The Collapse of Global Interest Rates

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MIT

Economics Alumni Breakfast

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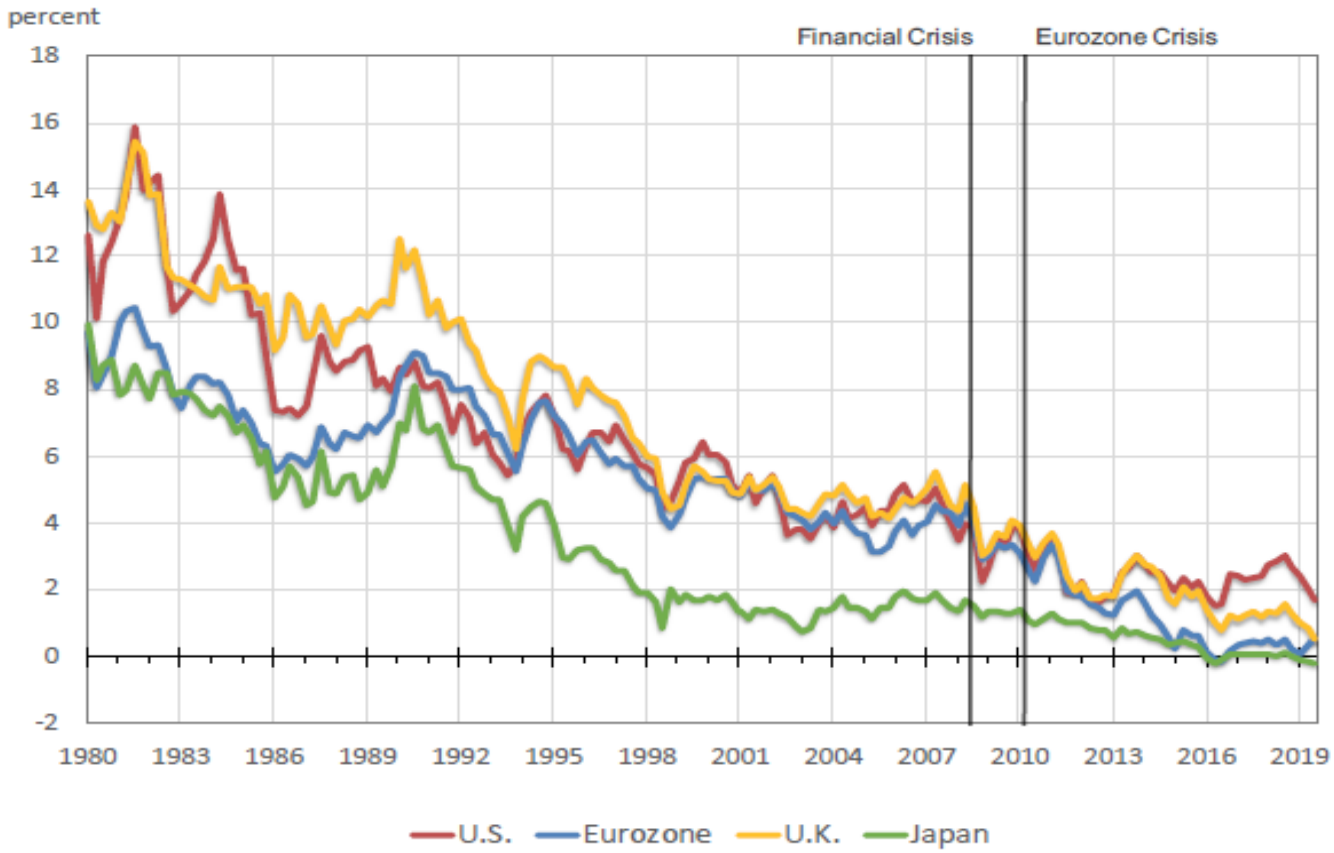
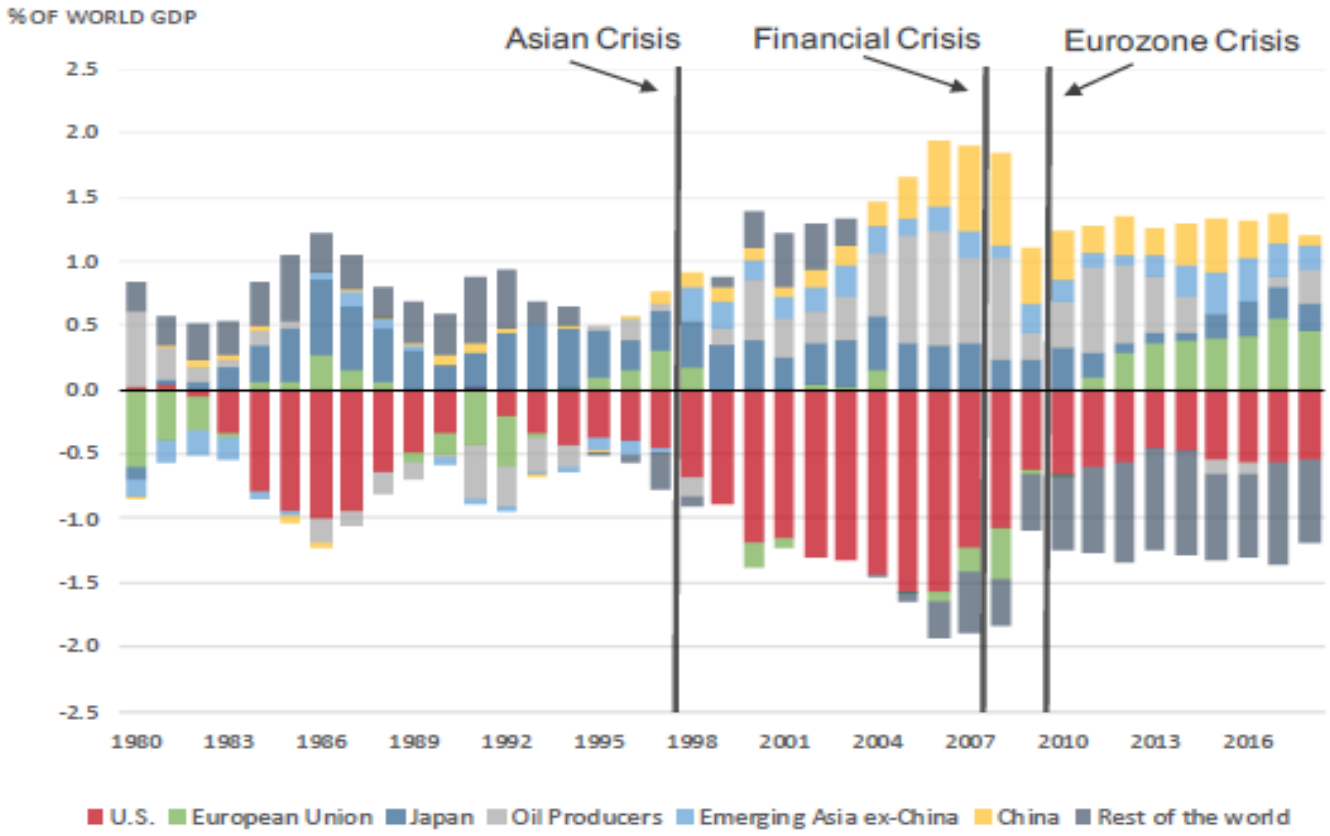
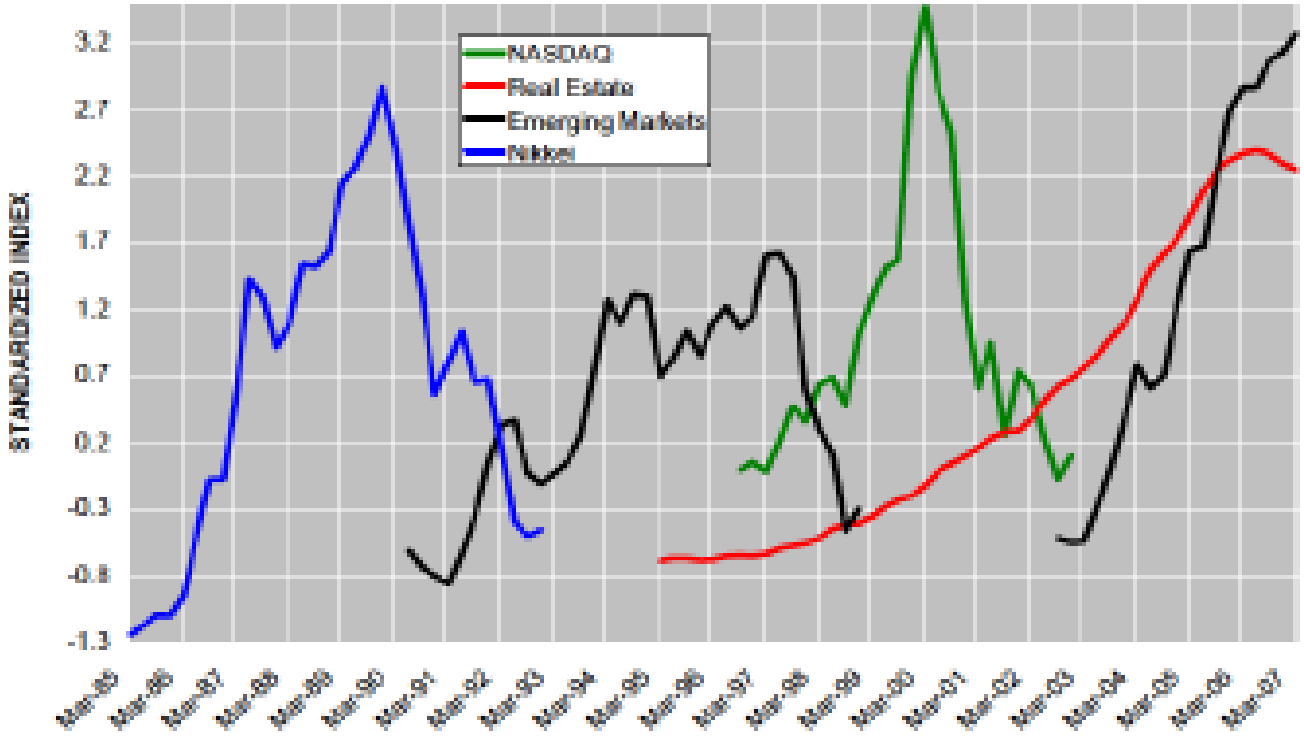
Early 2000s: Two Dominant Facts



