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Unnatural causes of debt

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Interest rates are too low. Whose fault is that?

GLOBALISATION may have helped to hold down inflation, but it has also raised some new dilemmas for central banks. Most notably, should they cut interest rates to stop inflation falling below their usual target in response to a boost to global supply—which is how they would deal with falling inflation caused by a slump in demand—or should they accept a lower rate of inflation? Most central banks aim for an inflation rate of close to 2%, in the belief that too little inflation can be as harmful as too much of it.

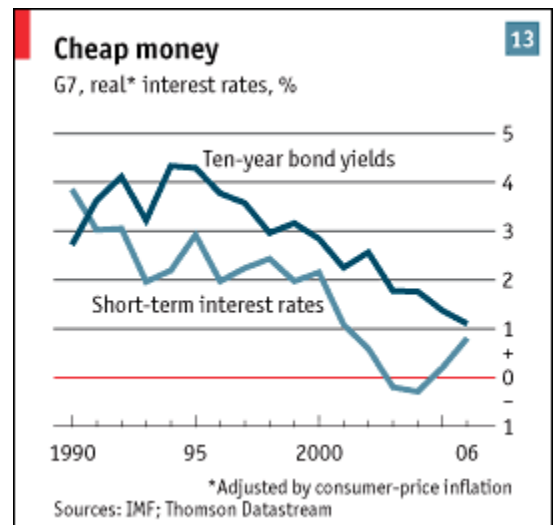
Real interest rates in the past few years have remained lower for longer than at any other time during the past half-century. Despite recent tightening by central banks, average real short-term rates and bond yields in the developed economies are still well below normal levels (see chart 13). Most commentators have concluded that a new era of cheaper money has arrived.

Yet globalisation might have been expected to raise, not lower, the world's natural rate of interest (ie, the rate that is consistent with long-run price stability and also ensures that saving equals investment). In theory, the long-term real equilibrium interest rate should be equal to the marginal return on capital. And the opening up of emerging economies has increased the ratio of global labour to capital, raising the return on capital, so real interest rates should rise, not fall.

Another way to look at this is that real interest rates should be roughly the same as the trend rate of GDP growth (a proxy for the return on capital). If greater global economic and financial integration leads to a more efficient use of labour and capital, economic growth will be faster, which again means that real interest rates should rise. So why have they been so low?

Analysts have put forward two main explanations for the low level of real bond yields in recent years. The first is that high saving (in relation to investment) by Asian economies and Middle East oil exporters has caused a global saving glut, pushing down yields. These economies are running large current-account surpluses, and much of that money has been piled up in official reserves, particularly in American Treasury securities, as central banks have intervened in the foreign-exchange market to prevent their currencies from rising.

Of gluts and floods



Various estimates suggest that such foreign-exchange intervention reduced American yields by less than one percentage point in 2004-05. But Nouriel Roubini and Brad Setser of Roubini Global Economics reckon that the impact could be larger. Most studies ignore the fact that without official intervention by foreign central banks the dollar would be lower and hence American inflation higher, which would push bond yields higher. And if central banks were not buying dollars to prop up the currency, many private investors might hold fewer greenbacks, which again would push up yields. Adding up these and other factors, Messrs Roubini and Setser reckon that American Treasury bond yields would have been two percentage points higher in recent years if central banks in emerging economies had not bought dollar reserve assets.

A second explanation for low bond yields is that excess liquidity has pushed up the prices of all assets, including bonds. Over the past few years, the global money supply has grown at its fastest pace since the 1980s. This excess liquidity has not pushed up conventional inflation (thanks largely to cheap Chinese goods), but has fed into a series of asset-price bubbles around the world.

Both developed and emerging economies have contributed to this flood of liquidity. Central banks in rich countries have held interest rates abnormally low to offset disinflationary pressures from emerging economies. At the same time, to prevent their currencies rising, emerging economies have also held interest rates low and engaged in heavy foreign-exchange intervention, which has inflated their money supplies.

