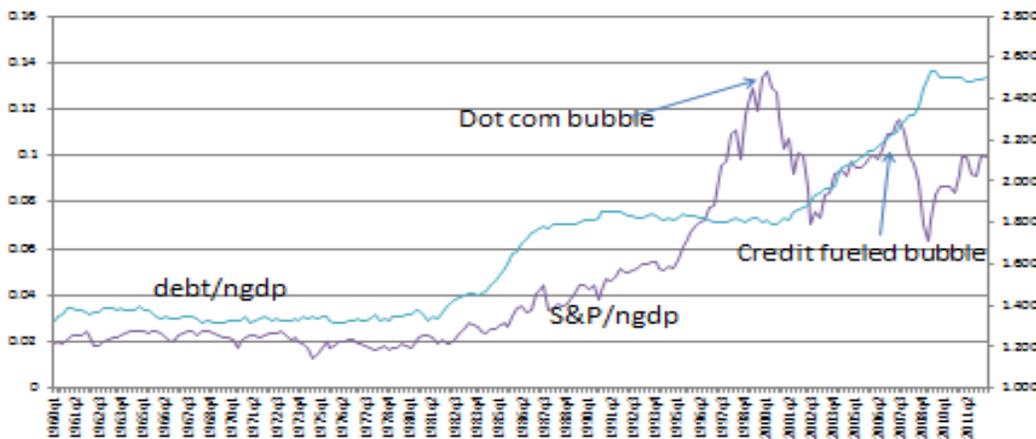
There have been four major market responses to the extreme easy monetary policy that has prevailed over the past five years. Easy monetary conditions have destroyed long held incentives, damaged an important sector of the financial markets, raised risk in investment portfolios, and corrupted valuation models.

First, it pushed money market and bank deposit rates down to trivial levels. Frustrated savers have been withdrawing funds from bank savings deposits and money market funds. As a result, banks have begun raising fees on checking accounts and finding innovative ways to increase fees for all bank services. Managers of money market accounts have had to waive fees to keep returns positive and to prevent them from having to close the funds. Second, investors were faced with negative rates of return on all short term assets and almost all maturities of Treasury securities. As a result, the incentive to save in traditional avenues has diminished. US household savings rates have slid to 3.4%, down from 6% in the midst of the credit crisis in 2009 and well below the 20 year average (8.5%) that prevailed in the past century.

Third, near zero yields on money market instruments pushed investors into buying longer maturity investments, which drove yields on longer maturity sovereign bonds throughout the world to unprecedented low levels. As yields plunged on longer-term government securities, it motivated investors to search for higher yields in more risky assets. Consequently, yields on corporate bonds and agency-backed mortgage securities declined to record lows. When yields plunged on all fixed income securities, investors allocated more of their portfolio to stocks and this helped inflate equity prices well above their historic relation to underlying economic activity.

Fourth, trivial interest rates on all perceived riskless securities propelled discount rates used in asset valuation models down to insignificant levels and promoted unrealistically high asset values.

## Debt and Equity Relative to GDP



Source: Federal Reserve Flow of Funds Z1, Department of Commerce for NGDP, Fabbri Global Economics

As Chart 3 demonstrates the relationship between stock prices and GDP was very stable throughout the first several decades of the post-World War 2 era. Similarly the relationship between credit and GDP was also very stable. In the 1980's financial reform was altering the structure of financial landscape from the depression era rules governing banks, thrifts

and national banking laws and transforming it into a credit *free for all*. As a result of the credit problems that developed during the thrift crisis credit growth began to accelerate at a much faster rate than GDP. The easing of credit rules therefore did not enhance real economic growth as much as it added leverage to the nation's financial balance sheet. The direct result was that the surplus credit fueled real and financial asset prices. Stock prices began to rise much faster than GDP and eventually it caused more than one price bubble in the past two decades. In the past few years the very loose monetary policy has again created the financial bonanza to push stock prices up much faster than the economy is growing. Thus, the present monetary policy mix is setting in motion the potential for another financial asset bubble.