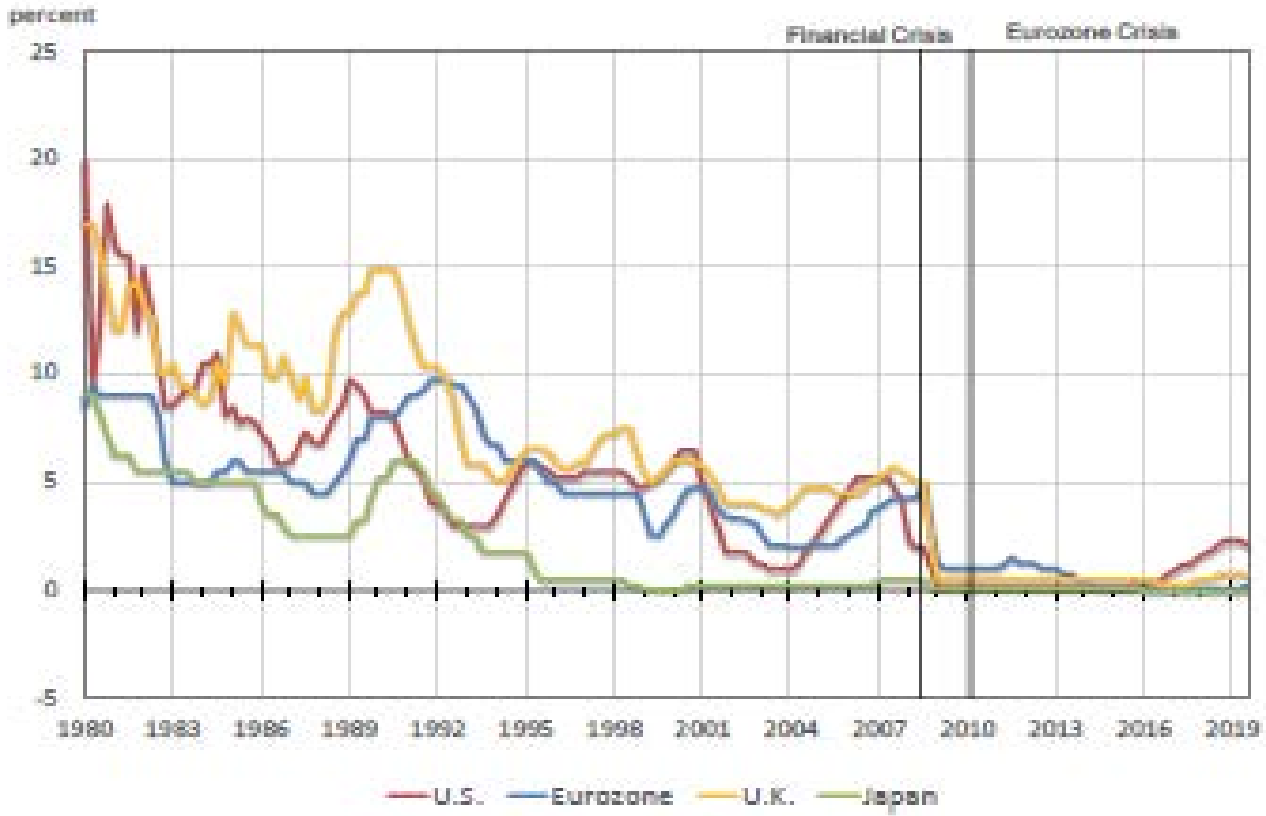
Early 2000s: Two Dominant Facts



A Store of Value Deficit



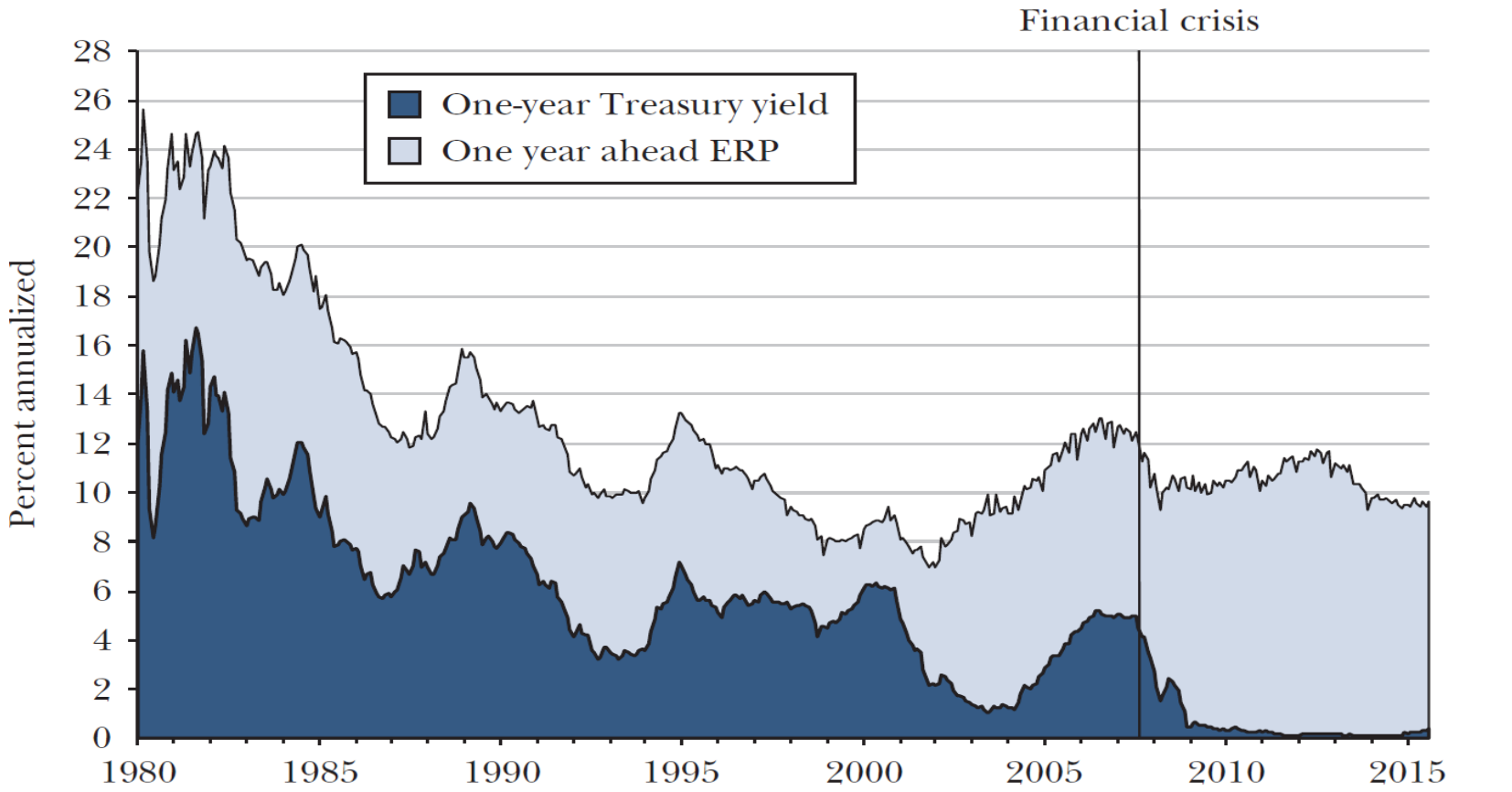
Eventually we hit the ELB



