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PERMANENTLY LOW INTEREST RATES MAY BE THE PROBLEM NOT THE SOLUTION

Strategy and economics

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In the immediate aftermath of the last recession and accompanying financial crisis, there was every reason to expect companies to be reticent about embarking on long-term, productivity-enhancing investment programmes. Moving the story on, we are now seven years from the end of the recession, and it remains the case that productivity growth in the larger western economies remains very weak. The corollary of this, which can be seen very clearly in the US, Germany and the UK, is that the rate of job creation accompanying relatively dull growth has been exceptional. In turn, this has seemingly created a policy dilemma for the US Federal Reserve and for the Bank of England (less so for the European Central Bank, which is more focused on deeper problems in southern eurozone economies) – should the direction of interest rates be influenced more by growth trends that are considerably weaker than those achieved prior to the recession, or by progressive tightening in labour markets that can be expected to lead to higher wage inflation? The seemingly counter-intuitive answer is that for many western economies to improve their growth potential, interest rates should now be pushed higher.

To an extent, this policy/growth dilemma can be resolved by the observation that growth in many economies in the decade or so prior to the recession was unsustainably fast – and that current growth rates can be considered more normal. But this 'normal' epithet is based on longer-term achieved rates of productivity growth. The rate of growth that an economy is capable of sustaining is based on achievable gains in productivity, adjusted for changes in the size of the workforce and employment rate.

In what follows, I will focus on the UK, but the conclusions can be more widely applied. Prior to the recession, the UK's long-term average annual improvement in productivity was around 2.0%. During the period of uninterrupted growth between 1992 and 2007, the annual rate also averaged 2.0%. This can be compared to an average GDP growth rate of 2.8%. The difference can be attributed to an expansion in the size of the working population (some of this as a result of immigration) and also to an increase in the employment rate. Looking ahead, official projections suggest that the size of the workforce (including all adults of working age) will increase by around 0.25% per annum. Given that the employment rate is already at an all-time high, it seems unlikely that it will rise appreciably higher. So, if the UK economy were able to achieve productivity growth in line with the long-term average, the achievable annual growth rate ought to be around 2.25% per annum, which is slightly above the 2.0% that has been averaged since the recession.

So, no problem? Well, there is a problem: the 2.0% average growth in GDP recorded over the past seven years has been supported by a growing working population and more significantly, a rising employment rate. The associated productivity improvement has been a meagre 0.8% per year. This situation is also evident in the US and Germany – that productivity growth is contributing to GDP growth at half the rate that might have been expected. The issue is clear: if productivity growth does not improve, then even the current comparatively dull growth rates will prove unsustainable. And without productivity growth, those in employment will find it increasingly difficult to achieve real increases in wages and salaries.

So, why are companies not undertaking productivity-enhancing capital investment? Conventional economics would suggest that at very low interest rates, companies ought to be encouraged to borrow for investment purposes. I believe that this is not happening because there is no competition for capital between asset classes within the economy. Through the associated monetary policies of exceptionally low interest rates and quantitative easing, central banks have added huge amounts of liquidity into the financial system and simultaneously forced down interest rates and longer-term yields along the yield curve. They have also made the process of lending much less profitable and undermined the process of creative destruction. Companies normally have to compete for investor capital, partly because dividend yields are usually lower than bond yields. However, with dividend yields above bond yields, there is no pressure on companies to compete for investor attention by growing profits. Hence, there is no pressure on them to embark on productivity-enhancing investment.

In any system, the process of challenge is vital to performance, but when interest rates and yields are below core inflation, this is absent. In effect, therefore, low interest rates induce economic laziness. So this is the paradox – by causing structural mispricing of government bonds and by holding interest rates exceptionally low, central banks are actually undermining economic dynamism and growth. This conclusion seems to be supported by what has happened in Japan over recent decades (albeit, Japan's problems have been exacerbated by demographic issues). While it has had the lowest interest rates over the past few decades, it has also achieved the lowest productivity gains when compared to the US, Germany and the UK.

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