

Do low interest rates foster investment ?

I would like to reflect on the following issue:

‘What is the effect of low or negative interest rates on long-term investment?’

It is sometimes believed that a non-conventional monetary policy with zero interest rates is conducive to a recovery in investment, since, by definition, financial conditions are easing.

Let's take a closer look.

I – First, the recent performance of global investment remains subdued

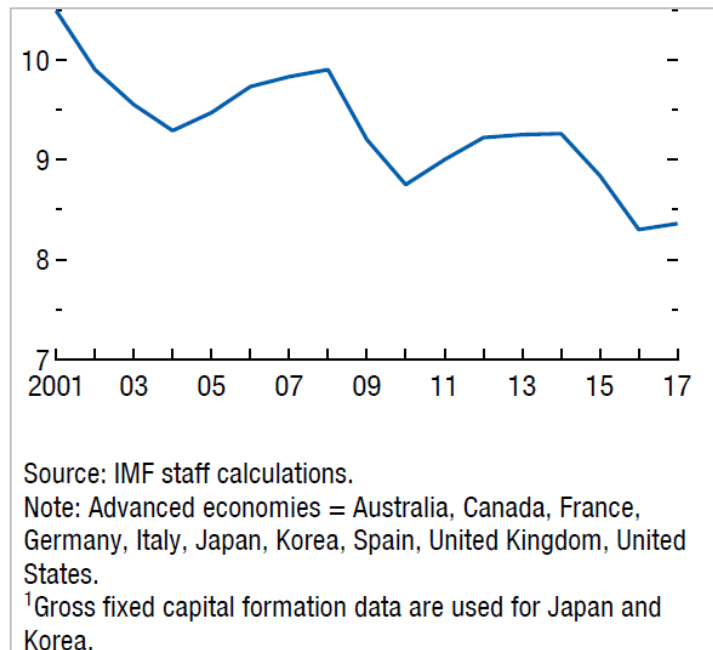
The evolution of investment over the last years shows the following trends:

1. The level of non-residential gross fixed investment in advanced economies as a percentage of GDP has significantly reduced (from 10.5% of GDP in 2001 to 8.5% today) (see graph 1);
2. This implies that growth in the capital stocks remains subdued;
3. The increase in intangible investment (which contributes to improving productivity) is hovering around 3-4% a year, which is significantly less than in the early 2000's (around 6%).

On the whole, the contribution of capital to potential growth appears weak in spite of very low interest rates provided by the financial system in this decade (see graph 2).

Graph 1

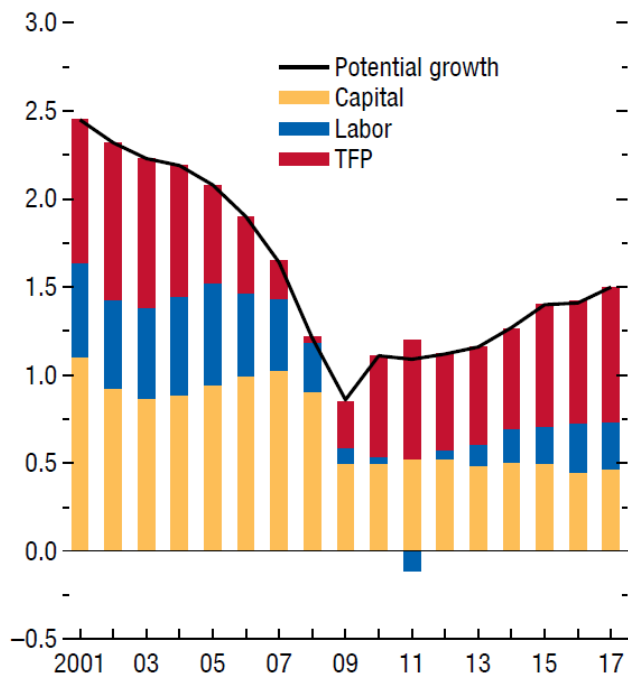
The level of non-residential gross fixed investment as a % of GDP is falling



Graph 2

Contributions to potential growth: capital contribution remains low

(Percent)



Source: IMF staff calculations.

Note: Advanced economies = Australia, Canada, France, Germany, Italy, Japan, Spain, United Kingdom, United States; TFP = total factor productivity.

II - Second, some empirical observations.