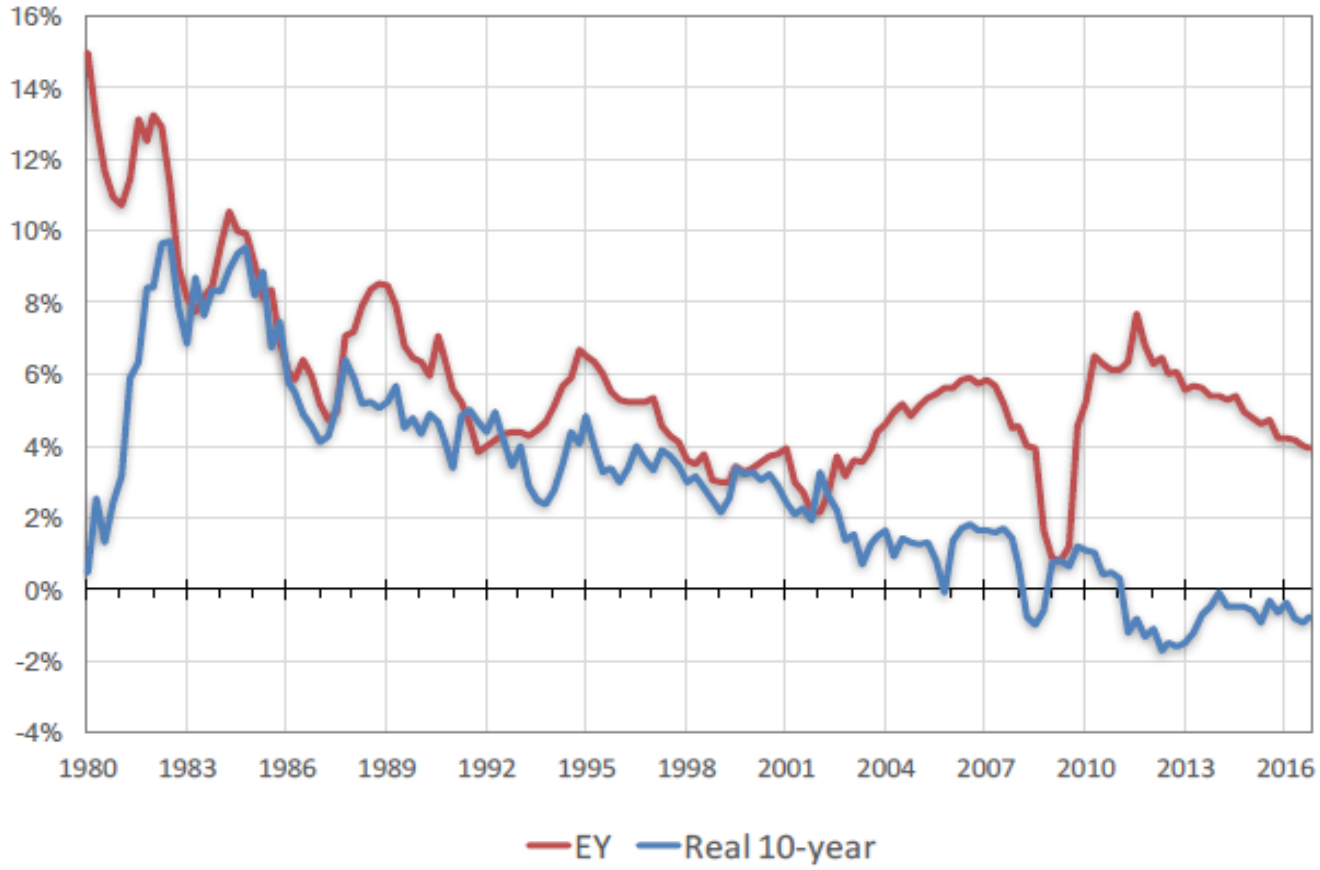
A Macroeconomic Problem

- Before ELB:
  - Distributional issues
  - Incentive problems in financial system
- Post ELB:
