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https://blog.en.erste-am.com/will-interest-rates-remain-low-in-the-long-term/

Will interest rates remain low in the long term?

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The interest rates seem to have been going one way for years – down. With the exception of a few corrections, the taboo has been broken for many years that bond yields should have to be positive all the time. The 10Y yield of German government bonds was negative for the first time in 2016.

This previously unthinkable situation seems to have become the new normal: the majority of government bonds in Europe and Japan are paying negative yields. The discussion of whether instruments such as savings books could bear negative interest has also entered the money market. What has led to this situation?

Receding rates of inflation

This phenomenon is well-known from the bursting of the speculative real estate bubble in Japan at the end of the 1980s. Weak consumer demand, not the least as a result of the ageing population, meets an ever more efficiently working production side. Globalisation has reinforced this effect around the world.

Due to the concentration of the production in regions and countries that have the best conditions for it a hitherto unseen volume of products was being produced at extremely low prices. This is one of the reasons why inflation – which has a significant influence on the level of interest rates – has been falling continuously in recent decades.

Past performance is not a reliable indicator of the future performance.

Expansive monetary policy of central banks

A further important factor was the necessary expansive policy of the central banks – especially the ECB – after the recent big financial crisis in 2008. In order to safeguard the Eurozone and the euro, government bonds from all euro countries, but especially from the periphery were being bought. Deflation was the big worry then, whose solidification would have set off a downward spiral of the economy.

Thus, the intention was to attain the inflation target via the various purchase programmes while at the same time keeping interest rates low for states. It was important to gain time for necessary structural reforms without having to pay excessive interest on the already relative high government debt.

Effects on the demand side unclear

On the demand side, the jury is still out on the effectiveness of the low-interest-rate policy. Some observers claim that the savings ratio among consumers, for example for retirement provisions, is still up as no interest is expected on these savings. Higher savings ratios lead to lower consumption. On the other hand, demand for investment or consumer credit has reacted less significantly to lower interest rates than for example leveraged real estate transactions. This also affected prices both in private and commercial real estate.

States benefit from low interest rates

Nowadays, low interest rates seem to be crucial for government debt, especially given the necessary new debt taken out in the wake of corona. The stimulus and support measures have to be financed. Some politicians say that we can afford it, seeing that interest rates are at zero. While this is true, it should not constitute an incentive to deviate from the goal of a balanced budget after the crisis.

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Low interest rates will be with us for longer

How long will interest rates remain low? For still a while, as it seems. The effects of the demographic development, the support by the central banks, and the weak consumer demand will probably last for longer. There are first signs of a stagnating trend in globalisation, and we have seen the re-emergence of regionalisation in recent months. This notwithstanding, it will probably take a few years until traditional savings books work for building capital again. Instead, we see more and more investment vehicles like equities, corporate bonds or such assets that promise a real gain in wealth.

Legal note:

Prognoses are no reliable indicator for future performance.

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