### **What are the effects: some positive and some potentially very negative?**

There are two important positive effects that have contributed to restoring financial health to the economy. One, corporations have benefitted from historically low interest rates and have refinanced the majority of their outstanding debt. This has reduced their overall borrowing costs and contributed to their profit over the past four years. Two, cheap sources of funds have liquefied commercial banks helping them unwind some of their large mortgage losses. In the process bank to bank lending rates like LIBOR have collapsed down to pre-crisis levels.

The perceived negative consequences from market distortions emanating from extreme monetary ease have yet to be observed, but they are believed to be potentially quite severe. Three potential issues presently stand out. One, exceptionally cheap credit costs have encouraged fund managers to use greater amounts of cheap leverage in financial portfolios to raise investment returns as unleveraged yields have been disappointingly small.

Two, it left retirees and those near retirement in a desperate search for income to supplement their social security. Savings deposit rates and government security yields are too low to be useful for retirees. Low yields pushed these investors into acquiring securities with significantly greater credit risk. Inadequate returns from low risk securities and a greater proportion of securities with higher credit risk in their portfolios will devastate a needy segment of the population when central banks raise interest rates again. Three, it left all investors (professional and individuals) at risk when central bankers decide to turn off the monetary policy spigot and begin raising interest rates. Portfolio

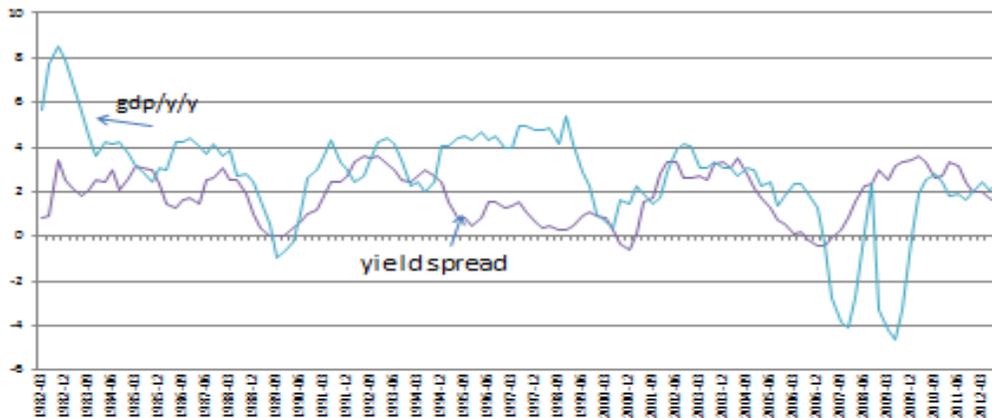
losses especially for retirees will hurt a growing and vulnerable segment of the population of most societies.

### The relatively flat yield curve

The relatively flat US Treasury yield curve is also producing minimum gains for banks as the Fed pursues its ‘operation twist’. Banks have traditionally derived significant earnings gains from a positively sloped yield curve that usually develops just before a new business cycle expansion. Since the cost of most of their liabilities (deposits) are tied to the Fed funds rate and their most expedient investment is longer dated Treasury securities. This simple maturity mismatch generates significant profits before the real business expansion kicks in. It has always been a relatively safe technique for the Federal Reserve to build banks retained earnings and invigorate them into new lending machines.

Today the curve is relatively flat in comparison with previous economic expansions. Operation twist is one of the novel ways that the Fed has used in the past year to reduce longer term interest rates in the hopes of stimulating new real economic investment. In addition to ‘operation twist’, the long end of the yield curve is also reflecting a curious supply demand imbalance.

