

Interest Rates: In Search of a New Normal - Reflections on long-term interest rates

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About the speaker



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- **German Insurance Association (GDV)**
- Federation of private insurers in Germany
- Representing the interests of German insurers (460 member companies)

Outline

Low for long? Prospects for long-term interest rates



- What are the reasons for the long-term decline in interest rates?
- Is the decline permanent, caused by a fall in the equilibrium rate of interest?
- If not, what is the „fair value“ of long-term interest rates? Focus on fundamental values

Important:

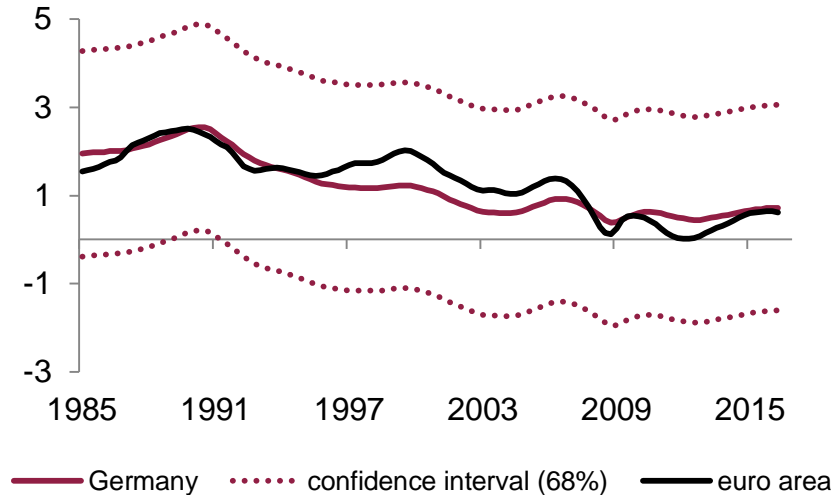
- **We do not provide a forecast for long-term interest rates!**
- But: concept of the „fair value“ of interest rates is of relevance for:
 - the supervisor when setting the framework for the valuation of technical provisions („Ultimate Forward Rate“)
 - monetary policy (gap between actual real and equilibrium real rate)

Equilibrium Interest Rates

The debate in economics

Equilibrium interest rate estimates

Source: German Council of Economic Experts



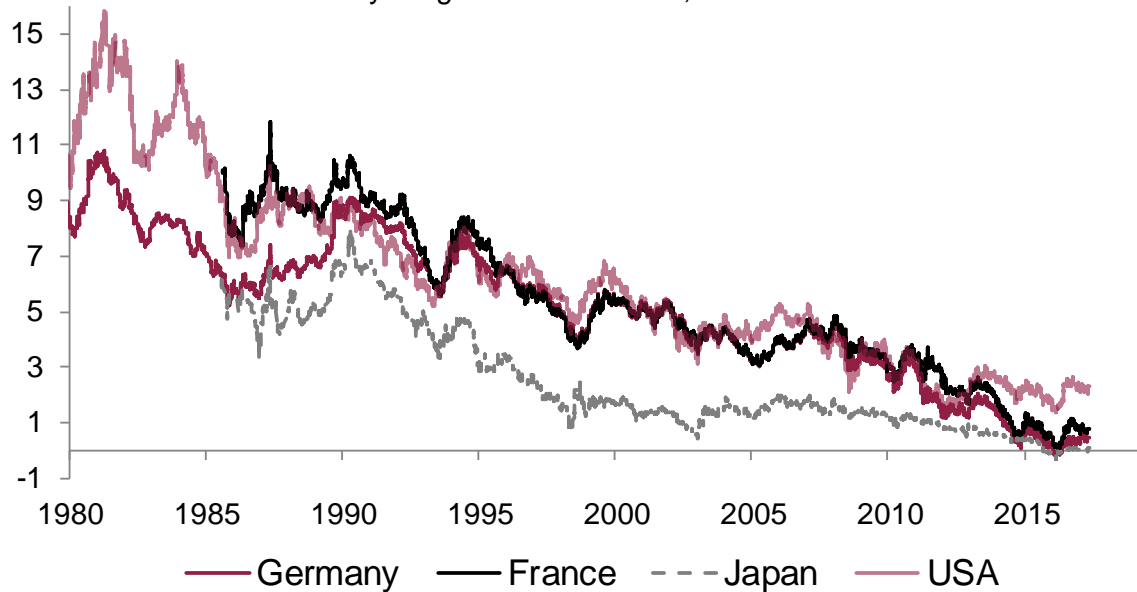
- Causes of persistent low interest rate environment
- Equilibrium rate of interest (R^*): consistent with stable growth and price stability
- Not directly measurable
- For short and medium-term rates: a number of empirical studies find a decline of R^* – but estimates are subject to a high degree of uncertainty
- ECB: decline in equilibrium rates reason for easing monetary policy

