**Key Points**

- Real interest rates worldwide are expected to increase in the medium term with the normalization of global economic conditions, reversing the decline into negative territory after the global financial crisis.

- But there will not likely be a return to high real rates. The increase from current levels is expected to be modest, because the factors that have mostly contributed to low real rates in the past recent years are unlikely to reverse substantially:
  - **Saving shifts:** The large increase in emerging market economy saving rate between 2000 and 2007 is expected to be only partly reversed, implying only a modest increase in real rates.
  - **Portfolio shifts:** The increased demand for safe assets since 2000s, which largely reflects the increased riskiness of equity relative to bonds and increased reserve accumulation in emerging market economies, is unlikely to be reversed unless there is a major, unexpected change in policies.
  - **Investment shifts:** The decline in investment rates in advanced economies as a consequence of the global financial crisis is likely to persist.

- Continued low real rates will help borrowers to lower debt ratios, but they also raise new policy challenges. Given the current monetary policy framework, the envisioned low real rate environment implies that the zero lower bound may reemerge as a constraint to monetary policy should risks of very low growth in advanced economies materialize.

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**Real interest rates worldwide have declined substantially since the 1980s and are now in slightly negative territory.** The ten-year global real interest rates, a weighted average of safe real interest rates across countries, has declined from an average of 5½ percent in the 1980s, to 3½ percent in the 1990s, to 2 percent between 2001 and 2008, and to slightly negative territory in 2012 (Figure 1). The cost of capital has also fallen but to a lesser extent because the required return on equity has increased since 2000.
Over the medium term, real interest rates and the cost of capital are likely to rise only *modestly from current levels*. Part of the reason is cyclical: the extremely low real rates of recent years reflect large negative output gaps in advanced economies. The analysis in this chapter, however, suggests that real rates and the cost of capital are likely to remain relatively low even when output gaps are eventually closed.

There are no compelling reasons to expect that long-term real interest rates will quickly return to the average level of 2 percent observed during the mid-2000s. The main reason is that the factors that have mostly contributed to the decline in real rates in the past recent years are unlikely to reverse substantially over the medium term (the conclusions here apply to the risk-free rate):

- **Saving shifts**: The steady increase in income growth in emerging market economies during 2000–07 led to substantially higher saving rates in these economies, especially China (Figure 2). Over the medium term, growth in emerging market economies will be lower than during the precrisis years, and this is expected to result in somewhat lower saving rates. Based on the evidence from previous saving shifts, the magnitude of the effect on real rates is likely to be modest.

- **Portfolio shifts**: More than half the reduction in real rates in the first decade of the 2000s can be attributed to an increase in the relative demand for bonds. This shift reflected an increase in the riskiness of equity and higher demand for safe assets on the part of emerging market economies because of increased official foreign reserves accumulation (Figure 2). This shift is unlikely to be reversed unless there is a major unexpected change in policies: while stronger financial regulation will further increase demand for safe assets, a reduction in both emerging market economy saving and the pace of official reserve accumulation would work the opposite way, although the net effect is likely to be small.

- **Investment shifts**: Scars from the global financial crisis have resulted in a sharp and persistent decline in investment in the advanced economies, which has contributed significantly to the recent decline in interest rates. The effect on saving has been more muted. The findings of the chapter suggest that the investment-to-GDP ratios in many advanced economies are unlikely shift back to precrisis levels during the next five years (Figure 3).

Prospects for continued low real interest rates raise new policy challenges.

- **Low real rates help borrowers to lower debt ratios. For one thing, achieving fiscal sustainability would be less difficult.** The results presented in the chapter show that if real rates were to remain around 1.5 percent — which is about 1 percentage point lower than the October 2013 WEO projection—the average
advanced economy could achieve the same debt targets with a primary-surplus-to-GDP ratio reduced by about 0.8 percentage point a year, all else equal.

- **In a low real rate scenario, increasing public investment may not lead to increases in public debt in the medium term.** If real rates are expected to be close to or lower than real GDP growth rates for a prolonged period of time, some increases in debt-financed government spending, especially public investment, may not increase public debt in the medium term.

- **A period of continued low real interest rates could mean that the neutral policy rate will be lower than it was in the 1990s or the early 2000s.** It could also increase the probability that the nominal interest rate will hit the zero lower bound in the event of adverse shocks to demand with inflation targets of around 2 percent. This, in turn, could have implications for the appropriate monetary policy framework.

- **Finally, savers may suffer, and an environment of continued low interest rates may induce financial institutions to search for higher yields by taking on more risk.** This, in turn, may increase systemic financial sector risks, and raise the importance of appropriate macro- and micro-prudential oversight for maintaining financial stability.