Falling Interest Rates

Why have interest rates been falling steadily for such a long time? Let’s think about interest rates in terms of the demand and supply of bonds, and not as the cost of credit or some abstract cost of money.

Demand for bonds:

- Savings and Investment. Households may deploy their savings in bonds. Households save out of income. The more income, the more savings. The larger the population, the more income there is to be saved out of.
- Social security, pensions and insurance companies demand bonds to match their liabilities.
- Monetary policy. Central banks are significant buyers of bonds, especially in recent years. Much will depend on how the US Fed decides, whether it will restore its balance sheet or maintain it at current levels.
- Greater inequality increases the demand for bonds relative to supply as it increases the savings rate.

Supply of bonds:

- Profligate governments. Running chronic and significant budget deficits soon have a government supplying the market with bonds. There is a current focus on unsustainably high debt levels but this has not yet led to determined action to reduce debt.
- Fiscal policy especially of the Keynesian variety can lead to a healthy deficit in need of financing.
- Social security and healthcare costs money. Lower labour productivity increases social security costs. Ageing populations increase healthcare costs.
- Investment requires funding and heavy investment, for example in infrastructure can result in an increased supply of bonds.