Overview

Bruce Preston and John Simon

Over the last 20 years, interest rates have declined across the world. Any number of factors are argued to have caused this decline: an ageing population, a saving glut, rising income inequality, low productivity growth. Overlaid on this have been global shocks – the global financial crisis and the COVID-19 pandemic – that have led to further reductions in interest rates. These circumstances have presented unprecedented challenges for monetary policy. Declining interest rates and negative shocks have made it more difficult for central banks to achieve their mandates of supporting demand and stabilising inflation. This has led many down the path of using unconventional monetary tools: negative interest rates, quantitative easing, forward guidance, yield curve control. And the decline in interest rates and deployment of unconventional policies has been argued to have had any number of consequences: unsustainably rising asset values, expanded and riskier central bank balance sheets, increased distortion of government bond markets, reduced bank profitability.

Reflecting this environment there have been calls for central bank mandates to be reconsidered in light of the new economic realities. Monetary policy has been argued to be, variously, the only game in town or out of ammunition. Given these challenges, the Reserve Bank of Australia organised a conference in June 2022 to bring together experts and policymakers to discuss the causes, challenges and consequences of the low interest rate environment. The results of this conference are captured in this collection of papers and presentations. It includes the presentations from authors and discussants as well as a summary of the roundtable discussions following each presentation.

The conference was organised in three sections. The first section was focused on institutional regimes and global trends in interest rates. The second section contained four papers. The first two looked at the consequences of low interest rates for the Australian banking sector and the economics of low interest rates. Whereas the last two papers focused on monetary and fiscal policy coordination and measurement of global interest rates co-movements. The third section contained two papers, where the first one highlighted that there could be multiple *r**s that are dependent on the central bank's monetary policy choice rule and the second paper described rates normalisation amid elevated global financial vulnerabilities and risks associated with it. The conference concluded with the panel discussion that wrapping up proceedings and distilled the theme of the conference. We summarise each of these in turn.

The first section started with Dr Paul Tucker's paper focused on fiscal, monetary and macroprudential regimes. The paper talked about the institutional design of monetary and fiscal policy authorities, the role of a central bank in supervision and the importance of central banks' communication strategy.

The discussion was focused on the difficulty of communicating policy, making sure the perspectives of a wide variety of stakeholders are heard when determining policy, and committing to credible and independent guidance about the stance of monetary policy. A further issue raised was the role of offsets and distributional outcomes. Fiscal policy is often discussed as neutral with respect to inflation outcomes because of monetary policy offset, while monetary policy is treated as neutral with respect to distributional outcomes due to fiscal policy offset – and yet the evidence and operation of both functions is limited. More consideration of how this works in practice, and what the trade-offs end up being with the instruments used, would help to inform this.

Given this, two directions were noted, where communicating these trade-offs and approaches matters – for receiving advice from non-economists about the types of trade-offs that are valued, and for ensuring that central banks are accountable to the public with respect to the choices they make.

Dr Marco Del Negro presented his paper on global trends in interest rates, highlighting that the decline in rates has been common among advanced economies as trends in real interest rates across countries have converged over this period. He concluded that this decline was driven by an increase in the convenience yield for safety and liquidity and by lower global economic growth.

A number of participants discussed how supply side fiscal policy could help to weaken current constraints, by helping to lift the neutral interest rate (r^*). Even if this was the case, it would require central banks admitting that their choices are dependent on the nature of fiscal policy more generally – which risks making it harder to communicate monetary policy choices as a whole.

In the second section, Dr Anthony Brassil presented on the consequences of low interest rates in the banking sector. Key questions included the existing evidence on the consequences of low rates for Australian banks and how the consequences for Australian banks differ from what the literature predicts. A key takeaway from this study was that maintaining lending spreads as rates fall improves financial stability. However, this has come at the cost of lower pass-through to lending rates, which is costly in a low-rate world where monetary policy is constrained. The discussion around this paper was focused on trying to tease out more of the details associated with how the Australian banking system differed from other countries, and how this interacts with prudential policy.

Dr Atif Mian presented on the economics of low interest rates highlighting the causes, consequences and policy implications of the very low real interest rate environment we have seen for a long time. His presentation concluded that monetary policy is ill-equipped to deal with weak aggregate demand resulting from extreme inequality. Fiscal policy can play a greater role in solving the issues to lead to equitable and inclusive growth, progressive taxation, increased public investment and competitive markets.

The discussion around this presentation was focused on trying to understand the specific magnitude of the domestic savings glut as an explanation for the declining neutral interest rates, and whether the results potentially reflected alternative mechanisms which may lead to a different understanding of the policy trade-off.