Persistent fall in interest rates since the 1980s



Long-term interest rates

10 year government bonds, Macrobond



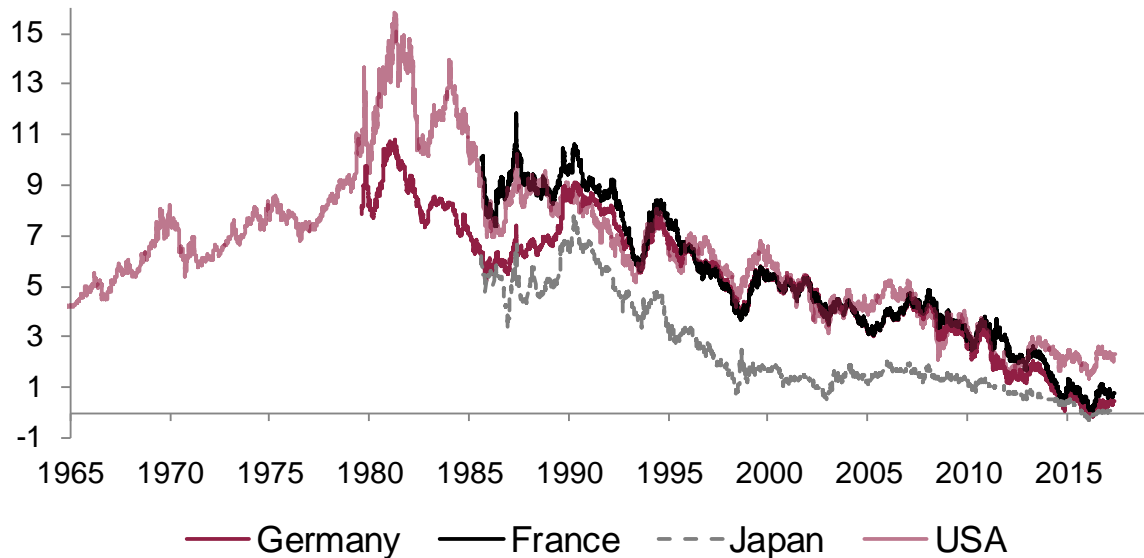
From a historical perspective...

... rates in the 1980s exceptionally high, but recently observed negative rates unique