  - A macroeconomic problem: Insufficient aggregate demand (too little wealth…)

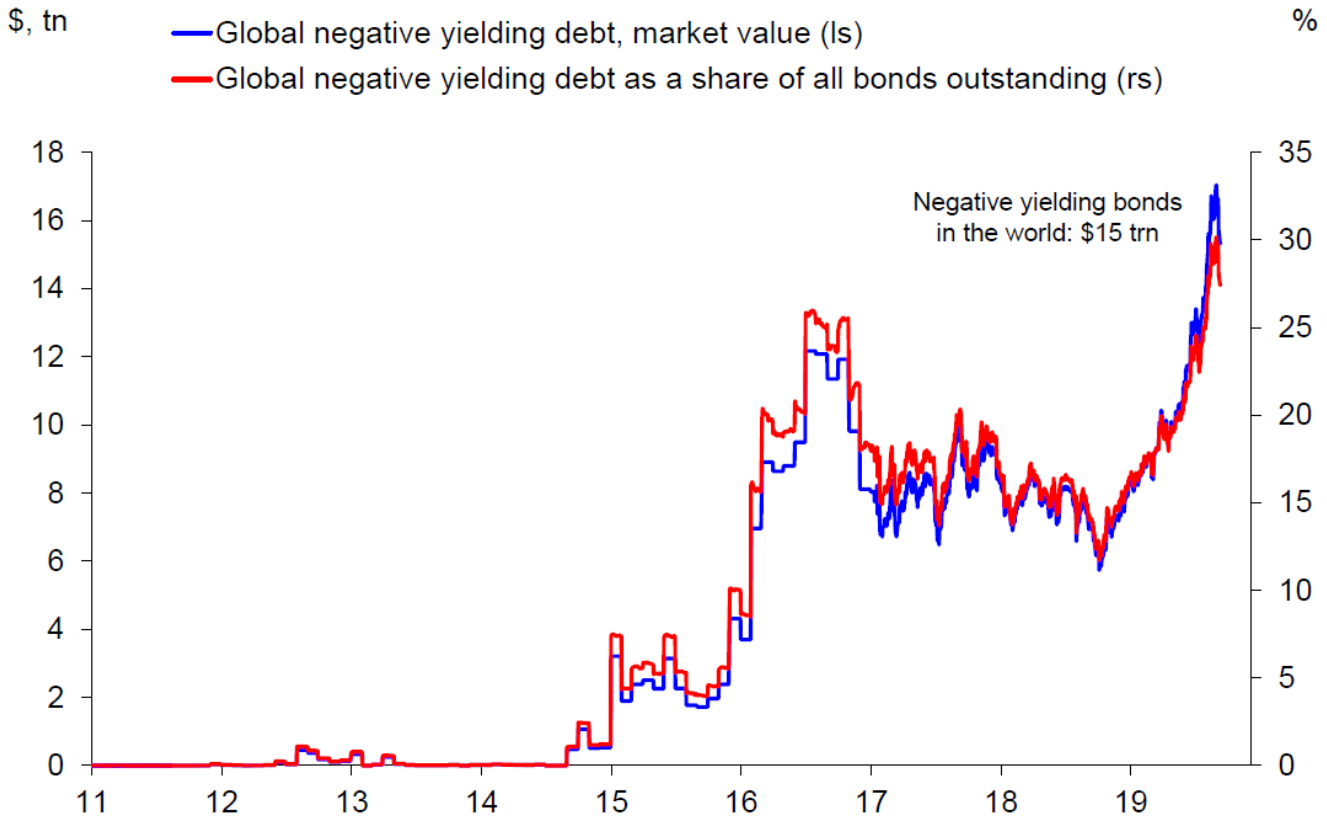
Which Interest Rate?



Which Interest Rate?

