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CAPITAL & ECONOMICS

U.S. Interest Rates And The Global Economy

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OVERVIEW

Interest rates have been stuck at historically low levels in most developed countries since the 2007-8 global financial crisis. After years of waiting, speculation has been growing about when central bankers might begin to raise benchmark interest rates. Strong U.S. employment figures in the latter half of 2015 turned all eyes to the U.S. Federal Reserve to lead the way.

Throughout 2015 there have been mixed messages from the global economy. Concerns about the potential impact of a Chinese slowdown have led some to worry about a negative impact on global growth, with the World Bank, International Monetary Fund and Organization for Economic Co-operation and Development all downgrading their growth projections for the year. But at the same time, employment has been recovering strongly in many countries, notably the U.S. (which recorded its lowest jobless claims in 42 years in early fall) – and the U.K. (which saw its lowest unemployment rate since early 2008 during the same period). Even the struggling Eurozone saw its lowest unemployment levels in four years in September.

Although a rise in official interest rates would be an indication of increased confidence in the state of the economy – both local and global – there is little agreement on the impact such a move could have. What's more, while the U.S. may be prepared to raise interest rates, it's far from clear that other developed countries will follow suit.

This extended era of low interest rates may not be ending any time soon – which means that investors are likely to remain under pressure. With many pension funds already stretched, the challenge for businesses to meet their commitments – and employees to prepare effectively for retirement – has become more difficult than ever.

IN DEPTH

Today's interest rates in context

"You can live moment to moment in interest rates," explains Aon's Bryon Ehrhart, CEO of Aon Benfield Americas and Chairman of Aon Securities, Inc., "but since the peak of the early to mid 1980s we've seen more than 30 years of decline."

The U.S. Federal Funds Rate peaked at 20 percent in 1981, averaged close to 10 percent for much of the 1980s, floated around the 5 to 9 percent range during the 1990s, and 4 to 6 percent in the 2000s. After being cut heavily in response to the 2007-8 global financial crisis, it has stayed in a range between zero and 0.25 percent since December 2008.

Meanwhile, the Bank of England base rate peaked at 17 percent in 1979, remained in the 9 to 14 percent range through the 1980s, averaged around 6 percent in the 1990s, and 4-5 percent for most of the 2000s, before it too was cut heavily following the financial crisis, to remain at 0.5 percent since March 2009.

Elsewhere, the European Central Bank's base rate dropped to 0.5 percent in September 2014, while the Bank of Japan's rates have been hovering around 0 percent since 2010.

These low interest rates have already created significant challenges for investors, notably pension funds and life insurers that aim to deliver a certain return over a long period of time. "In pensions and annuities in particular," warns Ehrhart, "the combination of better than expected longevity and lower than expected interest rates is creating significant challenges to the obligations undertaken decades ago to pay retirees and annuitants fixed or inflation adjusted lifetime benefits."

Why Rates Need to Rise

Investors and savers in the developed world, as well as in some emerging markets, have gotten used to very low headline rates of inflation, thanks to the low interest rate environment and the gradual nature of the economic recovery. But with the United States and United Kingdom approaching full employment, that may well start to change.

"Rates are set to rise in the U.S. because the underlying economic activity is sufficient to allow it," says Ehrhart. "GDP is growing, and unemployment has reached very very low levels, which leads to pressure for wages to rise, which leads to concerns about inflation."

While central bankers have been preoccupied with too little inflation – or even deflation – for the past several years, they now have to plan for the real possibility that inflation could rise faster than they currently expect, especially if oil prices begin to stabilize and rise in 2016. Indeed, core inflation rates – which exclude food and energy – are showing much stronger gains than overall inflation rates. Raising interest rates tends to help keep inflation in check.

There's another argument for raising rates, too. Lowering interest rates has traditionally been the primary weapon central banks have used to fight the onset of recessions – but when rates are already at rock bottom, they have nowhere else to fall. If a new global financial crisis were to hit, central banks – including the Federal Reserve – that still have low interest rates would be unable to cut them further without heading into negative interest territory.

Nonetheless, such a show of confidence in future economic growth could have some immediate benefits for the global economy – the health of which often depends on confidence in growth. A rate rise in the U.S. could be enough to help reduce the lack of confidence seen since the Chinese stock market crashes of summer 2015.

Why Rates May Need to Stay Low

At the most fundamental level, raising interest rates tends to discourage investment. Lack of investment tends to reduce the pace of economic growth. Global markets remain shaky and easily panicked, as evidenced by the initial response to the China market crashes. Even in the U.S., some argue that the economy is not as strong as recent falls in jobless claims may suggest, with productivity still low.

"There's uncertainty all over the world," says Ehrhart. "Everyone focuses on China first – is there enough uncertainty there that this could bring the world back into a recession?"

