Global interest rate “conundrum” recalls the 1930s

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It says something about the state of the world financial system when one of the key figures supposedly in charge of its operations publicly declares that he has very little idea about what is going on.

For some time now, US Federal Reserve Board chairman Alan Greenspan has been pondering what he calls a “conundrum” in the international bond market. Over the past year, the Fed has been lifting its base interest rate after reducing it to a record low to counter the recessionary impact of the collapse of the share market bubble. Normally this would have lead to an increase in long-term interest rates. However, in this case, long-term interest rates have been falling over the past year.

Greenspan first raised the issue in his testimony to the US Senate Banking Committee on February 16, noting that long-term interest rates were lower than when the central bank began its series of tightenings. Noting similar declines in the rest of the world, he pointed out that the greater integration of the world’s financial markets had increased the “pool of savings”, while there was a lower inflation risk premium. However, these developments were not new and could not be the reason for the long-term interest rate decline over the previous nine months.

“For the moment,” he continued, “the broadly unanticipated behaviour of world bond markets remains a conundrum. Bond price movements may be a short-term aberration, but it will be some time before we are able to better judge the forces underlying recent experience.”

Nearly four months on, the Fed chief seems no closer to an explanation. In an address to a bankers’ conference in Beijing on June 6, he pointed out that the “pronounced decline” in the return on long-term US Treasury bonds—down by 80 basis points, while the federal funds rate increased by 200 basis points over the same period—was “clearly without recent precedent”.

Greenspan put forward several possible explanations for this unusual behaviour. Among them were: the possibility that the market was signalling future economic weakness; that pension funds are making significant bond market purchases and pushing down interest rates; that the accumulation of US Treasury debt by foreign central banks is lowering long-term rates; and that the greater integration of financial markets has increased the supply of savings, thereby lowering the interest rates. However, none of these explanations seemed to provide a satisfactory answer.

Whatever the cause of this unexpected development, Greenspan made clear it was one of the factors behind increased risk in financial markets as investors reached for higher returns.

“The search for yield is particularly manifest in the massive inflows of funds to private equity firms and hedge funds. These entities have been able to raise significant resources from investors who are apparently seeking above-average, risk-adjusted rates of return, which, of course, can be achieved only by a minority of investors. To meet this demand, hedge fund managers are devising increasingly more complex trading strategies to exploit perceived arbitrage opportunities, which are judged—in many cases erroneously—to offer excess rates of return.”

In other words, the falling rate of return on long-term risk-free Treasury debt has lowered rates of return all along the line. Consequently, to obtain the same rate of return as in the past—or to increase it—financial investors must undertake riskier investments, often through hedge funds which trade in increasingly complex financial instruments.

This process, Greenspan warned, could mean that “after its recent very rapid advance, the hedge fund industry would temporarily shrink, and many wealthy fund managers and investors could become less wealthy.” Such an outcome would not pose many problems for the financial system as a whole were it not for the fact that hedge funds often enjoy large support from banks and other financial institutions.

Here Greenspan struck an optimistic note, suggesting that "so long as banks and other lenders to these ventures are managing their credit risks effectively, this necessary adjustment should not pose a threat to financial stability." That is, so long as things are going well, they should continue to go well.

But this upbeat assessment does not sit well with Greenspan's admission towards the conclusion of his remarks, that "the economic and financial world is changing in ways that we still not fully comprehend."

Significantly, Greenspan did not point to one development that some observers regard as playing a central role in the present peculiar situation—the rapid increase in financial liquidity over the past five years fuelled by the accommodative monetary policies pursued in the US, Europe and Japan.

The reason for this omission is not hard to find—the policy of increased liquidity has come to occupy a central place in the policy platform of Greenspan in the face of growing problems in the US economy. In fact, his first major decision as Federal Reserve Board chairman was to open the lines of credit from the central bank in order to prevent a global financial and economic crisis following the stock market crash of October 1987.

When the stock market began to rise rapidly in 1995-96, Greenspan acknowledged, in the confines of meetings of the Federal Reserve, that a "bubble" was starting to develop. But even after issuing his famous warning of "irrational exuberance", nothing was done. In fact, Greenspan became one of the chief boosters for the so-called "new economy" of the late 1990s, where increased productivity, globalisation, information technology were said to have produced an ever-rising market.

Following the bursting of the bubble in March 2000, Greenspan initiated a series of cuts in the federal funds rate, eventually bringing it to an historic low of 1 percent in 2003-2004. The sharp reduction in official interest rates has led to the growth of so-called "carry trades"—the process in which investors borrow funds at the low short-term rates in order to lend at higher rates. But the longer it continues, the greater the dangers this process poses for the stability of the financial system. This is because so long as the flow of funds continues, rates of return on less risky ventures start to come down and consequently increasingly riskier financial operations have to be undertaken to achieve the same return as previously.

It would be wrong to conclude, however, that the mounting problems of the global financial system can simply be attributed to the "wrong policies" of Greenspan and the other central bankers. Rather, the fact that the world's central bankers have fuelled an increase in the money supply is indicative of deeper problems. Above all, it is a sign of falling profit rates and the ever-present recessionary tendencies within the global economy.

This can be clearly seen by charting the course of the US economy over the past decade and a half. In the first half of the 1990s, growth was relatively low, following the 1991-92 recession. Growth rates started to rise from the middle of the decade as a result of the stock market boom. But with the deflation of the bubble, the US economy has become increasingly dependent on consumption spending, financed not by the growth of employment and wages income, but by higher levels of debt, and the emergence of a financial bubble in the real estate market. At the same time, US interest rates have been kept low by the inflow of funds from the rest of the world—now approaching $3 billion a day—to finance the growing balance of payments deficit.

In a major comment on the financial "conundrum" published yesterday, *Financial Times* economics commentator Martin Wolf ascribed the problem to what he calls a "paradox of thrift"—the emergence of a "global glut of savings" far in excess of the demand for investment funds. This excess of savings in about 60 percent of the world economy is responsible for low interest rates, the "somewhat manic reaching for yield", and the "growing and dangerous and global imbalances." It was necessary, he wrote, to go back and look at the analysis made by the British economist John Maynard Keynes in the 1930s.

Wolf does not probe any further to an examination of the contradictions within the profit system itself, which have produced this "savings excess". But the fact that he has compared the present situation to the conditions of the 1930s Depression is a measure of how seriously the present dangers are being regarded.