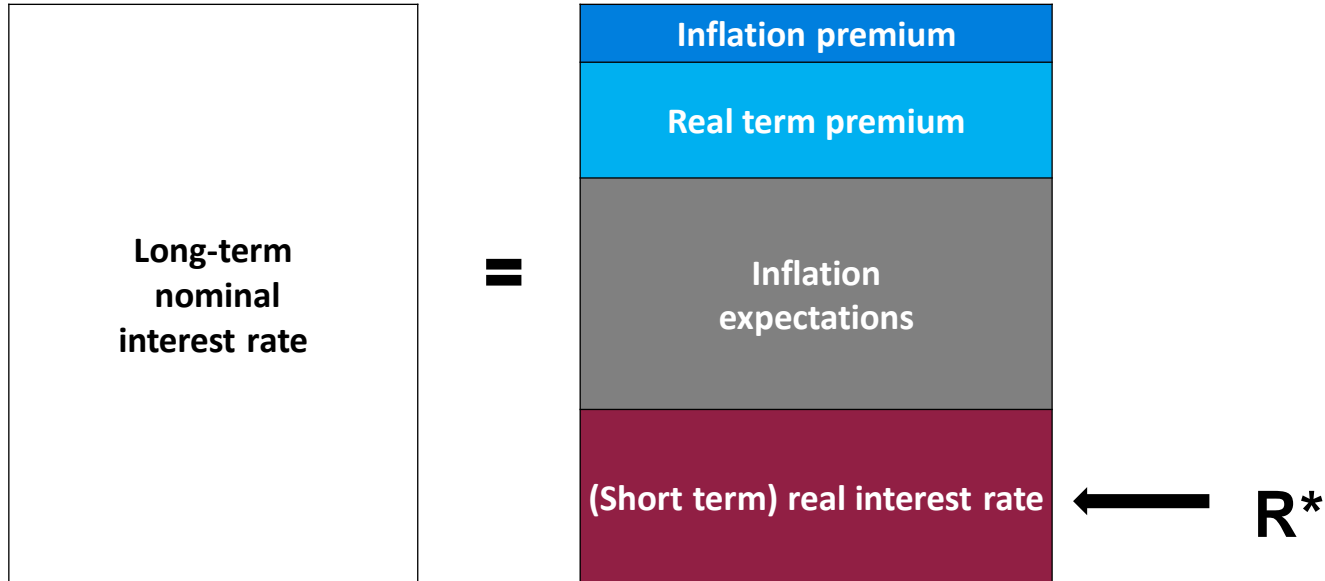
Long-term interest rates

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Decomposition of the long-term rate

Analysing each of the four components



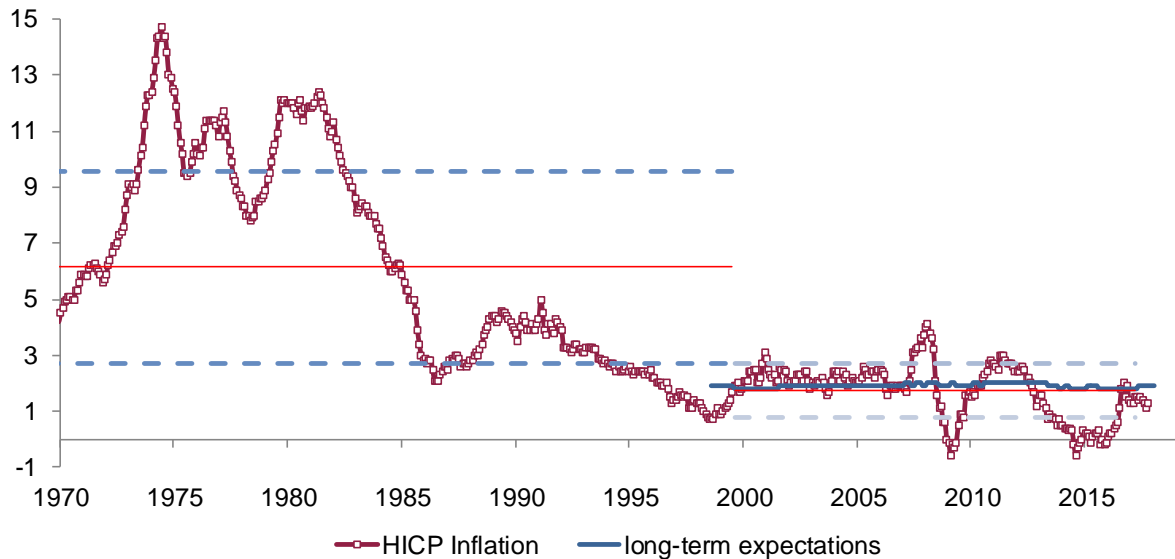
1. Inflation expectations

Great moderation: stabilising inflation in the mid 1990s - one of the main drivers of falling interest rates

