A Scarred Economy

Why the natural real interest rate remains low.

BY BIAGIO BOSSONE

When central bankers reflect on the first quarter of the twenty-first century, one defining trend may stand out prominently: the enduring decline of the natural real interest rate—the real rate consistent with full employment and stable inflation over the medium term. The idea originates in Swedish economist Knut Wicksell's concept of the "natural rate" of interest. In contemporary policy debates, it is frequently termed the neutral rate, or *r**.

After falling sharply following the global financial crisis, *r** struggled to recover during the long post-crisis expansion, declined again after the pandemic, and has remained unexpectedly subdued even after one of the most aggressive global tightening cycles in decades.

Many policymakers entered the inflation shock of 2021–2023 with the expectation that the ensuing surge in policy rates would reset *r**. Yet that reset has not occurred. Estimates produced by widely used frameworks (such as the Laubach-Williams approach used by the Federal Reserve) continue to place *r** in most advanced economies close to zero in real terms, far below its levels prior to the global financial crisis.

Long-term real yields remain patchy across markets, and the anticipated broad "reset" has definitively not taken shape. This anomalous outcome has reopened questions that once seemed resolved: what exactly determines *r**, and why has it proved so resistant to the very forces that, in theory, should have lifted it?

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The standard explanations—demographic aging, chronically weak productivity, global savings patterns, rising demand for safe assets—still matter. Yet they leave something essential unexplained. They treat r^* as if it were determined entirely by slow-moving structural forces, independent of psychology, memory, and institutional experience. That assumption no longer holds.

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A deeper dynamic has been shaping the macroeconomic environment, one tied not to long-run fundamentals but to the way societies have lived through, processed, and internalized a succession of shocks. Over the past fifteen years, the global economy has accumulated a kind of macroeconomic scar tissue. Households, firms, and financial institutions have developed a heightened sensitivity to uncertainty—one that is no longer cyclical or episodic but persistent. This shift acts through an old but oft-disputed channel—John Maynard Keynes's theory of liquidity preference—and through that channel, it exerts a steady downward pull on r^*.

We are now living in a world where uncertainty has become entrenched in agents' beliefs, due to a sequence of crises that have fundamentally altered what they consider to be possible. The central challenge for monetary authorities is that interest rates cannot escape the gravitational force of this new belief regime.

A DECADE AND A HALF THAT CHANGED EXPECTATIONS

What distinguishes the recent era is the accumulation of many shocks. The global financial crisis shattered confidence in the stability of the financial system. The euro area sovereign debt crisis eroded assumptions about fiscal and monetary cohesion within an advanced-currency union. Trade tensions, tariff wars, and geopolitical rivalry began reversing decades of global economic integration. Then came the pandemic, the sudden paralysis of economic life, supply chain collapses, unexpected inflation, and the fastest tightening cycle in a generation. All of this was followed by war in Europe, a resurgence of political and geopolitical fragmentation, and renewed conflict in the Middle East. These episodes did not merely disturb expectations; they rewrote them.

One can debate whether the economic fundamentals driving these events were new or whether the shocks were simply unusually visible. But for expectations formation, this distinction is irrelevant. What matters is that the lived experience of households, business leaders, and global investors changed. Shocks that were once considered tail risks became part of the ordinary decision-making horizon. A series of events that in earlier eras might have been treated as "one-offs" instead accumulated into a new set of conventions about the instability of the future.

It is this accumulation that has transformed uncertainty from a transient disturbance into a structural feature of the macroeconomic landscape.

THE RETURN OF LIQUIDITY PREFERENCE

Keynes's liquidity preference theory is often reduced to a behavioral account of why interest rates may not equilibrate saving and investment in the way classical theory presumes. But that simplification misses the theory's most profound insight: liquidity preference is fundamentally about the demand for stocks, not flows. It is about the desire to hold a buffer of safe, liquid assets to guard against unknown futures. Liquidity preference is not simply a reaction to interest-rate differentials; it reflects how households, firms, and investors assess the security of their balance sheets in an uncertain world.

This stock dimension matters enormously. When uncertainty is high, agents do not merely reduce spending or postpone investment at the margin. They rebuild balance sheets, restructure portfolios, and accumulate liquidity cushions. They shift not just their behavior, but their entire position in the asset space. They seek safety not because yields rise or fall, but because safety itself has become intrinsically valuable.

Liquidity Preference in The New Era of Economic Shocks

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—*B. Bossone*

Over the past decade, firms have hoarded cash, households have increased buffer savings, banks have shortened duration, and global investors have loaded up on government securities. These are not marginal adjustments. They are stock adjustments designed to insure against a world perceived as riskier, more volatile, and less predictable than before. They reflect a preference for liquidity as a state of readiness, not as an arbitrage response.

The natural rate may have fallen not because of structural shifts alone, but because the beliefs that underlie liquidity preference have changed. Agents have learned from experience that extreme shocks are possible.

In this environment, liquidity preference becomes a powerful, structural force pulling down long-term real interest rates. The more uncertain the world appears, the more society desires liquid assets. And because the supply of truly safe, liquid assets is limited, the premium on those assets rises, compressing yields regardless of the stance of monetary policy.

