THE ONLY WAY IS UP

WHAT A RISE IN US INTEREST RATES COULD MEAN FOR THE GLOBAL ECONOMY

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Central banks responded to the financial crisis by slashing interest rates. In August 2007, the United States federal funds rate was 5.25 percent. By December 2008, it had fallen to 0.25 percent. After seven years of sluggish economic recovery, the rate remains stuck there.

As the US economy picked up in 2014, pundits predicted a rate rise in 2015. But these expectations have been confounded by dramatic declines in prices recently across a broad range of commodities and stock indices. Investors fear an accelerated economic slowdown in China and knock-on effects on still-weak US and European economies.

Meanwhile the Federal Reserve has been sending mixed signals about the likely timing and size of rate rises. Many investors fear that a premature or overly large rate rise could be the final nail in the coffin for emerging market economies.

How worried should investors be? In other words, how likely is a material rise in US interest rates and what would it mean for markets?

A BRIEF HISTORY OF US INTEREST RATES

To answer the first part of our question, we need to understand the history of US interest rates and what drives it.

US interest rates have been declining steadily since the early 1980s. (See Exhibit 1.) Inflation is part of the explanation. Before a lender can earn any real interest, the rate on their loan must first compensate them for the erosion of their money’s purchasing power when the loan is repaid. As inflation has fallen since the early 1980s, interest rates have automatically fallen with it. Moreover, the real rate of interest (the nominal interest rate minus the rate of inflation), which ultimately influences an individual’s propensity to save versus spend, has also fallen.

Why have rates been falling?

Judging by media discussion of interest rates, you might easily believe that real interest rates are entirely at the discretion of central bankers. They aren’t. According to Ben Bernanke, “The Fed’s ability to affect real rates of return, especially longer-term real rates, is transitory and limited.”

In fact, the influence works in the other direction. The Fed aims to set interest at the so-called “equilibrium” rate. This is the rate at which borrowing is not so cheap as to cause “overheating” and consequent inflation, nor so expensive as to stifle spending and cause a recession. What this equilibrium rate is depends on economic circumstances beyond the control of the Fed.

For the past seven years, spending within the economy has been low as a result of high unemployment and the need to pay down debt built up during the pre-crisis boom. This depressed the equilibrium rate and required the Fed to keep rates low. The US now appears to be re-emerging from this slump, pushing up the equilibrium rate. The general consensus is that rates need to rise because the risk of overheating has started to outweigh the risk of an economic contraction.

A BIG RISE?

But by how much will interest rates rise?

The general consensus seems to be “not much.” According to such thinking, the Fed will gradually raise the fed funds rate to 2 percent or 3 percent, and even this may prove a brief peak. Structural changes in the economy, such as an aging population, mean that the
equilibrium rate will continue to remain low over the long run, limiting the extent of any upward pressure.

Set against this view, however, is the evidence of history. As the earlier periods of Exhibit 1 show, nominal interest rates can reach extraordinarily high levels and even real rates can be as high as 8 percent.

Of course, the US economy of the postwar period, which saw steadily rising nominal rates, was quite unlike today’s economy. The fact that real rates remained low during this period indicates that inflation was the largest driver of these rises. The Fed now has a much clearer policy of managing inflation within a tighter band; and the US is no longer so exposed to external shocks in energy prices, so the threat of spiraling inflation is hopefully limited. The sudden rise in real rates in the 1980s can perhaps be attributed to the baby boomers of the 1950s and 1960s coming of age in the workforce, combined with the liberalization of the economy during the Reagan era. By contrast, these same baby boomers are now preparing for retirement, causing a drag on the economy and a buildup of the supply of savings that is more likely to keep real rates low.

But this only suggests that if interest rates rise, it is unlikely to be for the same reasons that they rose in these earlier periods. A rise in interest rates could very well happen for some other reason. A profound technological advance might cause an investment boom. Or a dramatic increase in immigration might cause a boom in the housing and education sectors. Or a rise in rates may be inexplicable, because economies are complex open systems and, hence, unpredictable.

When the only way is up, and when history is full of large shifts, risk managers would be prudent to consider much larger rate moves.
What could a significant rate rise mean?

Over the past three years, concerns have been shifting away from the Eurozone peripheral nations, toward the fragility in emerging markets economies. (See Exhibit 2.) At the heart of the problem is the economic slowdown in China and its knock-on effects. The reverberations from China’s slowing economy are being felt most acutely in commodities-producing nations such as Brazil and Russia, whose economies can be viewed as a leveraged bet on China.

If US rates were to rise significantly, capital would flow out of China and other emerging markets and back into US assets. To protect their currencies from further devaluation, interest rates in emerging markets would have to rise above their equilibrium rates, further stifling already slowing growth. A US interest rate rise is the last thing emerging market economies now need. But that doesn’t make it any less likely.

History indicates that the Fed will act solely in the US interest when setting interest rates. The big question is whether the emerging markets crisis will be contained to equity and property markets or whether it will spread.

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into corporate debt markets (noting that many emerging markets corporates have been borrowing in dollars), potentially infecting the banking system and ultimately threatening the solvency of sovereigns.

SWINGS AND ROUNDABOUTS

According to proponents of globalization, improved economic prospects in one part of the world should act to benefit the rest of the global economy. However, the business cycles of emerging markets and the developed world are rarely in sync. Arguably the developed world has not benefited a great deal from the emerging markets growth story since capital has fled the developed world to seek opportunities in the emerging markets. As the US now recovers, the money will flow in the other direction, which spells bad news for emerging markets economies.

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