

McKinsey Global Institute

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Briefing note

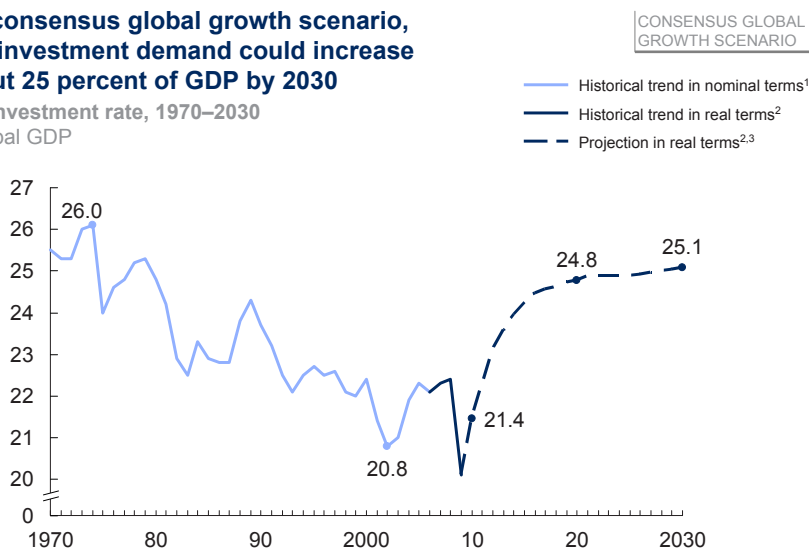
Farewell to cheap capital? The implications of long-term shifts in global investment and saving

The recent bursting of the global credit bubble followed three decades in which capital became progressively cheaper and more easily available. In this report, we offer a new view of why interest rates fell during this period and we show why they are likely headed higher in the years ahead.

We find that the long-term trends in global saving and capital investment that contributed to low rates in the past will reverse in the decades ahead. This is primarily because developing economies are embarking on one of the biggest building booms in history. Rapid urbanization is increasing the demand for new roads, power systems, and other public infrastructure. Companies are building new plants and buying machinery, while workers are upgrading their housing. At the same time, aging populations and China's efforts to boost domestic consumption will constrain growth in global saving. The world may, therefore, be entering a new era in which the desire to invest exceeds the willingness to save, putting upward pressure on real long-term interest rates.

In the consensus global growth scenario, global investment demand could increase to about 25 percent of GDP by 2030

Global investment rate, 1970–2030
% of global GDP



1 Based on actual prices and exchange rates of each year.
 2 Shown in 2005 prices and exchange rates.
 3 Forecast assumes the price of capital goods increases at the same rate as other goods and assumes no change in inventory.
 SOURCE: Economist Intelligence Unit; Global Insight; McKinsey Global Economic Growth Database; Oxford Economics; MGI Capital Supply & Demand Model; World Bank's World Development Indicators; McKinsey Global Institute

What's new?

This McKinsey Global Institute research sheds new light on why interest rates fell over the past three decades, and the forces that will influence them in the future. We analyze long-term trends in saving, capital investment, and interest rates globally and in a sample of 14 major economies. We also examined how the patterns of saving and investment could vary in the next two decades under different scenarios for GDP growth.

Takeaways

Capital costs are likely to increase in coming years, largely due to an impending capital investment boom. If real long-term interest rates were to return to their average since the early 1970s, they would rise by about 150 basis points. Real long-term rates may start moving up within five years as markets anticipate this structural trend.

Download the full report at www.mckinsey.com/mgi

- Throughout the report, we use “investment” to refer to gross capital investment in physical assets such as infrastructure, housing, plant, machinery, and equipment. This does not include investment in stocks, bonds, or other financial assets.
- Total investment around the world from 1980 through 2008 averaged \$700 billion per year less than it would have been had the investment rate of the 1970s persisted—a cumulative sum of \$20 trillion.
- China accounted for 23 percent of global saving in 2008, the year it overtook the United States as the world’s largest saver.
- In a consensus global growth scenario, we project desired global investment will rise from \$14 trillion in 2009 to \$24 trillion in 2030, in nominal terms, at constant 2005 prices and exchange rates.
- China could account for 25 percent of the world’s total desired new investment in 2030.
- Future global investment demand could increase if policy makers require new measures to bring greenhouse gas emissions to sustainable levels, and to help people adapt to the effects of global warming. While there is still substantial uncertainty about the likely size of these investments, they are likely to increase the gap between desired investment and saving, possibly putting additional upward pressure on real interest rates.
- We did not consider the potential effects on saving and investment of a sharp rise in commodity prices, since that would merely transfer saving from the commodity consumers to the commodity producers, without a significant net change globally.

Since the 1970s, global investment as a share of GDP fell from 26.1 percent to a recent low of 20.8 percent in 2002. Total investment around the world from 1980 through 2008 averaged \$700 billion per year lower than it would have been had the investment rate of the 1970s persisted—a cumulative sum of \$20 trillion.