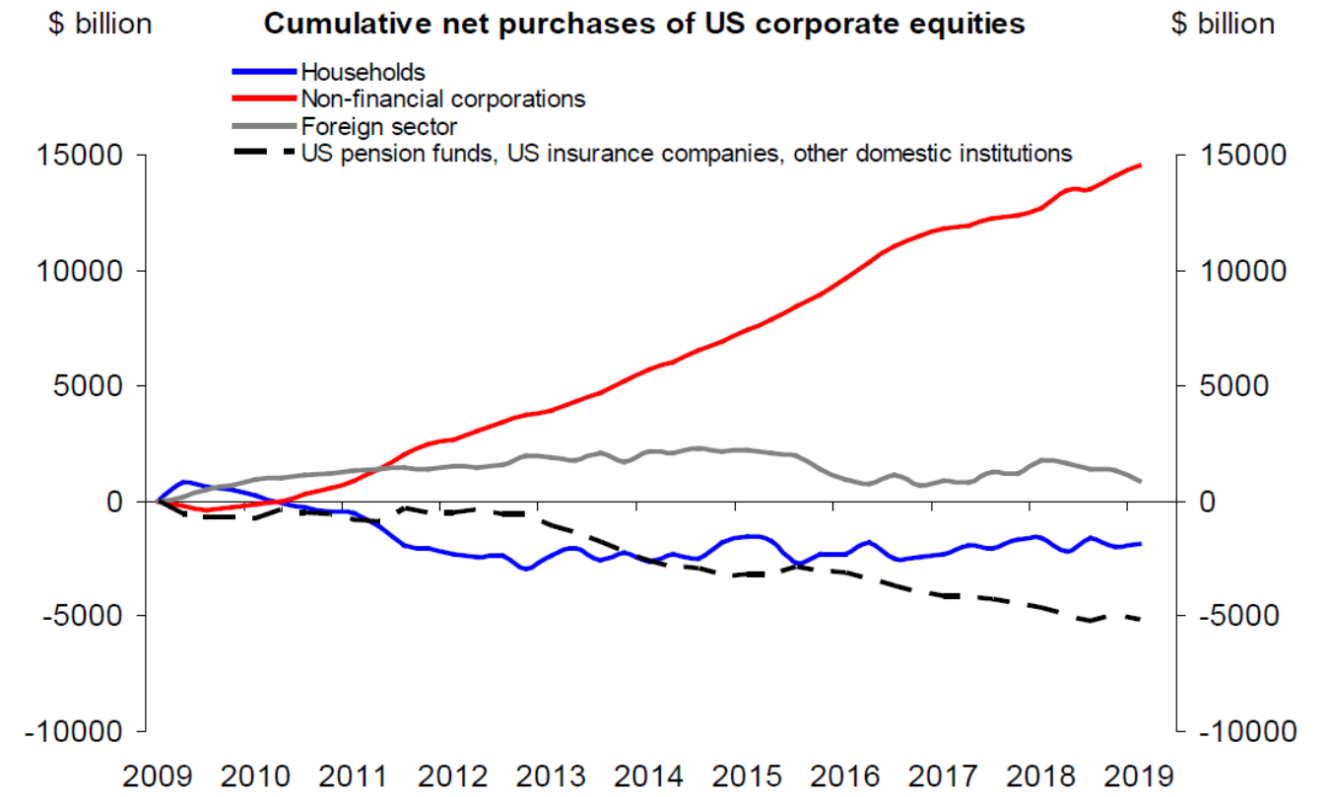


More on Risk Intolerance



Source: Bloomberg Finance LP, DB Global Research

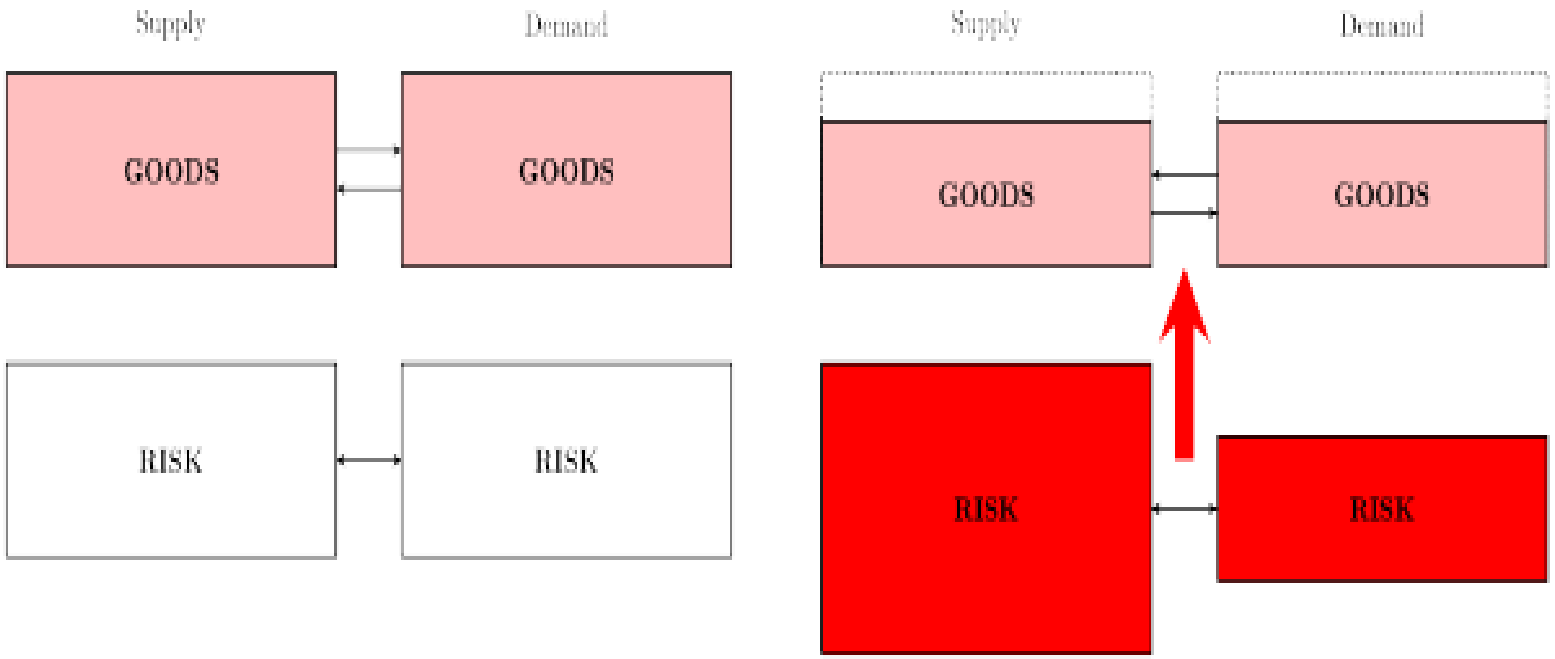
More on Risk Intolerance



Note: Other domestic institutions includes Property-Casualty Insurance Companies, Life Insurance Companies, Private Pension Funds, Federal government retirement funds and state/local government employment defined benefit retirement funds