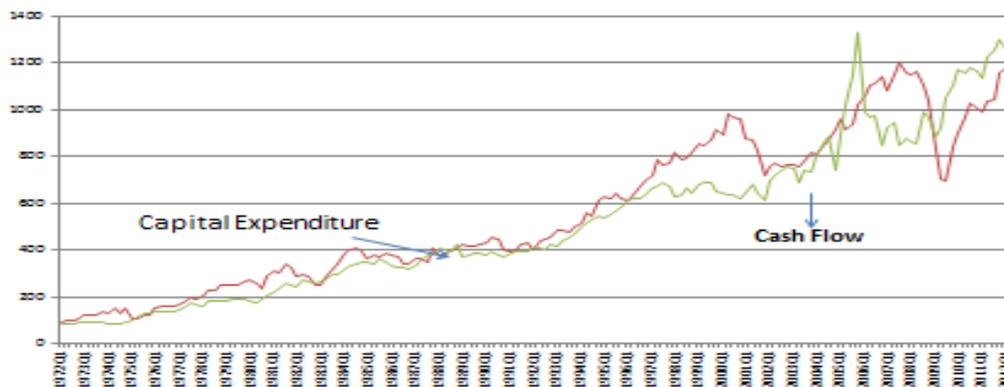
## Treasury Yield Curve Pointing Toward Growth Below 2%



Source: Federal Reserve H15, Department of Commerce for GDP, Fabbri Global Economics

One of the desired goals of policy makers is to stimulate companies into raising cheap equity capital and investing the proceeds into some income producing economic assets. Thus far businesses have chosen not to do so because of the political uncertainty surrounding potential tax changes and other legislative initiatives that will likely occur next year. Business investment has grown relatively slowly compared to the profits non-financial corporations have earned in the past three years. Companies have built up huge piles of cash rather than commit to new real investment. Consequently, non-financial businesses are sitting on a pile of cash either waiting to invest in new capital projects, or to distribute it through increased dividend payouts and stock repurchases.

### Corporate Cash Flow Exceeds Capital Expenditure (bn \$)



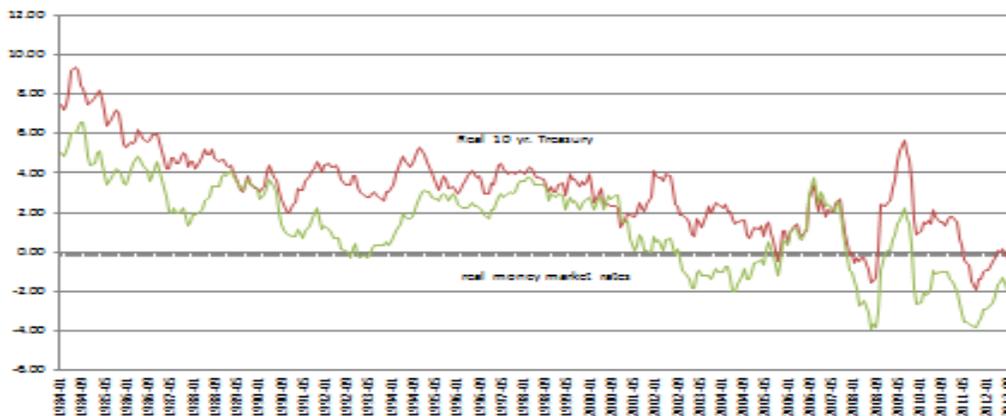
*Source: Federal Reserve Flow of funds Z1 Balance sheet and flow tables for Nonfinancial Corporate Business, Fabbri Global Economics*

On the eve before the fiscal cliff is reached and the dawn of higher tax rates companies have chosen to pass these retained earnings on to investors in a furious year end flurry. This too has driven up stock prices relative to the economy. Thus as the Fed has created massive amounts of new money it has been deployed into passive financial investment driving yields throughout the credit spectrum lower. And, some of these funds have left the country and have been used in financial investment in foreign markets.

## The real rate dilemma

For more than a century storied economists have been writing that real interest rates are a key determinant and explanation of the decisions to save and invest. It was argued that the real rate in mature economies would be roughly equal to the economies long run rate of economic growth. In the US the real rate of interest on Treasury securities is negative, around -30 basis points, and has been negative for more than a year. In contrast, the rate of economic growth in the US has been slightly less than 2% over the same time period. What accounts for this dilemma is the Fed’s current policy of purchasing a massive quantity of Treasuries over the past year. Their purchases helped lower Treasury interest rates to unprecedented lows and levels below that of the nation’s broadest inflation measures. This extra market demand for Treasury securities corrupted the market oriented information that was traditionally derived from sovereign real rates. In the EU a similar monetary policy of purchasing sovereign bonds has also distorted this relationship for all EU countries’ bonds that are rated AAA.