Statistics show that periods of investment growth have always been accompanied by positive real interest rates.

Thus, the real interest rate generated by a 10-year US Treasury Bond averaged +3.6% per year from 1990 to 2000 (a rather favourable period in terms of investment), while from 2000 to 2019 (a period in which investment performed poorly) the real interest rate was on average +1,2%.

If we look at them over a long period of time, these correlations are strong: thus the 19th century was a period when productive investment, which was very dynamic, was remunerated, on average, at close to 5% in real terms. Even if these correlations are not evidence, they have a consistency and robustness that cannot be dismissed out of hand.

What has happened to explain this decline in interest rates over the past several decades?

The phenomenon of the secular slowdown is often mentioned: ageing societies have less productivity gains, they consume and invest less: the result is less pressure on available resources and lower inflation.

It is also argued that the excess of global savings (the "savings glut") resulting from the structural current account surpluses of some major creditor countries amplifies global liquidity. This results in accumulations of reserves in those countries that struggle, through dollar purchases, against the appreciation of their exchange rate in order to preserve their competitiveness.

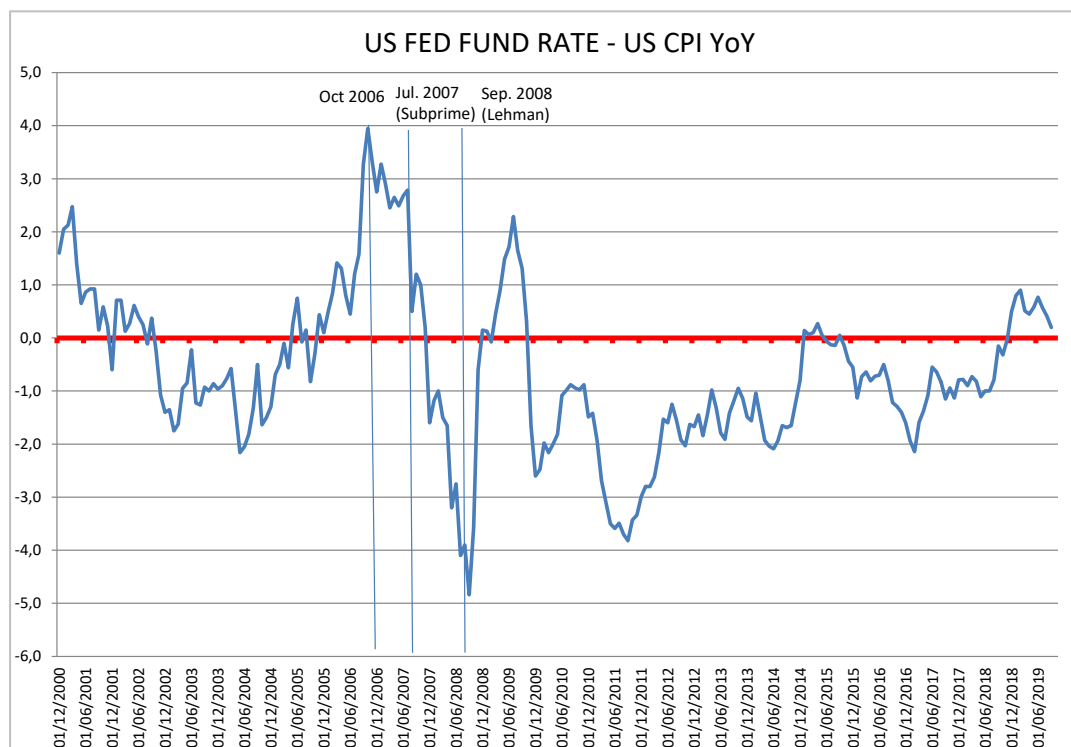
These phenomena have undoubtedly contributed to the downward trend in world interest rates.

But let us not forget that another strong factor is the monetary policy that has been in place for 20 years.

The Fed has systematically implemented a policy of negative real interest rates (Fed funds) since the early 2000s.

Over the 18-year period (2002 to 2019) - except for 2006-2008 and 2018 - **the Fed's key rates in real terms (less consumer price inflation) were negative for 15 years** (see graph 3). This has contributed to the rise in global debt and the crisis.

Graph 3



Source : Bloomberg

However, as we know, the Fed's policy has an impact on the rest of the world (if only because of the fear of countries that would like a more conventional policy to see their currencies appreciate against the dollar).