Source: FRB, Haver Analytics, DB Global Research

Risk-centric Macroeconomics



Risk-centric Macroeconomics

$$\frac{r^{risky} - r^{safe/fed}}{Risk \cdot Risk\ Intolerance}$$

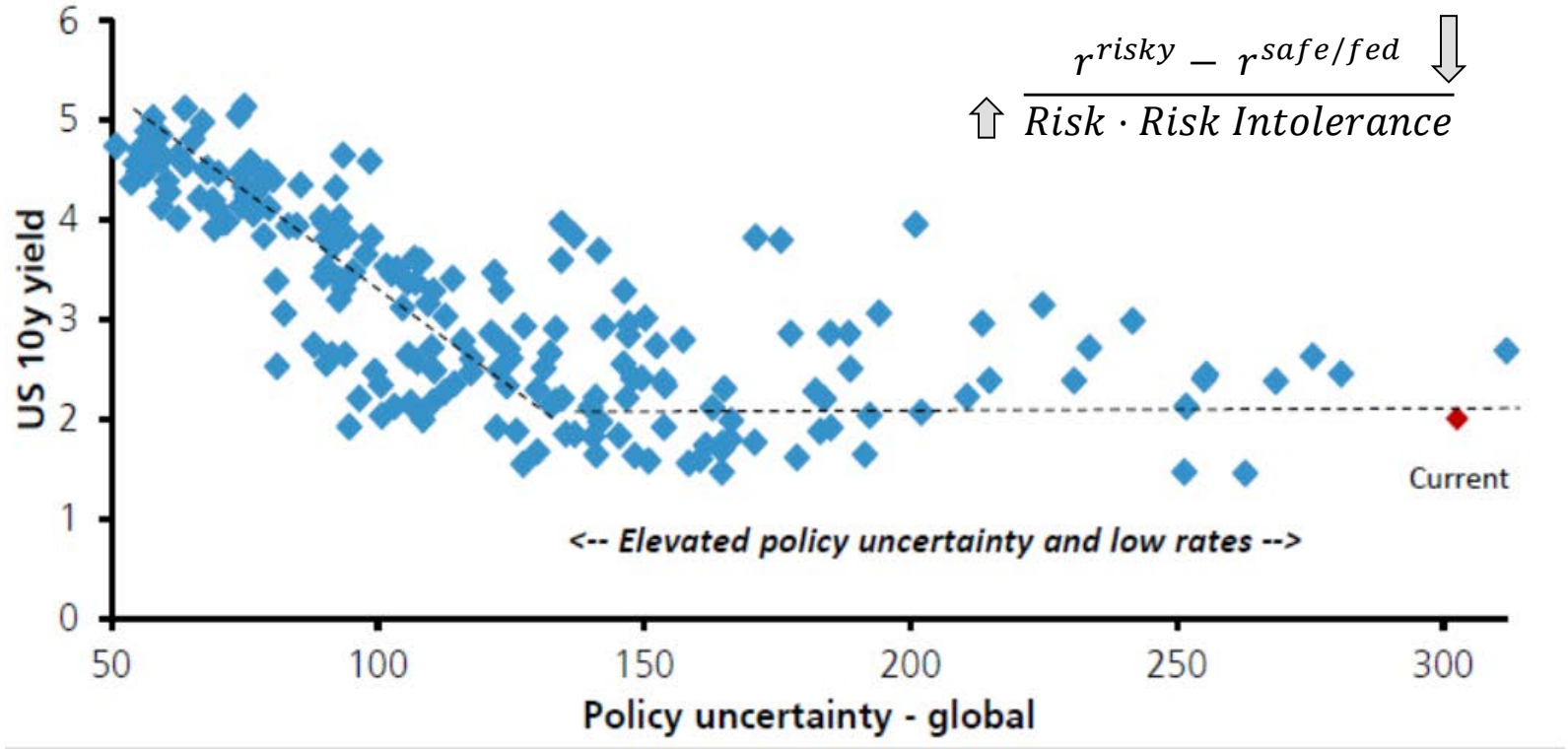
- Insufficient demand for risk leads to a drop in asset prices
- Negative feedback loop with real activity
- Central banks understand these connections (although they use a different language)