### Real Rates Turned Negative



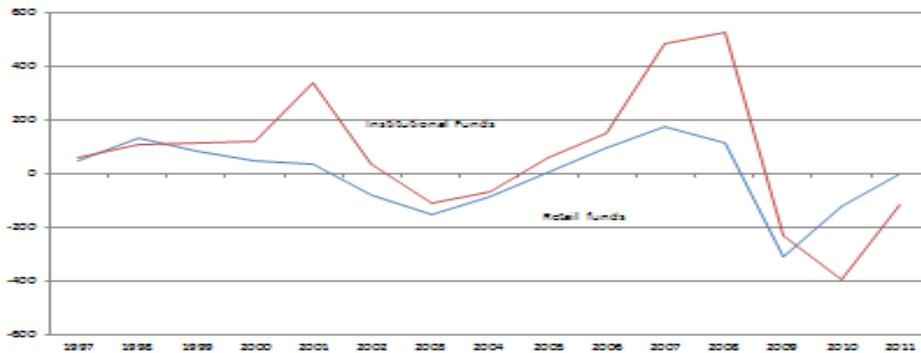
Source: Federal Reserve H15, Department of Labor for CPI, Fabbri Global Economics

What has been distorted is the incentive to save and invest. Saving no longer pays as interest rates on bank deposits, money market funds, and Treasury securities having maturities of 10 years and lower are below the inflation rate. Meanwhile, returns from potential investments are boosted by zero real rates which minimize the costs of

borrowing for real investment or for adding leverage to financial portfolios. This savings investment imbalance forces countries to fund the imbalance either externally, which creates a growing current account deficit, or through massive central bank balance sheet expansion or both as is happening now in the US. A rising current account deficit will reduce GDP and lower real economic growth.

Savers are receiving trivial interest on their bank and money market accounts and they are withdrawing funds from banks and money market accounts, as shown in chart --. The incentive for households are now directed toward paying down past high cost debt rather than building new savings. Household total debt is 5.7% below its peak in 2007, while financial assets have barely increased since Q1 2011 in spite of a gain in personal income of 6% over that period. While presently prudent this strategy will leave large segments of the population without sufficient funds to live on once they reach retirement age. In a recent article published by the National Bureau of economic Research the authors found that approximately 47% of respondents to their survey couldn't come up with \$2,000 in a month's time to meet an emergency. The study concluded that too many people in the US, UK and Germany are living too close to the financial edge.

### Funds Flowing Out of Money Market Funds (\$ bil.)



Source: Investment Company Institute, Fabbri Global Economics

## **The insipid retirement investment build**

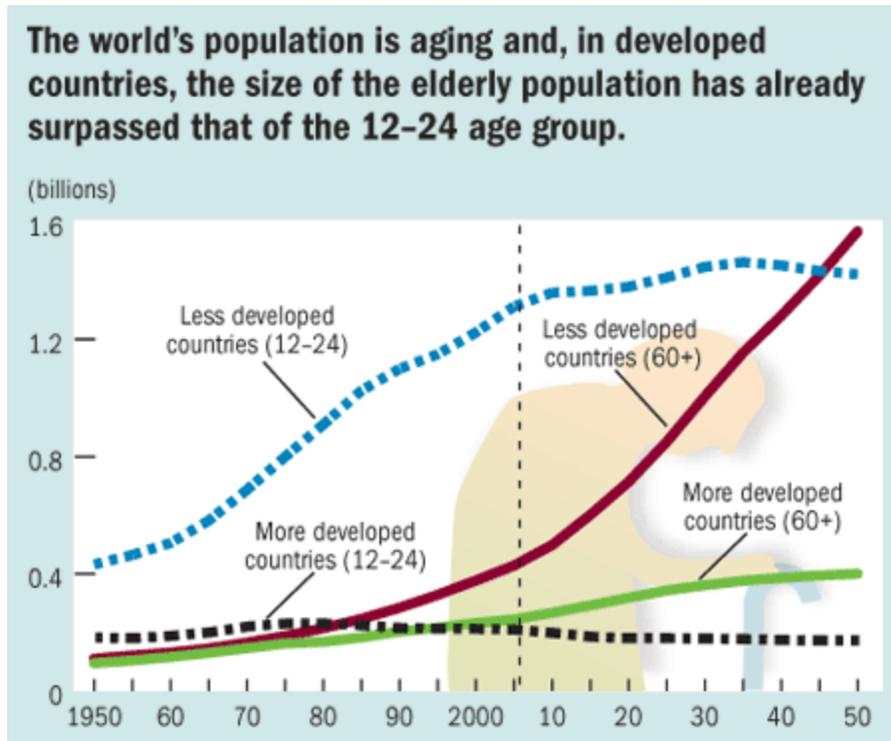
Insurers are also affected by low interest rates and 'operation twist'. Insurance company liabilities were written earlier in higher interest rate periods. As their fixed rate investment assets mature they can only replace them with much lower yielding fixed income assets (corporate bonds and mortgage backed securities). Therefore, they must reduce the returns on their new policy offers to investors. Insurance companies will also suffer significantly less profit from the assets they wrote if they were not fully immunized (matched by maturity of the assets invested in) at the time policy underwritings were booked.