III - Let us now turn to economics, which can shed light on the relationship: zero rate/investment.

Several factors must be analyzed.

It is undeniable that the fall in rates favours debtors: governments, companies, individuals. The debt of these agents becomes less heavy in terms of interest charges. Thus, we are witnessing a transfer of income from savers to debtors.

But does this improvement in the situation of debtor agents translate into an incentive to take on more debt? To some extent, yes: public and private debt has increased steadily since the 2008 crisis. The rise in the indebtedness of governments and non-financial corporations has been considerable; similarly, household indebtedness and the housing bubble it causes are significant. Overall, global debt has increased by 80% since the crisis.

But what about productive investment?

This is where the "liquidity trap"; comes in.

1. « The liquidity trap ».

When rates approach zero, it is difficult for a Central Bank to go lower. This is called the "zero lower bound". In fact, the ECB does apply a negative rate of 0.50% on reserves held with it by commercial banks. But it is difficult to go much further. Indeed, the profitability of the banking sector is directly affected by the existence of this "tax" on their reserves (reserves imposed, moreover, largely by regulation). If the ECB were to lower rates more significantly, banks would eventually be forced to pass this tax on to customers' deposits. Such a tax (already partially applied to large deposits in countries such as Germany, Switzerland and Denmark) would have the disadvantage, in addition to its unpopularity, of reducing household consumption capacities, which would run counter to the authorities' desire to stimulate domestic demand.

The "unconventional" policy response to this difficulty is as follows: to further lower real rates and escape the zero lower bound constraint, the only solution would be to increase inflation through a systematic monetary expansion (QE) policy.

But there is still a difficulty: if the recovery of inflation and demand proves to be unwilling (which is the case for a number of reasons: fear of a recession due to the trade war, structural factors slowing growth - already mentioned -, preference for liquidity) - which weigh down on the inflation rate - , then we do not see where this desired recovery in demand could come from. The reasoning becomes circular: not enough inflation, so more QE, but if that is not enough to trigger inflation, what should we do? This is where some start talking about "helicopter money" that would allow individuals to be credited directly in Central Bank currency with the hope - which is uncertain - that these allowances would be consumed.

The core problem of current monetary policy is the preference for liquidity. Since investment by purchase of securities is taxed, investors tend to give up illusory remuneration and to keep liquid instruments, which, in spite of being low-yielding, at least are not affected by the application of negative rates.

In the traditional investor trade-off between return, risk and liquidity, the notion of return loses its importance with low rates. The arbitrage is now only between liquidity and risk.

As can be seen in the attached graph (see graph 4), the decline in government bond interest rates has been accompanied by a very sharp increase in the share of liquid assets in the financial assets of economic agents¹.