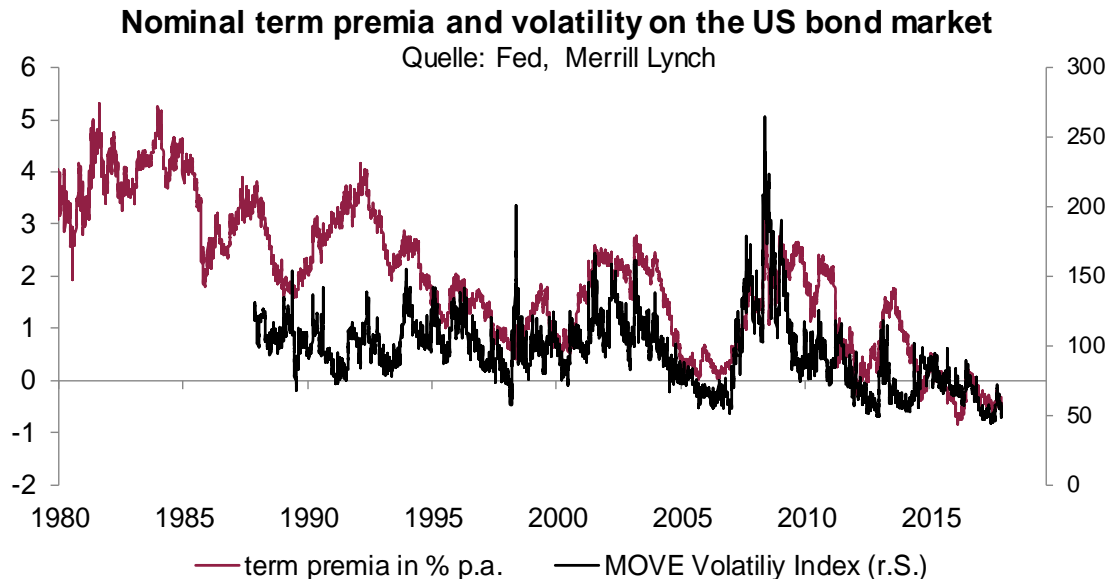


Inflation and Inflation Expectations in the Euro Area

Change on previous year in %; ECB



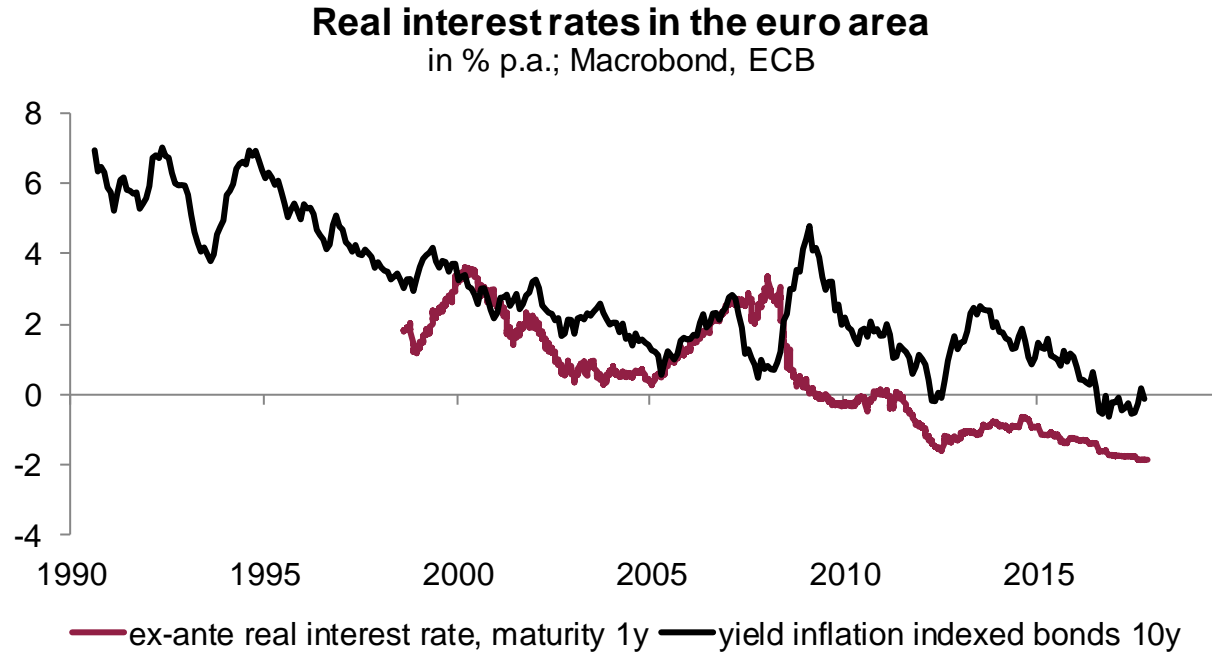
2./3. Term and inflation premia



- Limited risk of higher rates due to unconventional monetary policy measures and shortage of safe assets (negative term premia)
- Inflation premium: Decreasing volatility
- Estimates for the euro area before the financial crisis:
 - Real term premium 1%
 - Inflation premium 0,25%

