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The Upshot

A HISTORY OF MONEY

Why Very Low Interest Rates May Stick Around

Neil Irwin @Neil_Irwin DEC. 14, 2015

The Federal Reserve will most likely raise interest rates this week for the first time in nearly a decade. To understand what it means — and doesn't mean — consider a previous year in which interest rates were on the rise.

In 1920, borrowing costs soared to their highest levels since the end of the Civil War. Some people were terrified of what it was doing to the economy. Higher rates "would practically legalize usury," a real estate trade group warned. A Democratic senator complained that "manufacturers, merchants and businessmen are entitled to stability" after a steep rise in rates. The Federal Reserve was "confronted with conditions more or less abnormal," acknowledged a governor of the central bank, William P. G. Harding.

The interest rate that caused this anxiety? A mere 5.4 percent on the 10-year United States Treasury note — lower than the rates during the entirety of the 1980s and most of the 1990s.

What does this have to do with the Fed's likely move this week? For years, financial commentators have been predicting an imminent rise in rates. After all, goes the theory, the Fed has been engaged in extraordinary interventions to artificially depress the cost of borrowing money. Surely those rates will snap back to their pre-2008 levels, if not rise higher. If that happens, get ready for double-digit

mortgage rates and a substantially higher cost to maintain the government debt.

But if you look at the longer arc of history, a much different possibility emerges. Investors have often talked about the global economy since the crisis as reflecting a "new normal" of slow growth and low inflation. But, just maybe, we have really returned to the old normal.

Very low rates have often persisted for decades upon decades, pretty much whenever inflation is quiescent, as it is now. The interest rate on a 10-year Treasury note was below 4 percent every year from 1876 to 1919, then again from 1924 to 1958. The record is even clearer in Britain, where long-term rates were under 4 percent for nearly a century straight, from 1820 until the onset of World War I.

The real aberration looks like the 7.3 percent average experienced in the United States from 1970 to 2007.

"We're returning to normal, and it's just taken time for people to realize that," said Bryan Taylor, chief economist of Global Financial Data, which scours old records to calculate historical financial data, including the figures cited here. "I think interest rates are going to stay low for several decades."

If so, it would mean that many predictions through the last several years of ultralow interest rates have misread the situation. "Once the economy gets going, then interest rates are going to take a big leap," said George Soros, the billionaire hedge fund manager, in a 2013 CNBC interview.

"We can expect rapidly rising prices and much, much higher interest rates over the next four or five years," wrote the economist Arthur B. Laffer in The Wall Street Journal in 2009. In 2014, all 67 economists surveyed by Bloomberg predicted higher rates six months later; they fell sharply instead.

Of course, rates could go up. But what that analysis may have missed is that interest rates historically are most closely tied to inflation. How much investors demand as compensation for lending their money is shaped in no small part by how much they think that money will be able to buy when they get it back. And the pressures that normally generate inflation seem to have disappeared in recent years.

The Fed and its counterparts overseas at the European Central Bank and Bank of Japan have spent the last few years applying every policy they can think of to get inflation to rise up to their 2 percent target, with limited success. In a world awash in supply of workers, oil and more, financial markets show little sign that investors think that will change anytime soon. Current Treasury bond prices predict annual inflation in the United States of only 1.7 percent a year over the next three decades.

That would imply that we are in an economic era more like the late 19th century, with persistent low inflation or mild deflation, or perhaps like the 1950s, when the economy was growing but inflation was firmly in check.

“If we keep inflation under control, maybe we’ll enter a period like the ’50s,” said Richard Sylla, a financial historian at New York University and co-author of “A History of Interest Rates.” “Those were normal rates, and they were accompanied by a slight amount of inflation, 1 or 2 percent. That worried people then, where now it’s a target to be reached.”

Both financial markets and Federal Reserve officials seem to believe some version of this forecast. To understand why, it helps to start with a bit of the math behind the multitrillion-dollar bond market.

A crucial driver of long-term interest rates (which the Fed doesn’t directly control) is what investors think the Fed will do with short-term interest rates (which it does control). If people thought the Fed was going to raise short-term interest rates up to 5 percent soon, no one would lock their money up in a 10-year bond paying only 2.2 percent.

And while the central bank is likely to move that rate up a quarter percentage point at the two-day meeting that ends Wednesday, in their most recent forecasts Fed officials have made clear that they don’t expect that rate to rise back to levels that were common before the global financial crisis.

At the onset of the crisis in 2007, the Fed’s official target rate was 5.25 percent. Now the officials’ median forecast for that rate’s longer-term level is a mere 3.5 percent.

In other words, even after they are done with a series of rate increases, Fed officials envision interest rates substantially lower than they were. If anything, financial markets think even this is too optimistic. Thirty-year Treasury bonds are currently yielding 2.9 percent, implying that markets expect the Fed's target rate to be even lower than Fed officials expect over the coming decades.

Markets, and Fed forecasts, can be wrong, of course. Neither in 2007 predicted the sharp downshift in inflation and rates that was to come in the crisis. And our understanding of what shapes inflation and growth dynamics is quite limited.

Still, starting with Japan in the 1990s and now across the advanced world, the predominant problems of the last several years have revolved around weak demand, plenty of supply, low inflation and resulting very low interest rates. The simple fact that the Fed is poised to raise rates a bit above zero doesn't change that.

But the lessons of history do offer this guidance: Whether rates will be high or low a few years from now has very little to do with what the Fed does this week. It has quite a lot to do with what happens to forces deep inside the economy that are poorly understood and extremely hard to forecast. And just because many people are old enough to remember the high inflation and high rates of the 1970s and 1980s doesn't mean that is the normal to which the economy will inevitably revert.

Correction: December 14, 2015

An earlier version of this article misspelled the first name of an economist. He is Bryan Taylor, not Byron.

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