**Secular stagnation and Interest Rates**

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Under the guidance of monetary policy, interest rates have recently reached record low levels. In 2019, about a fifth of the sovereign, corporate and emerging market securities worldwide traded at a negative yield and almost 70 percent of euro government bonds did so in September 2019. While the COVID-19 pandemic has partially reversed the negative yield trend, the economic environment that has produced ultra-low interest rates is still present. Rising income and wealth inequalities, slow recoveries, low inflation and long-term trends toward a shrinking population in developed economies point toward the persistence of a low-growth, low-interest-rates environment. Unless economic policies are put in place to reverse the stagnationist trends, central banks will have limited willingness and ability to raise interest rates in any significant way.

**Interest rate trend over the past century**

Before making any prediction about the future, it is instructive to study what the past century tells about the dynamics of interest rates. Several things are worth noticing from Figure 1. First, the downward trend in interest rates is not new. Over the past 40 years, the average rate on long-term safe debts have come down from 15 percent in 1981 to less than 2 percent in 2020. Second, interest rates on long-term safe debts are exceptionally low today; even during World War 2, such interest rates did not go below 2 percent on average. The last, and most important, observation is that a key driver of interest rates in the United States is monetary policy. This is actually the case in any country where the government issues its own currency and issues public debt denominated in its own currency.1 Monetary policy consists in setting at least the overnight interbank rate; the federal funds rate (FFR) in the United States. One has to go back to the Great Depression to find a near-zero FFR. World War 2 led the Fed to expand its interest rate targeting to the entire yield curve with the rate on T-Bills set at 3/8 of one percent and T-bonds purchased at a price consistent with a yield of 2.5 percent. Following the end of the War and the 1951 Accords, the FFR rose and other rates followed until the early 1980s when the FFR started its long decline to the present level.

Given the heavy influence of monetary policy on interest rates, any opinion about the future direction of interest rates must be made with a view of future monetary policy. One must study what could lead the Federal Open Market Committee (FOMC) to raise its FFR target. The mandate of the Fed is to promote price stability (defined as inflation around 2 percent) and maximum employment (defined as employment consistent with price stability). The FOMC informs its decisions by looking at a wide range of indicators regarding labor market conditions, inflation, inflation expectations, among others. Short-term and long-term outlook for these factors are pointing to interest rates that will stay low for an extended time. While the FOMC may decide to raise its FFR temporarily, the long-term trend is for the FFR and other rates to remain very low for a very long time.

FIGURE 1 HERE

**Short-to medium term employment and inflation situation**

Loss of consumer confidence and lockdowns have stalled the US economic activity with the annual real GDP growth equal to 0.3 percent in the first quarter of 2020. Labor market conditions worsened significantly in the second quarter. The official unemployment rose steeply to 13 percent and the employment-population ratio fell in April to its lowest level ever recorded at 51.4 percent of the civilian population available for work actually employed. Similarly, the capacity utilization rate fell to 64.4 percent, its lowest level ever recorded since data are available. The sharp drop in economic activity, driven by a large decline in private domestic consumption, has led to a sharp decline in core inflation well below the implicit 2 percent inflation target of the Fed. Given the worsening economic situation is it easy to understand why the FFR has fallen sharply with short-term rates matching the same trend. However, long-term rates have also fallen sharply reflecting expectations among market participants that the FFR rate will stay low in the upcoming year or two.

TABLE 1 HERE

**Long-run trend: Secular Stagnation**

While covid-19 related economic events explain the short to medium-term interest rate dynamics, Figure 1 points to a long-term downward trend. This trend is explained by structural changes that have led to a slower and more unstable US economy. Decline in the tax burden on the wealthier households, deregulation and lax enforcement, the financialization and globablization of the economy, and the decline in the labor protections have destroyed shared prosperity. They also have led to jobless recoveries, lowered inflationary pressures, and limited capital investment in the economy. As a consequence, a growing majority of households is not sharing the fruits of economic prosperity that itself has stalled. Given this stagnationist trend, one may expect interest rates to stay low over the upcoming decade.

TABLE 2 HERE

The annual growth rate of real GDP per capita has slowed to 2 percent or less since the 1990s. At the same time, income and wealth inequalities have soared with the top 1 percent of the population recording large increase in their share of income and wealth to the detriment of the rest of the population. In terms of income, the top 1 percent share grew from about 12 percent of national income in the late 1960s to about 20 percent of national income in the 2010s. This gain came entirely from a loss of income share of the bottom 50 percent of the US population (Figure 2). While the benefits of economic expansion used to be relative broadly shared, since the 1980s, income gains have gone almost entirely to the top 10 percent. During the last economic expansion (2009-2020), 76.9 percent of the national income gain went to the top 10 percent of income earners. In terms of wealth share, given that the bottom 50 percent of the US population has little to no wealth, all the transfer of wealth share to the top 1 percent came from the 49 percent of the population below them. The top 1 percent wealth share almost doubled from 21 percent in the mid 1970s to 37 percent of national wealth in 2016.