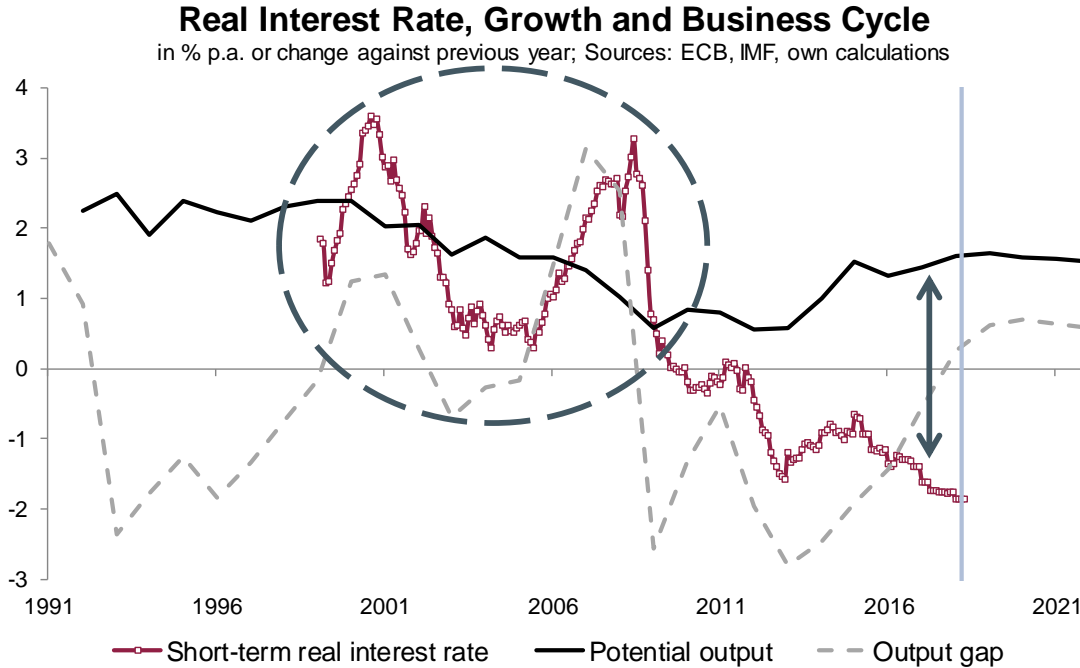
4. Short-term real interest rate

Declining trend since 2000



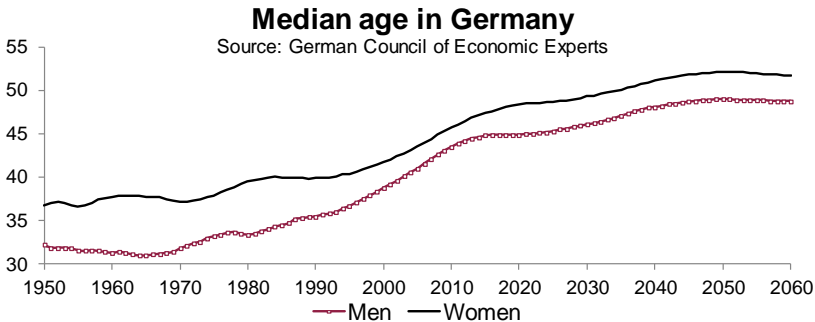
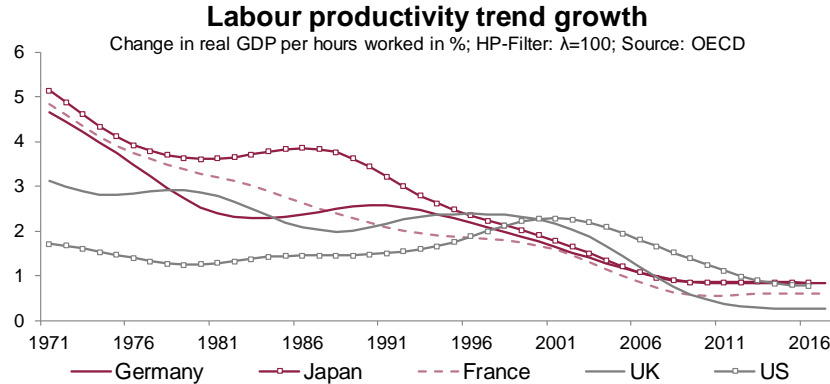
Decline in short-term real interest rate