Dr Eric Leeper's presentation focused on monetary and fiscal policy interaction and on the inadequacy of the standard perspective amongst policy institutions that treats them as decoupled. Because inflation is jointly determined by monetary and fiscal policy, his study suggested the creation of a joint monetary–fiscal policy authority would be beneficial.

The discussion in the room was focused on whether the idea of an 'independent' monetary–fiscal authority made practical sense given the significant areas of debate in fiscal policy – and the prevalence of political economy concerns.

There were questions around whether current institutional settings in the United States already sufficiently corresponded to this – with the constraint of Congressional Budget Office (CBO) projections and monetary policy that is contingent on the stance of fiscal policy providing a rational basis for monetary–fiscal coordination. One participant noted that in an environment of low interest rates (specifically a real interest rate below the real growth rate), persistent primary deficits would be consistent with such coordination.

However, Dr Leeper noted that CBO projections have pointed to an explosive process for debt in the past, and with the COVID-19-related low interest rates rising these projections are likely to show the same in the future. As a result, they do not appear to provide an anchor to rational policy setting – and there is no 'feedback' from these projections and monetary policy setting into fiscal policy. Further questions focused on two areas: where are fiscal rules possible and credible? and where does this imply research on the nature of fiscal policy should be focused?

Several participants noted that the clearest areas for such fiscal rules were related to long-run fiscal rules, with an independent fiscal authority responsible for – and thereby taking the blame regarding – the transition path for those rules. As a result of this, such an agency would be responsible for estimating the appropriate size and structure of fiscal stimulus in the same way that current monetary authorities provide a path of interest rates.

Dr Leeper noted that such rules can be successfully applied – but that this isn't the type of coordination that is being discussed when it comes to integration with monetary policy, which is itself short term. Instead it is the concept of optimal fiscal stimulus itself which could be objectively defined and targeted.

The last presentation of the second section was delivered by Dr Fry-McKibbin who described a new general measure they have developed to identify the strength of the co-movements of global interest rates. This paper contributes to interdependence of international interest rates with a new and more general approach which allows for nonlinear channels through higher-order co-moments, including co-skewness, co-kurtosis and co-volatility.

Some participants speculated as to whether these insights could be used to understand the risk of the US Treasuries losing their special status. It was agreed that such an episode would involve either a significant change in general global risk profiles or another asset being seen as the low-risk reserve asset. As a result, this would constitute a state change, where the current set of co-movements are conditional on the current state – meaning that this cannot necessarily inform contagion risk.

In the third section, Dr Paul Beaudry gave a hysteresis perspective on the neutral interest rate (r^*) – suggesting that money may be non-neutral. His paper examines the 'within' versus 'between' group breakdown of the increase in wealth-to-income ratio and savings rates over the period of decreasing interest rates. He then shows how the combination of intertemporal substitution and retirement motives offers an explanation of this pattern. The paper concluded that there could be multiple r^*s that are dependent on the central bank's monetary policy choice rule.

The discussion around his paper was focused on clarifying how to use the toy model of multiple neutral interest rates to consider the timing and magnitude of this effect on neutral interest rates. A participant queried whether such a multiple equilibrium argument, based on an overlapping generations model where the agents live for three-periods, did imply 'quick' changes in the real interest rate. Such state changes may be quite gradual when applied to situations where individuals live for more periods, and this would also more clearly relate to the gradual decline in the neutral rate that has been observed since inflation targeting has been applied.

The final session included a paper by the IMF. The paper presented by Dr Fabio Natalucci described rates normalisation amid elevated global financial vulnerabilities and the risks associated with it. Participants appreciated the set of stylised facts given in the presentation, but felt there needed to be more of a framework around how these fit into the growth-at-risk framework for considering future risks, fragility and appropriate policy setting. With sovereign debt risks, Dr Leeper noted that debt to GDP only provides part of the story.

Broader fiscal capacity and the currency composition of the debt are also important, and are likely to be less of an issue for a number of countries than they were in earlier years. At face value the indicators about financial risk from China were also seen as concerning by a participant – with the correction in the Chinese housing market and cooling in corporate debt issuances bearing similarities to the 2007–08 US experience prior to the global financial crisis.

The conference closed with a panel discussion moderated by Dr John Simon. The panellists were Luke Yeaman from Australian Treasury, John McDermott from Motu and Geoff Summerhayes from Zurich Insurance. The three panellists outlined their key takeaways from the conference split into both the causes and consequences of the low interest rate environment.

In terms of causes, the panellists focused on the breadth and depth of the relative drivers of falling neutral interest rates – with an appreciation of some of the less standard explanations that were outlined, such as rising income inequality and rate hysteresis.

The consequences of a low neutral rate were also discussed, but appeared to be more unclear or more contentious. The key consequences discussed by the panellists related to rising debt levels, financial risks and the possibility of political economy concerns – with central banks losing sight of their mandate to comment on unrelated issues.