FIGURE 2 HERE

The main effect of such a lack of shared prosperity has been the disappearance of a middle class that can earn sufficient income to sustain its consumption and home purchase, both of which are key drivers of US economic growth. More broadly, low and middle class households have used debts and their savings, if any, to sustain their housing, education, casual consumption, health needs, among others. This has led to a very rapid increase in the debt-to-income ratio of the bottom 50 percent and middle 40 percent of income earners.2 Debt and asset-price growth rather than income growth have become a key means to sustain economic activity, which has promoted the growth of financial instability over the past half-century.3

Related to growing inequalities, another factor that has led to stagnation is the growing joblessness of economic expansion over the past 40 years. Prior to the 1980s, it took less than 2 years to recover the jobs lost during a recession, but the past four expansions required more than 2 years with the job losses of the Great Recession being regained only after 6 years. One has to go back to the Great Depression—prior to which the economic conditions were somewhat similar to the current economic situation—to see a longer period of recovery. Not only has it taken more time to recover from recessions, but also job precariousness has grown with job quality falling constantly since data is available. Jobs have become more insecure, more intermittent and have not provided the same salary and benefits as they used to.

Finally, there has been a marked decline in investment dynamics of the economy. This is true not only for business investment and but also for public infrastructure investment. On the business investment side, while corporate profits have been large they have not been used to invest to the economy and a growing proportion of corporate profit has come from financial income.4 On the infrastructure side, investment has not kept up with the needs of the economy and maintenance has been poor, leading to a low quality infrastructure in the United States. The *Infrastructure Report Card* published by the American Society of Civil Engineers has constantly graded US infrastructure around D for the past three decades, which has generated millions of job loss and thousands of dollars of income loss.5

Unless major changes in economic policy occur to counter the previous trends, the economy will record low growth, low-inflation, growing inequalities and growing precariousness of employment for the upcoming decades. All these elements give less of an incentive to the FOMC to raise its policy rate quickly. They also point toward a more unstable economy, which gives less ability to the FOMC to raise interest rates quickly without generating financial problems. While the FOMC may start raising its FFR target, it will not be able to do it quickly and permanently. Thus, unless there is a dramatic shift in the way the US economy is managed, the default expectation of market participants should be that interest rates continue to stay low for the upcoming decade or more. A low-growth highly-leveraged economy can only accommodate so much in terms of interest rate.

**Implications of permanently low interest rates**

Secular stagnation and its impact on interest rates has important implications for the sustainability of our current form of capitalism—one that is heavily reliant on finance and money managers—and for the role of government in such an economic environment.

While a low-interest-rate environment makes debt servicing easier, it creates challenges for money managers (pension funds, mutual funds and others) to meet their return on equity target. This is all the more so that financial investment opportunities based on long-term income growth are far fewer than the funds available to portfolio managers. As such, it seems doubtful that a private-based retirement system is a sustainable means to achieve financial safety for retirees while at the same time promoting financial stability for the overall economy. In order to counter a low-yield low-growth environment money managers have focused on riskier segments of the credit market and/or have used more leverage in their financial strategies. Both strategies promote the use of leverage in the rest of the economy, increase systemic financial fragility ultimately lead to financial instability. The most recent example is the early-2000s housing boom with its reliance on subprime mortgages, exotic mortgages, and complex structured-finance products that hid true leverage; all of them encouraged by the search for yield of institutional investors.

Governments of developed economies will need to tackle several major challenges; their population is aging, trillions of dollars of infrastructure upgrade and expansion are needed, and most of all, climate change is the major socio-economic threat. Massive increases in government spending will be needed to meet these challenges and, given everything else, they will lead to higher fiscal deficits relative to the size of the US economy. The tendency toward higher deficit, however, would be mitigated by major investments in infrastructure and greening the economy because such investment would boost economy growth and so raise tax revenues. In any case, a rapid increase in the public debt will be sustainable as long as interest rates stay low relative to the growth rate of the economy. Some market participants may wonder about the impact of a higher public debt on interest rates. For economies that are monetarily sovereign such as Japan, the United Kingdom or the United States, there no significant relation between the size of government deficits or debt and interest rates. As usual, central banks will have a major role to play in accommodating fiscal needs by keeping interest rate low enough to make public debt sustainable.

**Endnotes**

1. See Tanweer Akram and Huiqing Li, “What Keeps Long-Term U.S. Interest Rates so Low?,” *Economic Modelling* (January 2017). Claudio Borio, Pite Disyatat, Mikael I. Juselius, and Phurichai Rungcharoenkitkul, “Why so Low for so Long? A Long-Term View of Real Interest Rates,” BIS Working Paper, No. 685. (December 2017). Timothy P. Sharpe “A Modern Money Perspective on Financial Crowding-out,” *Review of Political Economy* (November 2013). Hibiki Ichiue and Yuhei Shimizu, “Determinants of Long-Term Yields: A Panel Data Analysis of Major Countries,” *Japan and the World Economy* (May-August 2015).

2. Alina K. Batsher, Moritz Kuhn, Moritz Schularick and Ulrike I. Steins, “Modigliani Meets Minsky: Inequality, Debt, and Financial Fragility in America, 1950-2016,” New York Federal Reserve Bank, Staff Report No. 924 (May2020).

3. Eric Tymoigne and L. Randall Wray, *The Rise and Fall of Money Manager Capitalism:**Minsky Half-Century from World War Two to the Great Recession* (Routledge, New York, 2014)

4. Daniele Tori and Özlem Onaran “The effects of financialisation and financial development on investment: Evidence from firm-level data in Europe” Greenwich Political Economy Research Center, Working Paper 44 (2017).

5. American Society of Civil Engineers, *Failure to Act: Closing the Infrastructure Investment Gap for America’s Economic Future* (Economic Development Research Group, Boston: 2016).