

The Discount Rate

Knowing or unknowingly, the discount rate plays a critical role in many of our daily routines and decisions. Since it guides our behavior, it also impacts the timing and effectiveness of economic policies, the role of government in society, and can guide reform priorities including preparing for a post-crisis world.

Before we proceed, we first have to define what the discount rate is. Essentially, the discount rate captures the trade-off between enjoying something today and in the future. A person with a high discount rate has a strong preference for here and now and is alternatively described as impatient, having a high rate of time preference, or a short planning horizon. The market discount rate is in turn shaped by the prevailing macroeconomic conditions and by aggregated individual preferences.

Many economic decisions revolve around the discount rate, not in the least, the decision whether to consume now or save for future consumption. After all, a patient person that saves today earns interest, allowing more consumption in the future. However, future consumption is valued less than current consumption and we will only save if the interest earned compensates for our impatience.

So how is this concept of the discount rate applied in the broader economic context? Some observers have argued that the emergence of global imbalances (the large current account deficit in the United States matched by large surpluses in countries that rely on exports, including of commodities) can partly be attributed to the U.S. consumer being relatively more “impatient” leading to high, and by some measures excessive, consumption before the onset of the global financial crisis.

The stock market too depends on the discount rate. Equity values are, or should be, determined to a large extent by the (expected) discounted stream of current and future dividend payments. As famed investor Warren Buffet once put it “The stock market is simply the transfer of wealth from the impatient to the patient”.

Our collective discount rate also informs us about the merits of implementing economic policies now or later. This applies in particular to long-term challenges the world is facing, including from population aging and climate change. The more weight we attach to the future, the more beneficial it is to tackle the prospective fiscal burden from demographic change head-on. This is also the case for the economic costs associated with climate change. The Stern Review concluded that the costs of climate change could total a whopping 5-20 percent of global GDP per year if left unaddressed. The lower the discount rate, the greater the benefits of early actions designed to reduce greenhouse gas emissions.

Countries rich with natural resources also face a delicate trade-off between now or later. This applies both to the extraction rate of commodity reserves and the management of resource revenues.

These longer-term issues affect several generations and the lower the discount rate, the more weight we place on the well-being of future generations.

The effects of economic policies also depend on the discount rate. It has been demonstrated that fiscal stimulus is more effective if consumers have a shorter planning horizon. There are good reasons for this. If households take a long-term perspective, a tax cut today will simply be saved to pay for higher taxes in the future to redeem the higher government debt. Some have suggested that this partly explains the recent increase in consumer savings in the U.S. This is the case for wealthy households, but not for the poor who live from paycheck-to-paycheck and have no income to save. The larger the share of the latter group, the more fiscal stimulus increases consumption and output, at least if the stimulus is TTTT: targeted, temporary, transparent, and timely.

The role of government in society is also influenced by our collective view on the (appropriate) discount rate. For example, apart from being used for income redistribution and risk sharing, social protection systems in many countries have evolved recognizing that voluntary savings or insurance are often inadequate as households' insufficiently plan for the future. As a result, in many countries the government takes a pro-active stance to ensure that people's incomes are sufficiently insured against various risks, such as disability and unemployment, and that savings are adequate for retirement.

In other words, the government institutes policies to lengthen the planning horizon of households. In other instances, economic theory suggest that it is the government itself that may need to be constrained. Fiscal rules, anchoring the budget in a medium-term framework, and a fiscal responsibility law have been adopted in various countries to ensure that the incentives of policymakers are sufficiently long term.

A high discount rate also contributed to the current global financial crisis. Financial sector regulation did not sufficiently account for changing economic tides, while bonuses packages were focused on short-term financial results with insufficient appreciation for risks associated with securitization and leverage. As a result, improved financial sector regulation to achieve countercyclical and risk-based provisioning and capital-adequacy requirements are now one the top of the agenda to reform the international financial sector architecture. There is also a need to strengthen self-regulation in the financial sector, which requires bonus packages in line with the longer-term objectives of shareholders.

Even though the world economy is recovering, global trade will remain subdued, and many emerging economies, including in Asia, will have to rely increasingly on domestic consumption. Strengthening the social safety net, expanding insurance markets, and improved access to financial markets would reduce pre-cautionary savings and instead allow households to live more in line with their preferences and increase their consumption.