Low Real Interest Rates[1]

Executive Summary

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My talk is about the decline in real—that is, net of inflation—interest rates since 2007. I begin by describing how, over the past six years, the demand for safe assets has grown, while the supply of those assets has shrunk. These changes in asset demand and asset supply imply that households and firms spend less at any level of real interest rates. It follows that the Federal Open Market Committee can only meet its congressionally mandated objectives for employment and prices by taking actions that greatly lower the real interest rate relative to its 2007 level. This is my first of three main messages: The FOMC should be thought of as having been *forced* to lower the real interest rate in order to *respond appropriately* to dramatic changes in asset market demand and supply.

I suggest that these dramatic changes in asset demand and asset supply are likely to persist over a considerable period of time—possibly the next five to 10 years. If that forecast holds true, it follows that the FOMC will only be able to meet its congressionally mandated objectives over that time frame by taking policy actions that ensure that the real interest rate remains unusually low. I point out that low real interest rates can be expected to be associated with financial market phenomena—like high asset price volatility—that are seen as signifying instability. This is my second main message: For many years to come, the FOMC

will only be able to achieve its objectives by following policies that necessarily give rise to signs of financial market instability.

These financial market phenomena could pose macroeconomic risks. In my view, these potentialities are best addressed using effective supervision and regulation of the financial sector. It is possible, though, that these tools may only partly mitigate the relevant macroeconomic risks. The FOMC could respond to any residual risk by tightening monetary policy. However, it should only do so if the *certain* loss in terms of the associated fall in employment and prices is outweighed by the *possible* benefit of reducing the risk of an even larger fall in employment and prices caused by a financial crisis. Hence—and this is my third main message—the FOMC's decision about how to react to signs of financial instability will necessarily depend on a delicate probabilistic cost-benefit calculation. The Committee is in a better position to make that calculation now than it was in 2007, and continues to make progress on this dimension.