The \$20 trillion dwarfs some other commonly cited explanations for falling interest rates. This amount is nearly four times the size of cumulative Asian current account surpluses and nearly five times the growth in money supply in excess of GDP over the same period. Therefore, this substantial decline in the demand for capital was a key contributor to the three-decade-long fall in real interest rates that helped feed the global credit bubble.

The world is now at the start of another potentially enormous wave of capital investment, this time driven primarily by emerging markets. We project that by 2020, global investment demand could reach levels not seen since the postwar rebuilding of Europe and Japan and the era of high growth in mature economies. Global investment could increase from \$11 trillion today to \$24 trillion per year by 2030 (in real terms).

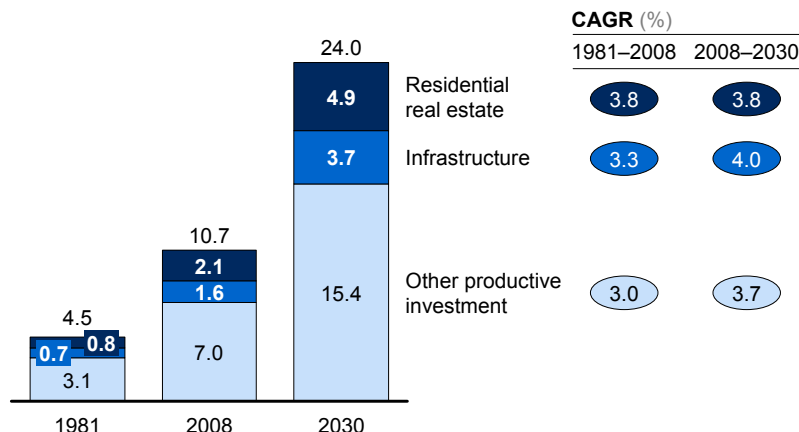
The mix of investment will change, with projected global infrastructure investment rising to \$3.7 trillion in 2030 and projected residential real estate investment rises to \$4.9 trillion.

In 2030, global desired residential real estate investment is expected to reach about \$5 trillion per year, while desired infrastructure investment will reach about \$4 trillion

CONSENSUS GLOBAL GROWTH SCENARIO

Desired global investment¹ by industry

\$ trillion, selected years, constant 2005 prices and exchange rates



¹ Forecast assumes the price of capital goods increases at the same rate as other goods and assumes no change in inventory. SOURCE: Economist Intelligence Unit; Global Insight; McKinsey Global Economic Growth Database; Oxford Economics; World Development Indicators of the World Bank; MGI Capital Supply & Demand Model; McKinsey Global Institute

Global saving is not likely to increase enough to fund all projected future investment demand. China’s saving rate will likely decline as it rebalances its economy so that domestic consumption plays a larger role in generating GDP growth. Meanwhile, the aging of the world’s population will increase spending on health care, pensions, and other services for the elderly, which will lower global saving, either through larger government deficits or lower household and corporate saving. Therefore, in most of the economic growth scenarios we considered, saving will not increase enough to meet desired investment by 2030, leaving a gap between the two. This gap could range from \$1 trillion to \$2.4 trillion, which would put upward pressure on rates.

The difference between the demand for capital to invest and the supply of saving will likely cause real long-term interest rates to rise. We do not predict how much interest rates will increase. But if rates were to return to their average since the early 1970s, they would rise by about 150 basis points. And real long-term rates may start moving up within five years as investors anticipate this structural shift. Capital costs could easily go higher. Real interest rates also include a risk premium to compensate investors for the possibility that inflation might increase more than expected. History shows that real interest rates rise when investors worry about the possibility of unexpected spikes in inflation. Today, many investors are beginning to anticipate higher inflation because of central banks' monetary policies aimed at stimulating economic growth.

Implications

The world may be entering a new era in which capital is more costly and less plentiful. Higher interest rates would benefit savers and perhaps lead to more restrained borrowing behavior than we saw during the credit bubble that preceded the 2008 financial crisis. However higher capital costs would constrain investment and could slow the global economic growth rate by a little less than 1 percentage point. To avoid this outcome, it will be necessary to increase global saving or raise capital productivity.

Business models and investment strategies will have to evolve. Financial institutions will have to expand their operations in developing economies and develop new products to serve the customers and access the savers there. Non-financial companies will have to boost their capital productivity. Having access to secure funding could be a competitive advantage. Investors will want to adjust their portfolios and strategies as the returns on different types of investments change.

Governments could play an important role in easing the transition. Policy makers should encourage the flow of capital from the world's savers to the places where it can be invested in productive ways, while minimizing the risks inherent in closely intertwined global capital markets. In mature economies, they should encourage more saving and domestic investment. In developing economies, they should promote the continued development of deep and stable financial markets. At the same time, they should create the conditions to promote long-term funding and avoid "financial protectionism" measures that prevent cross-border capital flows. They should ease constraints on cross-border investing, such as restrictions on pension funds and other investors or on capital accounts.

Business leaders and policy makers should enable and encourage more long-term investment funding. They must create the governance and incentives that enable managers of investment funds with long-term liabilities (such as pension funds, insurance companies, and sovereign wealth funds) to focus on long-term returns and not quarterly results that reflect market movements and can deviate from intrinsic valuations.