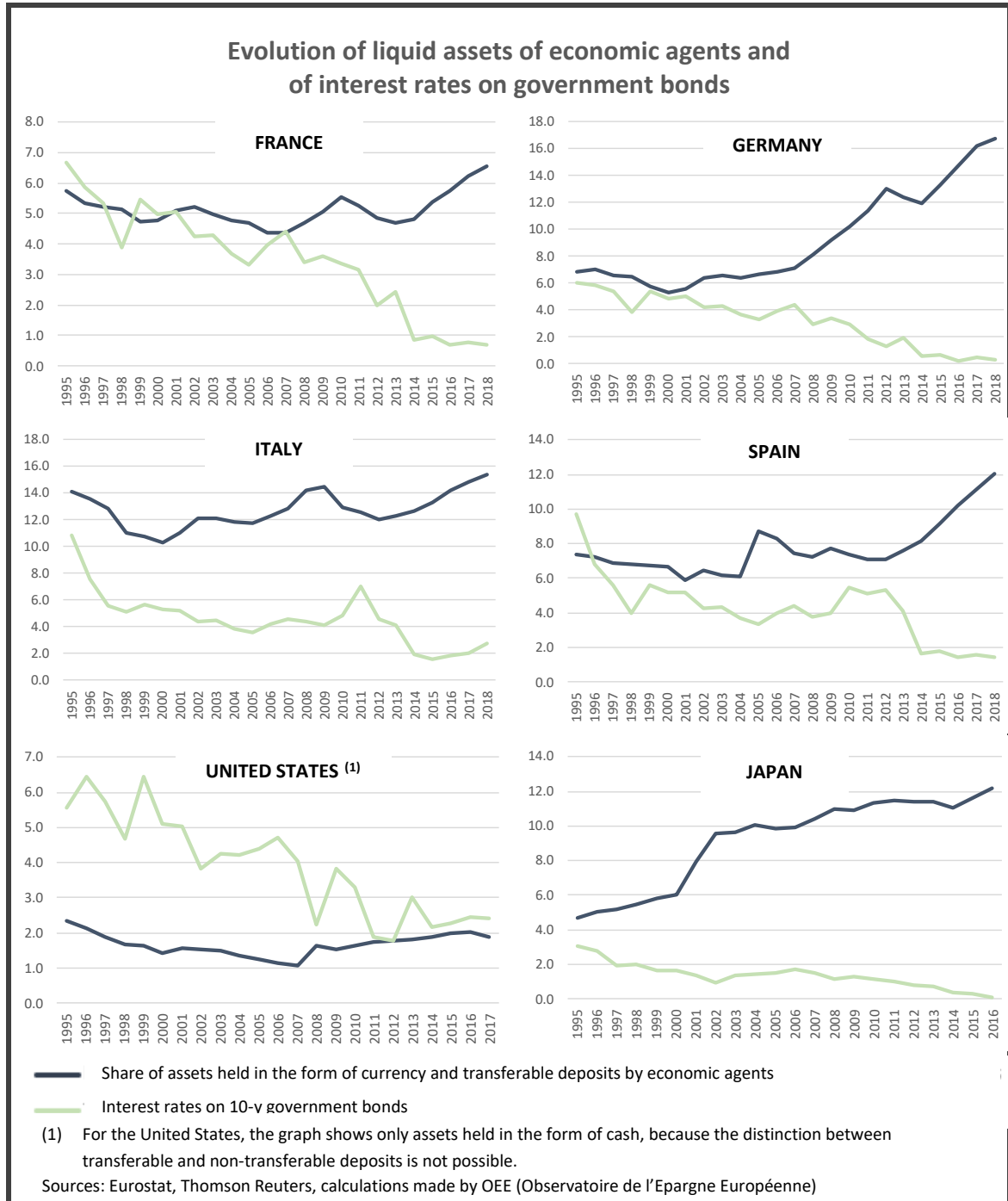
But such a preference for liquidity (Keynes' nightmare) diverts savers away from long-term investment.

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¹ Thus, the share of liquid assets held by economic agents in their total financial assets has gone down, from 1995 to 2018, from 6 to 16% in Germany, from 7 to 12% in Spain, from 4.5 to 12% in Japan (see *Observatoire de l'Épargne Européenne*). The risk aversion shown by the above rates, notably in Germany, results in an increase in liquid savings and a preference for the German public debt on which interest rates are falling.

Graph 4

A sharp rise in liquid assets accompanies very low interest rates



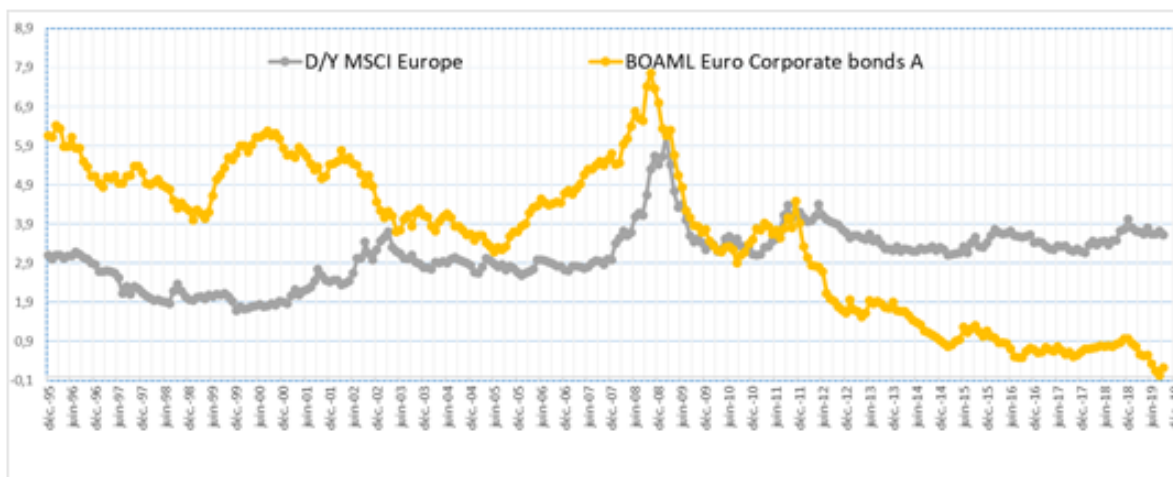
2. Markets involve serious risks

When there is a craze for so-called “risk-free” assets, the price of these assets rises while their interest rates fall. At the same time, returns on stock markets go up (see Graph 5).