Pension funds are also suffering from low interest rates especially defined benefit programs. These public and private retirement funds are typically guided by union contracts that specify program benefits and therefore it makes it very difficult for the fund managers to cut benefits. As the present environment of extremely low interest rates cause their portfolio yields to dwindle, corporations and state and local governments must contribute a larger proportion from their profits and general government budgets to make up for the benefit shortfall caused by low yielding assets.

Working age populations will therefore suffer greater loss in asset accumulation as these traditional widely used forms of retirement income management return less and less. According to the latest Federal Reserve Flow of Funds household balance sheet data a total of 28.6% of household financial assets are invested in pensions and insurance reserves. Another 35% of household financial assets are invested in low yielding bank deposits, money market funds, and Treasury securities. The task of building a retirement portfolio will become quite daunting for the next generation.

## **The demanding demographic challenge**

Declining birthrates through the world and particularly in developed countries and increasing life expectancies are combining to drive population aging. This is a global phenomenon. Moreover, the proportion of older age groups of 80 years and older is also rising. Some western countries such as Germany, Italy, and Japan already have 20% or more of their population above 65 years or more. Although the proportions of elderly are lower now, the pace of population aging among less developed countries is more rapid such as in China and Indonesia where elder populations will double over the next 25 years.



Source: IMF Finance and Development Volume 43, no.3

Population aging raises serious questions about the financial viability of existing pension and social security systems. Dependency ratios in many western countries are already high and as the chart shows dependency ratios will rise much higher in the next few decades as the number of retired people increases above the number of new births. When these immutable demographic changes are coupled with today's extremely low interest rates the financial challenges ahead for survivors and for governments is daunting. If interest rates persist at such low levels there will not be enough funds saved in public or private funds to maintain benefits at the rate they are presently promised. Those in the working age groups will probably have to consume less than they would under a steady state of growth scenario to make up for the advancing proportion of the aging dependent population. This will lead governments to make many unpopular economic decisions that will eventually create social strife.

**Conclusion: no safe exit for central banks**

Investor vulnerability may restrain efforts by central banks to tackle rising inflation promptly as the financial repercussions from raising interest rates on investor portfolios

would be quite severe. When interest rates rise prices of fixed income assets will fall. Because central bank rates are so far below normal the adjustment back to a relative norm say 4% (2% inflation plus 2% real growth) would cause a significant loss on all financial asset portfolios.

Even Chairman Bernanke had to acknowledge that these unconventional policies could have some negative unintended consequences. In a speech made at Jackson Hole in August 2012 he said “nontraditional policies could induce an imprudent reach for yield by some investors and thereby threaten financial stability.” He has already envisioned the problem that he may face when the need for exceptionally low interest rates is no longer warranted. His trade off will be to accept somewhat more inflation to protect those portfolios that will be shattered by abruptly raising interest rates.

No central bank has as yet exited from quantitative easing.

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