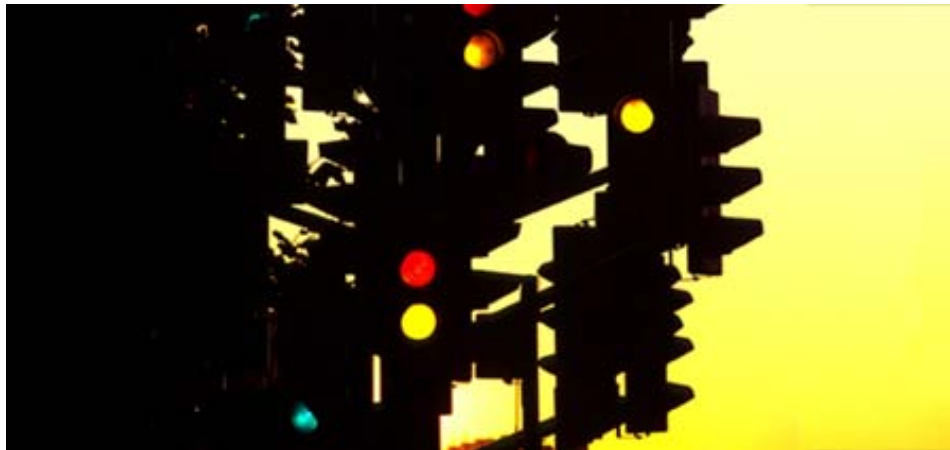


[About sponsorship](#)**World economy****Traffic lights on the blink?**

Aug 18th 2005

From The Economist print edition

Alamy

**Capital markets are hindering, not helping, global economic adjustment**

THE world currently displays an alarming number of large economic and financial imbalances. America's current-account deficit is forecast to widen to over \$800 billion this year, while Germany, Japan and China look set to run record surpluses. Total government debt in rich economies has risen to a new high as a percentage of GDP, and in many countries households are sliding ever further into debt. Meanwhile, the growth rates of America and other rich economies have diverged to an unusual degree.

Many economists try to explain these trends in terms of underlying structural factors, such as differences in demographic trends or productivity growth. An alternative, more worrying, explanation is that the price signals that are supposed to bring the world economy back into balance have become distorted.

Start with the most obvious example: America's current account. In theory, a rapidly rising current-account deficit should cause investors to demand higher interest rates to compensate them for the increased risk of currency depreciation. Dearer money then helps to dampen domestic spending and thus trim the external deficit. This is what happened when America's current-account deficit exploded in the first half of the 1980s. Real bond yields rose, cooling domestic demand. Along with a cheaper dollar, this helped to reduce the deficit.

This time, however, the adjustment mechanism has jammed: real American bond yields have fallen not risen over the past few years, partly because Asian central banks have been eager to buy US Treasury bonds to prevent their currencies rising. So long as low yields continue to support America's housing bubble and hence strong consumer spending, they will block any significant reduction in the country's current-account deficit.

Patrick Artus, chief economist at IXIS, a French investment bank, points to the disappearance of another equilibrating force that would normally help to correct financial imbalances. In the past, a rapid rise in consumer borrowing and spending would cause a central bank to push up interest rates to curb inflation. Today, however, inflation is being held down by cheap goods from China and other low-wage economies, and inflationary expectations are well anchored thanks to the credibility of central banks. As a result, central banks have been able to hold interest rates below the growth in nominal GDP (the income from which debts must be serviced) for a prolonged period. This has, in effect, lifted any constraint on credit growth, allowing a bigger build-up of private-sector debt.

A third broken circuit is that between interest rates and growth. Sluggish economies with low inflation require lower real interest rates than economic sprinters. This speeds up the tortoises and holds back the hares. Yet despite its faster growth, America's real bond yields are lower than Japan's and about the same as in the euro area. Yields are arguably too low for America, but too high for Germany and Japan, causing the growth gap to persist.

Europe's single monetary policy has also severed the link between short-term interest rates and economic performance in the euro area, says Mr Artus. Because all member states share the same nominal interest rate, slow-growing economies with lower inflation, such as Germany and Italy, have higher real interest rates than fast growers, such as Spain and Greece. This is the exact opposite of what is needed, exacerbating the divergence in growth rates.