Europe, too, is still a concern. Though the region has left the worst of the debt crisis behind, growth has yet to really take off despite extraordinary stimulus measures from the European Central Bank. The monetary authority introduced quantitative easing in 2015, and has also introduced negative interest rates in a bid to get banks lending to credit-starved small- and medium-sized businesses in the European periphery.

The Impact of a U.S. Rate Change on the World

The Federal Reserve may be a U.S. institution, but its decisions have global impact. The reverse is also true: In an increasingly globalized economy, the Fed also has to take into account the health of the United States' trade partners when making decisions about whether to raise interest rates.

"Given the global outlook the Fed will need to walk a fine line in its policy manuevers," says Jas Thandi, of Aon Hewitt's Global Asset Allocation Team. "Too fast a move and there are lots of unintended consequences that could push the world into recession and instability, too slow and the world will not believe in the recovery and lose confidence."

If the U.S. begins to raise its official interest rates, says Thandi, "the ripple effect that touches most businesses – exporters, importers, and others– is the currency."

Rising interest rates tend to raise the value of a currency. If the U.S. dollar increases in value then non-U.S. exporters will benefit because their goods will become relatively cheaper. (The reverse is true for U.S. exporters because their goods become relatively more expensive.) Foreign importers – and consumers who buy imported products – suffer from a stronger dollar, as they get less for the money from goods priced in dollars.

An appreciating dollar could also prompt a fresh flow of capital into dollar-denominated bonds and instruments and away from higher-yield but riskier investments in the emerging markets. These markets have already been hit hard by sluggish demand for commodities and other exported goods due to slowing Chinese growth.

The Impact of Interest Rates on Pensions and Investments

While low interest rates may encourage spending by making it less profitable to save, they can also have a significant negative impact on long-term savings and investments. "Pensions everywhere in the world were typically already under-funded, and low interest rates have not helped," says Thandi. "When interest rates fall, liabilities increase, which means that they become more under-funded."

The retirees of the next decade would all have started their pensions back in the 70s and 80s, when pensions were much higher – and these funds were set up with the expectation of significantly greater returns. This has been a major contributing factor in the recent shift away from Defined Benefit pension plans, in which retirees know the sums they can expect to receive on retirement. In the current era of low interest, such guarantees are simply becoming too expensive for businesses to maintain.

"This is why," says Ehrhart, "risk capital has become so abundant and so much more efficient for so many industries. Investors have actively sought diversification and reasonable returns. A growing source of diversification has been insurance and reinsurance risk as an asset class with risk adjusted returns continuing to outpace similar risk-adjusted credit indices." Even with a Fed rate rise, interest rates are trending at historically low levels worldwide, and signs suggest we will not regain the norms of the late 1990s or 2000s any time soon. "There is clearly to opportunity for risk managers to find risk transfer solutions to problems that were once thought impossible, and insurers and reinsurers have become the core conduit to these opportunities," concludes Ehrhart.

TALKING POINTS

"The problem is that no one knows how long capital outflows from China will persist or how long the Chinese authorities will continue to intervene. From this standpoint, the Fed's decision to wait to begin liftoff is eminently sensible. And, given that China holds (and is therefore now selling) euros as well, the European Central Bank also should bear this in mind when it decides… whether to ramp up its own program of quantitative easing." – Barry Eichengreen, Professor of Economics, University of California, Berkeley

"The big thing is really the divergence of monetary policy across the world. The Fed may be about to increase its rates, but at the same time the European Central Bank and Japan are about to enter a new round of quantitative easing. What happens when you have these big central banks moving in different directions? Typically, you'd see this play out in their currencies – the dollar should strengthen, and the yen and the euro get weaker. The dollar's central role in global trade means that this will be felt across all businesses." – Jas Thandi, Associate Partner, Global Asset Allocation Team, Aon Hewitt

"Even if savers are willing to tie up their money for one to two years, they are unlikely to get a return much above 1pc now. This is sending exactly the wrong signal to a younger generation which needs to save more for their retirement, as they are likely to live longer than their parents and grandparents." – Andrew Sentence, Senior Economic Adviser, PWC

FURTHER READING

- U.S. Federal Reserve is Right to Raise Interest Rates, Yet Risk Remains – The Guardian, November 6, 2015
- Why Global Markets Want the Fed to Leave Interest Rates Alone – U.S. News & World Report, October 21, 2015
- Opinion: Here's the Big Problem with Low Interest Rates – MarketWatch, November 13, 2015
- Are Your Investments Safe from U.S. Interest Rate Lift-Off? – The Daily Telegraph, November 08, 2015

- Investing in a World of Low Yields – The Economist, November 21, 2015
- Diverging Toward Europe and Switzerland – The Financialist, November 30, 2015
- Aon Market Outlooks – regular updates on the state of global markets