Anxiety and interest rates: How uncertainty is weighing on us

By Robert J. Shiller
February 7, 2015 – *The New York Times*

Anxiety and uncertainty are weighing on individuals even where the overall economy is growing.

Some of this angst is the fallout from advances in information technology. The Internet, ubiquitous computing, robotics, 3-D printers and the like are wonderful advances, yet they may also be personal threats: For some, the technologies may eliminate our jobs or potential future jobs, or make them less lucrative. For others, they may bring new riches.

Even people with moderately high incomes have reason to be uncertain. Some college professors, tenured or not, might lose their jobs in the face of massive open online courses, while others prosper from them. Lawyers might find less demand for services that can be supplanted by computerized legal research tools. News and entertainment media have already faced huge technology-related job losses.

Along with this enormous problem is the psychic cost of growing income inequality. Poor people, who see themselves slipping further and further behind, are hurting, of course. What's less obvious is that yawning inequality also seems to be preoccupying the rich. For example, an Oxfam report issued last month, "Richest 1 Percent Will Own More Than All the Rest by 2016," was the focus of many nervous conversations at the recent World Economic Forum in Davos, Switzerland, which I attended. Davos is a gathering of the global elite yet even many of those in such rarefied circles are wondering whether they and their friends and loved ones will lose their privileged status in the future.

Such fears are not measured by the usual consumer confidence indexes. The University of Michigan Consumer Sentiment Index reached its highest level since 2004 in January. But this index, and others like it, look ahead only into the short term and report about perceived aggregate conditions rather than individual risks.

I suspect that there is a real, if still unsubstantiated, link between widespread anxieties and the strange dynamics of the economic world we live in today — a link that helps to explain why it's not just short-term interest rates that are very low, but long-term rates, too. Understanding long rates might also help explain why stock market prices are so high in some countries and why real estate prices have come up in many places since the financial crisis.

In the United States, for example, the 30-year Treasury bond yield hit a record low on Jan. 30 of 2.25 percent, and the 30-year fixed-rate home mortgage reached 3.59 percent as of Feb. 5, also a very low level. The rate for 30-year Treasury Inflation Protected Securities was just 0.52 percent on Jan. 30. These unusual rates cannot be attributed entirely to the Federal Reserve, because it stopped quantitative easing in October, and rates have dropped since then. While other central banks certainly are affecting global interest rates, something else is going on.

One puzzle is that many people are willing to lock up their savings at these paltry rates for decades. When rates are this low, there may seem to be very little incentive for people to save. Yet according to the Bureau of Economic Analysis, personal saving as a fraction of disposable personal income stood at 4.9 percent for the United States in December. That may not be an impressive level, but it's not particularly low by historical standards. The answer may be that all this uncertainty impels them to do that.

In a classic 1978 paper, "Asset Prices in an Exchange Economy," a University of Chicago economist, Robert Lucas, presented a mathematical model that shows that increased uncertainty about future incomes can indeed push up all asset prices and push down expected returns, even in perfectly efficient markets.

When there is unusual uncertainty about the future, and if not enough new business initiatives can be found to increase the supply of good investments, people will compete to bid up existing investable assets. They may go so far in bidding up prices that even though the assets may have horrible prospects, people will still want to hold them because they feel they have to save somewhere.

There is a great deal that we don't know about market movements. Interest rates and prices generally reach extreme levels when there is an unusual confluence of many precipitating factors, like anxiety, and others as well. We are usually puzzled by this multiplicity.

And, because markets are really not very efficient, the effect of these varied factors tends to be amplified through emotional feedback. For example, when people start to see rates or prices changing, some of them take action: They are enticed into the market when prices are rising, and often leave when prices fall. We then are typically surprised by the extent of apparent market overreaction to precipitating factors that we didn't think were really on everyone's mind.

At the moment, anxiety does not seem to be the basis of much public discussion of asset pricing. That's understandable: There may be no real benefit from bringing up the effect of these diffuse fears on market strategy with your tax preparer, lawyer or financial adviser, who surely will not have an authoritative opinion on what to do about them.

Anyone can tell you that there is no certainty about the effect that new technologies will have on job security in coming decades: There is a risk, but it is hard to quantify for general categories of jobs, and nearly impossible to calculate for individuals. Yet these concerns have effects on investor decision-making through the emotional component of our actions — what John Maynard Keynes, the great British economist, called our animal spirits.

Uncertainties about individual economic fortunes can affect asset prices through an important indirect channel, government policy, which is swayed by popular concerns. Raghuram Rajan, governor of the Reserve Bank of India, in his book "Fault Lines: How Hidden Fractures Still Threaten the World Economy" (Princeton 2010) argued that governments were more tolerant of excessive credit expansion when their citizens were upset about rising inequality. Governments, he said, use expanded credit in a desperate effort to placate a dissatisfied electorate. Credit expansion can create housing bubbles and an illusion of wealth for many people, for a while, at least. The idea is: "Let them eat credit."

But with rising anxiety about our economic lives and about the state of the markets, we need something more substantial than credit expansion to help us. We all need to think hard about the underlying mechanisms producing individual uncertainty and inequality, and we need to devise financial and insurance plans to help us to deal with whatever looms ahead.

Robert J. Shiller is Sterling Professor of Economics at Yale and has released a new Third Edition (Princeton 2015) of his book "Irrational Exuberance."