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# With near-zero interest rates unlikely to return soon, public debt will constrain fiscal policy

**In 2021, eurozone interest rates had not risen above 1% since 2009**

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What a difference two years make. In 2021, when interest rates were near zero in the US and the UK and slightly negative in the eurozone and Japan, the consensus was that they would remain low indefinitely. As recently as January 2022, investors put the probability of rates in the US, eurozone and the UK rising above 4% within five years at only 12%, 4% and 7%, respectively. After adjusting for expected inflation, real interest rates - adjusted to remove the effects of inflation - were negative and projected to stay that way.

In fact, despite the US Federal Reserve and other central banks' aggressive monetary tightening, real rates remained significantly negative until late 2022. The Fed recently raised its policy rate to 5.25%. In the US and many other countries, real interest rates have also moved into positive territory. And now that the US appears to have avoided a recession after all, rates will probably stay well above zero for a while.

In 2021, some monetary economists believed that the "neutral" real interest rate had fallen below zero. This shift was widely viewed as a long-term phenomenon. When it comes to fiscal policy, one silver lining of chronically low real interest rates is that they make elevated levels of public debt more sustainable.

Governments could operate with primary budget deficits (which exclude interest payments) and still manage their debt, as it would decrease relative to GDP over time.

But with rates having risen, the US debt is suddenly an issue again. The debt-to-GDP ratio is expected to resume its upward path from here on out. This was one of the reasons that Fitch Ratings downgraded US debt from its AAA credit rating on 1 August. The rise in real interest rates has worsened debt problems elsewhere too, especially in developing countries.

In 2021, investors and economists could be forgiven for expecting rates to stay low in the long term. After all, short-term rates in the US had been near-zero for nine of the previous 13 years, from 2009 to 2015 and again from 2020 to 2021. Similarly, interest rates in the eurozone had been at or below 1% since 2009. In Japan, they have remained under 0.5% since 1996. Such prolonged periods of low interest rates had not been observed since the Great Depression. Comprehensive analyses spanning seven centuries of data on long-term real interest rates have identified a gradual but persistent decline since the Renaissance, at about 1.2 percentage points a century.

Possible explanations for the decline in real interest rates include slowed productivity growth, demographic shifts, growing global demand for safe and liquid assets, rising inequality, lower capital-goods prices and a savings glut coming from east Asia.

Other factors such as longer lifespans and reduced transaction costs could help explain why real rates have been declining for centuries. To be sure, prominent economists did not dismiss the potential for future increases. But while they acknowledged the possibility of periodic rate spikes, many viewed them as unlikely in the short term and transitory in the long run.

In 2018, the former US treasury secretary Lawrence H Summers argued that the US is "likely to have, by historical standards, very low rates for a very large fraction of time going forward, even in good economic times". Short-term nominal interest rates are now above 5%, and real interest rates have returned to positive territory. While some still expect interest rates to revert to zero, they may have been overly influenced by the dramatic shifts of 2008-21.

While I cannot predict the future, I am sceptical that interest rates will return to zero anytime soon. If this assessment is correct, it bodes well for monetary policy, which would be less constrained than previously. But high rates are bad news for fiscal policymakers, who could find themselves once again constrained by unsustainable debt-to-GDP ratios.