The Trend

$$\frac{r^{risky} - r^{safe/fed} \downarrow}{Risk \cdot Risk\ Intolerance \uparrow}$$

- Initially the pressure from the denominator was absorbed by a drop in safe interest rates
- There is very limited space for more of that. Negative feedback loop with real activity around the corner!
- Risk•RiskIntolerance becomes very volatile

Current (risk-centric) Shocks



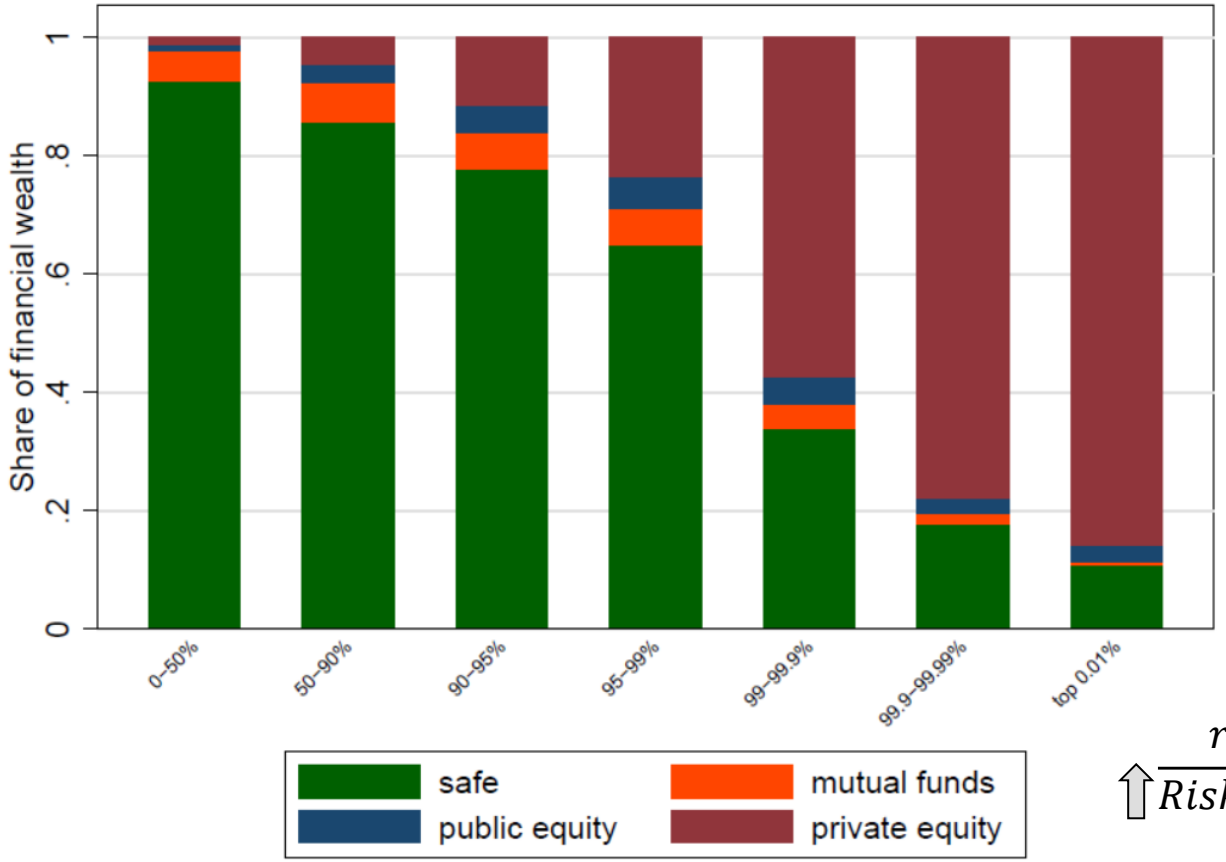
Source: Baker, Bloom & Davis, Bloomberg, UBS

Perverse Growth Feedback

- Increase in uncertainty leads to lower investment and aggregate demand
- Fed lowers rates to increase wealth and consumption
- Investment doesn't react
- AD composition worsens (C up, I down)
- Growth potential worsens

$$\frac{\Downarrow \quad r^{risky} - r^{safe/fed} \quad \Downarrow}{Risk \cdot Risk\ Intolerance}$$

Perverse Inequality Feedback



$$\Uparrow \frac{r^{risky} - r^{safe/fed} \Downarrow}{Risk \cdot Risk\ Intolerance}$$

Final Remarks

- If policy uncertainty drops, rates are likely to rise (the entire yield curve)
- But we have a structural problem
  - Temporary solution:
    - Public debt issuance by some DM sovereigns (buy risky assets and/or infrastructure investment)
    - Financial engineering… pseudo-safe assets

Final Remarks

- But we have a structural problem (continued…)
  - For a more permanent solution:
    - Somehow increase private demand for risk (pension reforms?) (regulatory reforms?)

      Together with systemic insurance
    - Increase in production of store of value by China et al. (internationalization of RMB?)

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