Why are interest rates so low? And what can you do about it?

Many savers in Malta have been expressing their disappointment and frustration at the persistently low interest rates that their banks have been paying them on their hard-earned savings. However, this is not restricted to Malta, and has been a feature that savers have had to face across the world. Never in recent economic history have savings rates been so low for such a length of time in advanced economies, including the EU.

Banks in the Eurozone base their interest rates on the interest rates quoted by the European Central Bank (ECB). For many months now the short-term intervention rates of central banks have been effectively zero, and yields on long-term government bonds have been at less than 0.2% for a 10-year German Treasury bond. Yields on a range of short to medium-term bonds have even turned negative, which means that the investor pays interest rather than earning it!

Many people ask why. One of the factors is the expectation of continued low inflation across the world. Usually, an investor expects to benefit from an “inflation premium”, i.e. the investor expects to be compensated through higher interest rates for committing to a long-term investment. However, in recent years the inflation premium came down to very low levels, attributable to the success of central banks in keeping inflation low and stable.

Just like the Federal Reserve and the Bank of England before it, the ECB has led a policy of large-scale purchasing of government bonds which is known as ‘quantitative easing’ (QE). Through this process, the ECB has injected a substantial amount of liquidity into the banking system, thereby pushing interest rates even lower. The aim is to generate economic growth in the wake of the global financial crisis by cutting borrowing costs in order to encourage businesses to invest more and to create jobs. Low lending rates in turn means that inevitably, banks cannot offer better interest rates to their depositors. In Europe, this policy will continue at least until the end of this year, although the ECB’s monthly purchase of bonds will be reduced to

€60 billion from €80 billion, as from next April. So Eurozone interest rates continue to be at record lows. Last month the ECB kept both the deposit rate and the lending rate steady at -0.4% (negative) and 0.25%, respectively. It is therefore no surprise that senior bankers warn that very low savings rates are likely to be the norm for some time, given the precarious economic situation across the world.

Given this scenario, if you want your money to at least keep pace with inflation, you will need to look at other alternatives such as investments instead of a regular savings account. Such investments would include stocks, bonds and mutual funds. However, there is more risk involved with such investments. Local banks do provide guidance for financial planning if you wish to take this step and decide you want to build your wealth with specific goals in mind, including retirement.

If you choose to invest, you would still need to keep a cash reserve in a savings account that you can access easily in case you need to access money quickly for an unexpected expense or emergency. Investments may take time to sell and it may not always be opportune to do so.

It is therefore important to understand the difference between saving money and investing. When you save money, you are putting it aside to cover a rainy day but when you invest money, you are putting it to work for you and to help you build up your wealth. Being aware of this concept will help you make wise financial decisions. (606 words)

Ray Calleja **12 Feb 2017**

Ray Calleya, is Head of consumer banking at Mediterranean Bank. He is writing on behalf of the Malta Bankers' Association