The Collapse of Global Interest Rates

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Early 2000s: Two Dominant Facts
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![Graph depicting world GDP growth with shaded bars for different regions and crises: Asian, Financial, and Eurozone. The x-axis represents years from 1980 to 2016, and the y-axis shows % of world GDP.]

Legend:
- U.S.
- European Union
- Japan
- Oil Producers
- Emerging Asia ex-China
- China
- Rest of the world
A Store of Value Deficit
Eventually we hit the ELB
A Macroeconomic Problem

• Before ELB:
  – Distributional issues
  – Incentive problems in financial system

• Post ELB:
  – A macroeconomic problem: Insufficient aggregate demand (too little wealth…)
Which Interest Rate?
Which Interest Rate?
More on Risk Intolerance

![Graph showing global negative yielding debt and its market value and as a share of all bonds outstanding.]

Source: Bloomberg Finance LP, DB Global Research
More on Risk Intolerance

Cumulative net purchases of US corporate equities

Note: Other domestic institutions includes Property-Casualty Insurance Companies, Life Insurance Companies, Private Pension Funds, Federal government retirement funds and state/local government employment defined benefit retirement funds

Source: FRB, Haver Analytics, DB Global Research
Risk-centric Macroeconomics
Risk-centric Macroeconomics

\[ \frac{\gamma_{\text{risky}} - \gamma_{\text{safe/fed}}}{\gamma_{\text{safety}}} \]

Risk \cdot Risk Intolerance

- Insufficient demand for risk leads to a drop in asset prices
- Negative feedback loop with real activity
- Central banks understand these connections (although they use a different language)
Initially the pressure from the denominator was absorbed by a drop in safe interest rates.

There is very limited space for more of that. Negative feedback loop with real activity around the corner!

Risk • Risk Intolerance becomes very volatile.
Current (risk-centric) Shocks

\[
\frac{\bar{r}_{\text{risky}} - \bar{r}_{\text{safe/fed}}}{\bar{r}_{\text{safe/fed}}} \uparrow \text{Risk} \cdot \text{Risk Intolerance}
\]

Source: Baker, Bloom & Davis, Bloomberg, UBS
Perverse Growth Feedback

- Increase in uncertainty leads to lower investment and aggregate demand
- Fed lowers rates to increase wealth and consumption
- Investment doesn’t react
- AD composition worsens (C up, I down)
- Growth potential worsens

\[
\downarrow \frac{r_{\text{risky}} - r_{\text{safe/fed}}}{\text{Risk} \cdot \text{Risk Intolerance}}
\]
Perverse Inequality Feedback

\[ r_{\text{risky}} - r_{\text{safe/fed}} \]

\[ \uparrow \text{Risk} \cdot \text{Risk Intolerance} \]
Final Remarks

• If policy uncertainty drops, rates are likely to rise (the entire yield curve)

• But we have a structural problem
  – Temporary solution:
    • Public debt issuance by some DM sovereigns (buy risky assets and/or infrastructure investment)
    • Financial engineering… pseudo-safe assets
Final Remarks

• But we have a structural problem (continued…)
  – For a more permanent solution:
    • Somehow increase private demand for risk (pension reforms?) (regulatory reforms?)
      Together with systemic insurance
    • Increase in production of store of value by China et al. (internationalization of RMB?)
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