Fundamental reasons vs. temporary effects



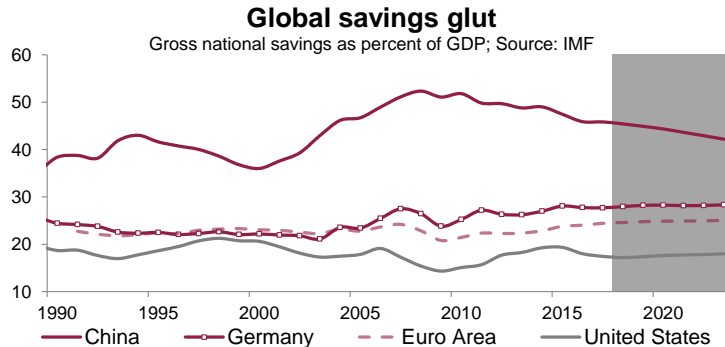
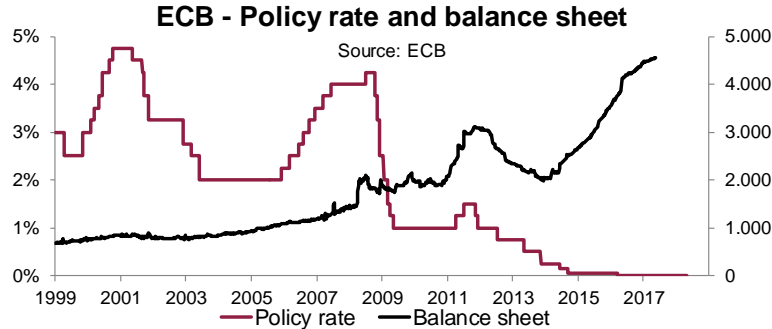
Fundamental factors...

... but negative real interest rates are not equilibrium values



- Decline in trend growth
- Slower productivity growth already prior to the financial crisis
- Demographic change
 - Higher propensity to save of middle age people (life-cycle-hypothesis)
 - Increase in life expectancy supporting higher savings
- Some factors are interlinked

Temporary effects pushing the real interest rate below the natural rate



- Very accommodative monetary policy stance since the global financial crisis
 - Diverging potential growth and real interest rate since 2015
- Global savings glut
- Increasing demand for safe assets
- Higher liquidity preference in the aftermath of the financial crisis

Outlook for the long-term interest rate

Normalization of interest rates expected in the medium/ long-term



	base scenario
Inflation premium	0,25%
Term premium	0,75%
Inflation expectations	2,0%
Real interest rate	1,2%
Nominal interest rate	4,2%

- Reasons for the normalization of interest rates (baseline scenario):
 - Change of monetary policy
 - Normalization of real interest rates and risk premiums
 - Stable inflation expectations

BMF experts come to similar conclusion

BUSINESS NEWS

MARCH 31, 2018 / 2:16 PM / A MONTH AGO

German finance ministry sees hefty interest rate rises: Spiegel

Experts usually see interest rates of between 3 percent and 4 percent as “normal”, compared to below zero percent now, reported Der Spiegel.



Conclusion

- Based on fundamental factors and ignoring extreme monetary policy stances, geopolitical risks as well as regulatory distortions: Fair value of long-term interest rates $\approx 4\%$
- Near to medium-term: Rates likely to remain distorted at much lower levels due to
 - very gradual monetary policy normalization (ECB to err on the side of caution)
 - bloated central bank balance sheets (for years to come)
 - low underlying inflation (for structural reasons; “benign” deflation)
 - ongoing flight to quality (geopolitical risks to remain elevated)
 - prolonged current cycle (US upswing 2nd longest in post-war history)
- That said: 2016 “ice-age” period in yields over

Thank you very much for your attention!



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