Graph 5

Returns on equity and government bonds

Evolution since 1995 of returns on shares (MSCI Europe) and on EU corporate A-rated bonds (Bank of America Merrill Lynch Euro Corporate A Index).



Monetary policy of low interest rates has favoured the return on equity vs. the yield on riskless bonds:

- Dividend yield of MSCI Europe Index= 3.62% as of 30.09.2019 (Source MSCI)
- Yield of bonds in the ICE BofA Merrill Lynch Euro Corporate rating A = 0.22% as of 30.09.2019 (Source ICE BAML)

The risk here is the proliferation of asset bubbles: in equities, bonds, consumer credit, the purchase of real estate financed by very low-interest debt, not to mention “zombie” companies that continue to survive thanks to zero interest rates, but penalize the most innovative firms by maintaining their market share.

This search for returns at all costs results in a deterioration in the quality of financial assets.

Thus, bonds rated BBB (one notch above junk bonds) now represent more than 50% of the total outstanding amount of investment grade bonds, which is a perilous record.

The debt issued by US non-financial corporations amounts to more than \$9 trillion (compared to \$5 trillion in 2008), an increase of more than 40% in ten years.

This explosion in non-financial corporate debt is the result of the monetary policy pursued in recent years, which has kept interest rates at historically low levels.

This debt is largely in the form of collateralized loan obligations (CLOs), which are popular with investors around the world seeking returns (particularly Japanese banks).

The coming recession and the fate of many companies with excessive credit risk exposure will be at stake.

The risk is well known: it is the 2007-2008 risk of an increase in the number of bubbles that eventually burst, and the financial crisis that comes after the "Minsky moment".

In fact, continuing the practice of zero interest rates for too long encourages, as we have seen, speculation on risky assets ("search for yield"); blurring risk premiums, and causing financial bubbles. This diverts investors away from the "real"; long-term projects - which are essential, however - while making the financial system more vulnerable.

Between engaging in a risky project with a risk premium of around 6-7% or buying back shares with a 0% credit, the temptation for a company is great to choose the second solution. This is, moreover, what we are seeing on a large scale today (see graph 6). Since 2008 one observes a very significant increase in share buybacks. These buybacks have reached record highs in 2018, representing a total flow of more than 600 billion \$ (in the years 1996-2004, the figure was typically around 100 billion per year) - (Bloomberg, Stock buybacks).

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Graph 6

Low interest rates are pushing share buybacks up



Source: Bloomberg; Buyback data for stocks currently in the Russell 1000 index excluding financials

Share Buybacks Vs Stock Returns GARY MISHURIS

And it is at the very moment when governments are telling us that financing the energy transition is essential...

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In conclusion, we must understand the current monetary dilemma.

By pursuing an inflation target of 2%, which is proving unattainable for the structural reasons already mentioned (ageing, globalisation, changes in the functioning of the labour market, technological progress, etc.), central banks are anchoring in minds the idea that interest rates will remain low for an indefinite period. This expectation of low rates has a "depressing" effect: economic agents conclude that the growth horizon will be closed for a long time and therefore refrain from undertaking.

We are in a situation where the inverted yield curve (long-term rates lower than short-term rates) is less the result of a feared cyclical slowdown than the realization by the public that central banks no longer believe in growth since they are entering an indefinite phase of low rates, as a result of their inability to reach 2% inflation. Setting an unattainable goal has a real psychological cost. Fixing the target closer to equilibrium inflation (around 1 to 1.5%) would lead to a monetary policy that is less systematically expansive and less likely to generate pessimistic self-fulfilling expectations.

Whatever the arguments presented by the proponents of non-conventional policy, there is no objective evidence that zero rates generate growth and investment.

Jacques de Larosière