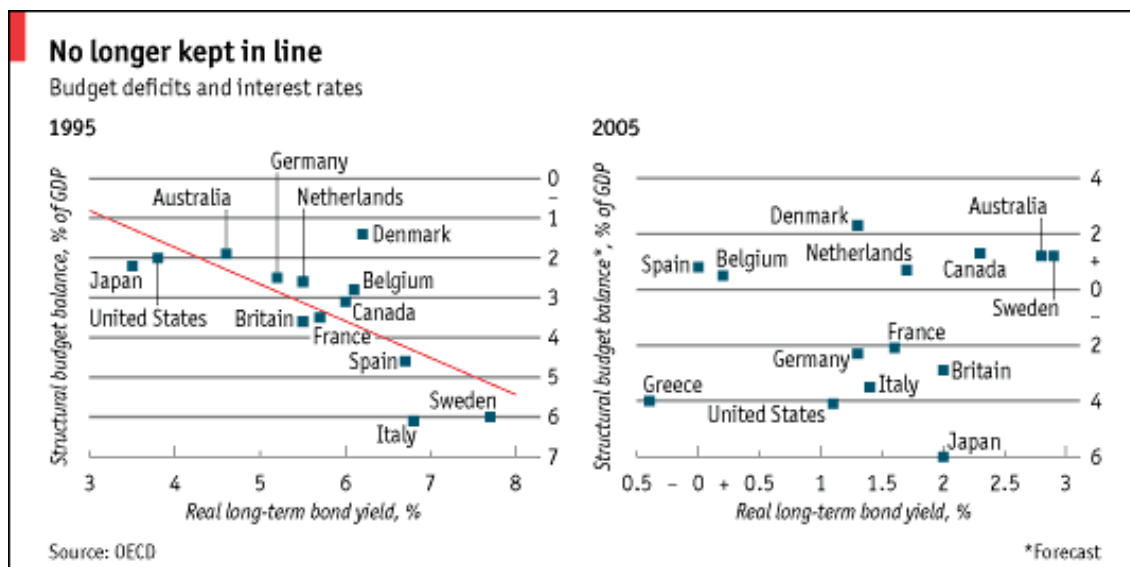
Euro-area interest rates are giving the wrong signals to governments as well as to consumers. Yields on government bonds barely differ, despite differences in countries' fiscal health. In the early 1990s, yields on ten-year government bonds were 450 basis points higher in Italy than in Germany. Today Italy pays a penalty of only around 20 basis points, even though its ratio of public debt to GDP is almost twice Germany's. Such thin interest-rate spreads give governments little incentive to trim their deficits. The convergence in yields reflects mainly the removal of exchange-rate risk since the creation of the single currency, but that still leaves default risk. The Maastricht Treaty explicitly forbids the European Central Bank to bail out any member country, but the markets clearly reckon that there is little chance that a government would be allowed to go bust.

Interest rates and bond yields are the traffic lights of the global economy: they tell economies when to go and when to stop. When traffic lights break down in the ways discussed above, there is a risk that the global economy can get snarled up or even crash.

In the early 1990s, James Carville, Bill Clinton's campaign manager, said: "I used to think if there was reincarnation I wanted to come back as the president or the pope... but now I want to come back as the bond market. You can intimidate everybody." The liberalisation of international capital flows has undoubtedly increased the power of global capital markets. Combined with new technology and financial innovation, this should have made markets more efficient at disciplining economic performance. The market would punish economies where governments or households borrow recklessly with higher bond yields, prompting them to tighten their belts. Prudent economies would be rewarded with lower real rates. So what has gone wrong?

From watchdog to puppy

The chart below shows that in 1995, countries with big budget deficits did generally pay a penalty in higher real long-term interest rates. Today, however, as the right-hand chart shows, there is no correlation at all between borrowing and real interest rates. Similarly, a study by the OECD in 1995 found that countries with big current-account deficits over the previous decade tended to have higher real bond yields. An update of that analysis by *The Economist* shows that this relationship has broken down, too. Financial markets seem to be doing a poor job as economic watchdogs: in particular, America's profligacy is being subsidised rather than punished.



Some convergence in real bond yields is a natural consequence of a global capital market. In a closed economy, if a government increases its budget deficit it must pay higher interest rates to persuade domestic investors to hold more bonds. But if it can tap global savings, it can borrow more cheaply because a smaller rise in rates is needed to attract the required funds. Even so, a more efficient international capital market is supposed to ensure that capital is allocated to the most productive use. Yet much of the recent inflow of foreign money into America is not financing productive investment, but a housing bubble and a consumer binge.

Despite Mr Carville's awe at the harsh discipline of the global capital market, it has actually been a soft touch, encouraging some governments and households to follow spendthrift ways. One explanation is that, with interest rates low pretty much everywhere, investors are hungry for any sort of yield. This has made them more willing to buy high-yield bonds, and has pushed down the spread that riskier borrowers must pay compared with safer borrowers. This not only encourages investors to price risk too low; it may also produce bigger economic imbalances.

The inevitable correction, when it comes, is likely to be all the more painful. When financial conditions tighten, investors are sure to become more discriminating. Sooner or later, the traffic lights will turn red.