A key implication is that monetary tightening does not automatically reduce liquidity preference. Raising policy rates affects the flow cost of holding liquidity, but if the underlying motive is fear of the future, the stock demand for safe assets remains elevated. Households and investors are willing to forego higher returns in exchange for the reassurance that liquidity provides. This mechanism helps explain why the natural rate remains subdued even in periods of rising nominal yields.

WHEN THE NATURAL RATE BECOMES BELIEF-CONTINGENT

Because liquidity preference is rooted in beliefs rather than purely in fundamentals, its effects on r^* depend on the prevailing belief regime. This broader role of sentiment in economic decision-making is explored in my recent book *Bringing Sentiment into Economic Rationality* (Springer Nature, 2026), which argues that expectations shaped by lived experience can become structural drivers of macroeconomic outcomes.

When societies feel secure, liquidity preference is moderate, risk tolerance is higher, and r^* drifts upward as investment prospects improve. But when societies feel insecure, precautionary motives dominate, liquidity is prized as protection, and r^* falls—even if demographic and technological forces remain unchanged. In other words, the natural rate varies with the state of expectations: it becomes belief-contingent rather than purely structural.

Over the past decade, financial markets, policymakers, and academics have treated the decline in r^* as a structural phenomenon, driven by deep economic trends. But the extraordinary persistence of uncertainty—and its imprint on balance sheet behavior—suggests a different interpretation. The natural rate may have fallen not because of structural shifts alone, but because the beliefs that underlie liquidity preference have changed. Agents have learned from experience that extreme shocks are possible. This insight helps reconcile an apparent paradox: despite the dramatic rise in policy rates since 2021, estimates of r^* have not shifted nearly as much as might have been expected.

Beliefs about the future are also shaped by the credibility of economic institutions. When policy frameworks are trusted, uncertainty diminishes and private actors feel less need to insure themselves through large liquidity buffers. But when institutional credibility weakens, or when policy appears inconsistent, precautionary motives intensify. In this sense, credibility does more than anchor inflation expectations—it shapes the broader belief environment within which households, firms, and investors form their portfolio decisions. Through this channel, credibility can influence liquidity preference itself and therefore the level of the natural rate.

We are now living in a world where uncertainty has become entrenched in agents' beliefs.

A NARROWER MONETARY POLICY SPACE

A belief-contingent r^* alters the terrain on which central banks operate. If elevated liquidity preference depresses r^*, then the effective space for monetary expansion shrinks. Policy rates may have to approach zero—or even fall below it—to stimulate demand in times of stress. In fact, further reductions in policy rates may do little to stimulate spending because economic agents remain reluctant to run down their liquidity buffers, and monetary easing encounters a practical limit even before policy rates reach the zero lower bound. One might think of this constraint as a "liquidity-preference floor"—a situation in which precautionary demand for liquidity weakens the ability of lower interest rates to stimulate economic activity.

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This is why credibility, communication, consistency, and institutional stability have become more important than ever. They are not just tools for anchoring inflation expectations. They are tools for shaping the belief environment itself. When central banks are trusted, and when the surrounding institutional ecosystem is coherent, uncertainty diminishes and r^* rises, giving monetary authorities more room to maneuver. Credibility functions as a macroeconomic stabilizer precisely because it counteracts the downward pressure on the natural rate created by elevated liquidity preference.

And yet, not even credibility alone might be enough to erase decades of accumulated shock experience. The drivers of uncertainty—geopolitical fragmentation, climate instability, economic rivalry, technological disruption, wars—lie outside the central banks' remit. This means monetary policy must accept the reality of working in a world where chronic uncertainty depresses the natural rate and narrows the usable policy corridor.

This also implies that restoring policy space is not simply a matter of moving interest rates. It requires rebuilding confidence in the durability of the economic and institutional environment within which private balance sheets are formed. Monetary policy remains necessary, but it is no longer sufficient on its own. Fiscal policy, institutional stability, and credible economic governance all play a role in shaping the expectations that ultimately determine liquidity preference and the level of the natural rate.

A FUTURE STILL SHAPED BY THE PAST

The scars of recent crises will hopefully fade, at some point, as new experiences, new narratives, and new conventions emerge. But until they do, uncertainty will continue to exert structural influence, shaping balance sheets, portfolio allocation, risk-taking behavior, and ultimately interest rates. Economies remember. And for the time being, this memory points toward caution.

If the future feels persistently fragile, households, firms, and investors will naturally choose to hold more liquidity. And when liquidity becomes a prized stock of security, the natural rate remains weighed down. Central banks therefore face a new challenge: they must help economies not only navigate shocks but gradually transcend their memory. Managing expectations now means managing the broader sense of stability in which economic decisions are made. Until confidence is rebuilt, the forces shaping r^* will lie not only in demographics or productivity, but in the deeper influence of elevated liquidity preference, an influence that may itself be one of the hidden drivers of secular stagnation. ◆

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