Both of these explanations for low interest rates—the saving glut and the excess liquidity—involve emerging economies; either through their impact on developed economies' inflation and hence monetary policy, or through their foreign-exchange intervention. In that sense, global monetary conditions are increasingly being influenced by policies in Beijing as much as in Washington, DC. Over the past year, emerging economies have accounted for four-fifths of the growth in the world's monetary base.

Have central banks in developed economies been right to pursue lax monetary policies? For borrowers, low interest rates are an unmitigated blessing, but for economies as a whole the gap between interest rates and the long-run return on capital has created some serious economic and financial imbalances. Thanks to cheap money, American households are saving too little and borrowing and spending too much. At the same time bubbly house prices have soared to record levels in relation to incomes.

Bill White, chief economist at the Bank for International Settlements, suggests that central banks' inflation targets may be too high, given the big boost to global capacity from China's and India's re-emergence. If a negative supply shock (from higher oil prices, say) were to cause inflation to rise, most central banks would do nothing about it as long as it did not increase inflationary expectations and lead to second-round effects on other prices. The logic is that central banks should ignore price changes that they cannot control. To be consistent, says Mr White, central banks should also have tolerated the inflation-lowering impact of a positive supply shock from the emerging economies, allowing cheaper goods and wages to reduce inflation. Instead, in 2001-03 central banks prevented inflation from falling by pushing interest rates much lower than they would otherwise have been.

Ben Bernanke, the chairman of America's Federal Reserve, would argue that when the Fed slashed interest rates to 1% in 2003, it was trying to prevent harmful deflation. However, deflation need not be what it was in the 1930s, a vicious circle of deficient demand, falling prices and rising real debt. Historically, most deflations have been benign, caused by technological innovation or the opening up of economies (ie, positive supply shocks), and were accompanied by robust growth. During the rapid globalisation of the late 19th century, flat or falling average prices went hand in hand with strong growth in output. Today's world has much more in common with that period than with the 1930s.



Too much, too soon

With hindsight, the deflation that the Fed was fretting about in 2003 was largely benign, caused by cheaper goods from China and by the IT revolution. But the Fed was so determined to prevent deflation of any kind that it cut interest rates to unusually low levels. This, argues Mr White, could have long-term costs because persistently cheap money encouraged too much borrowing, too little saving and unsustainable asset prices. The risk is that if central banks lean against benign deflation, they will unwittingly accommodate a build-up of imbalances. Ironically, these could cause a bout of bad deflation as they unwind.

The problem is that most central banks base their policy analysis on Keynesian-style economic models in which deviations from their inflation goal are assumed to reflect excess or inadequate demand, requiring a change in monetary policy. But supply shocks such as globalisation can cause deviations in inflation that require a completely different policy response. A more relevant model might be one based on the Austrian school of economics, developed in the late 19th century, when economic conditions were more akin to today's. In Austrian models the main result of excessively low interest rates is not inflation but overborrowing, an imbalance between saving and investment and a consequent misallocation of resources. That sounds like America today.

Mr White argues that if central banks focus solely on price stability, they might allow ever bigger financial imbalances to build up. This is why they need to watch a wider range of indicators beyond inflation, including the growth in credit, money, saving rates and asset prices. They should be prepared to raise interest rates in response to clear evidence of financial imbalance, says Mr White, even if it means they undershoot their inflation targets.

The other risk of holding interest rates too low for too long is that inflation will suddenly rise. This is what has now happened in America, where the inflation rate has risen above 4%, prompting the Fed to push interest rates higher this year. If the low bond yields were also largely due to excess liquidity, then rising short-term rates could push yields much higher than the markets expect. At some point rates will rise to their higher equilibrium level. The likely consequence is a severe weakening or a slump in housing markets around the globe and a sharp slowdown in consumer spending.

Central banks have been slow to grasp the fact that the rapid integration of emerging economies into the global market system requires them to rethink their monetary policy. If they fail to recognise benign deflation created by positive supply shocks, then excessively loose monetary policy will fuel not only financial bubbles but also bigger current-account imbalances—the subject of the next article.