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Why Decline in Long-term Interest Rates are a Concern for the Economy

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In the advanced economies of today, it is almost common that long-term interest rate levels are low. Especially in Europe, not only the lowness of the level but the speed of the decline is striking. Decline of interest rates, for companies in debt, are initially convenient since borrowing costs will decrease. This is one of the aims of central banks when lowering their policy interest rates during a recession. But under the circumstance of spreading concerns of deflation, particularly in Europe, things are different.

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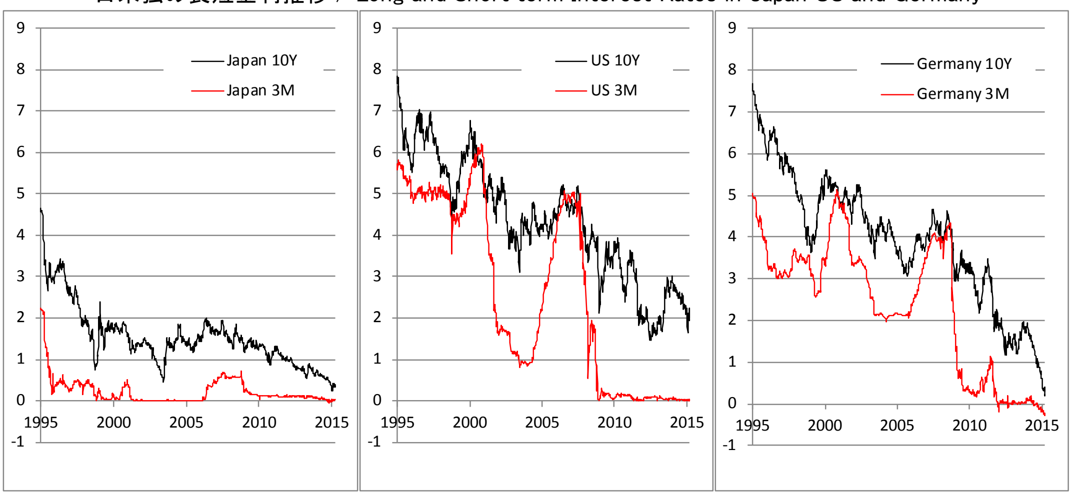
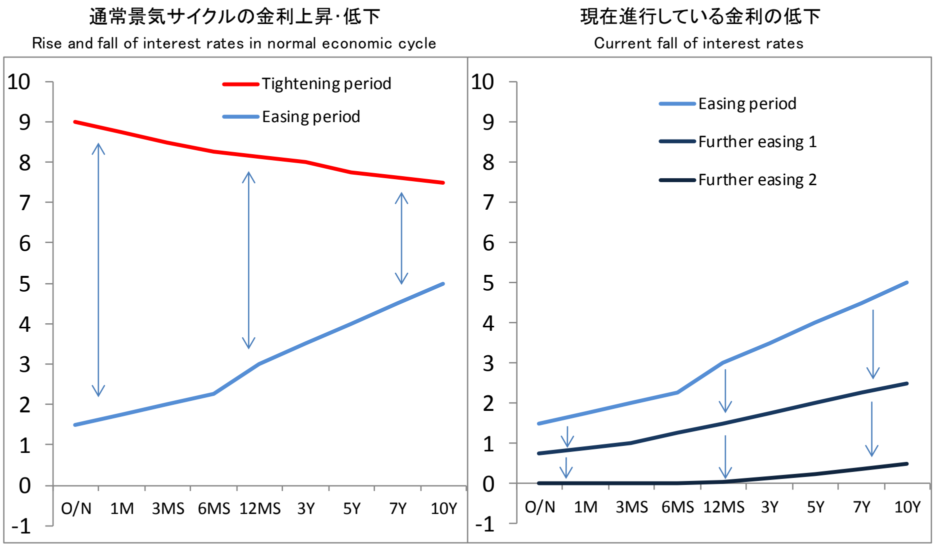


(Source) Datastream

There are two patterns in the decline of long-term interest rates. One is the decline under a normal economic cycle, during which, generally short-term interest rates will decline faster than long-term interest rates. In the markets this is called a "steepening" in the yield curve. When the decline in interest rates and the steep incline in the yield curve occur at the same time, the desire to borrow recovers as interest rates decline and the desire to lend also recovers as the lenders would find it easier to gain profits from funding long-term investments with short-term funds.

The second pattern is what it is like in today's advanced economies, where under a low inflation environment the long-term interest rates decline further. Although it is the same decline in long-term interest rates, the impact to the economy is greatly different. Since short-term interest rates have reached zero, the yield curve does not fall to a steep incline but instead it flattens.



As difference between short and long-term interest rates become small, the commercial banks will find it difficult to compensate enough reserve for potential bad debt, making them conservative in their lending policies. The stagnation in lending will hold back the investing mood of the companies. Then the real economy will stagnate, leading to a more decline in the expected inflation rate, which will lead to a further decline in the long-term interest rate and then a negative spiral will begin.

This negative spiral will cause a further large inconvenience if the long-term interest rates also decline to nearly zero as it has nowadays. If inflation enters into negative numbers, the fall of prices will immediately become the rise for the real interest rate as long-term interest cannot decline any further. The increase in real interest rate will lessen the borrower's desire to borrow. By this the risk of the economy falling into a long-term deflation will increase further.

In order to avoid this, the expectation of inflation must be increased no matter what. The leader for this should be the guardian of the currency, the central banks. The central banks need to announce that "we shall lower the value of the currency". This is a must to start changing people's minds. At the same time, it should not be just a start but continuously lead people's minds from deflation to inflation. For this, there is needed to grow the expectation of a rise in the growth potential of the real economy. The government needs to make efforts of restructuring uncompetitive zombie companies, deregulation that would lead to an innovation on the supply side and regulatory reforms to raise the birth rate. The action of private enterprises responding to such policy changes is necessary as well.