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Greenspan's Conundrum

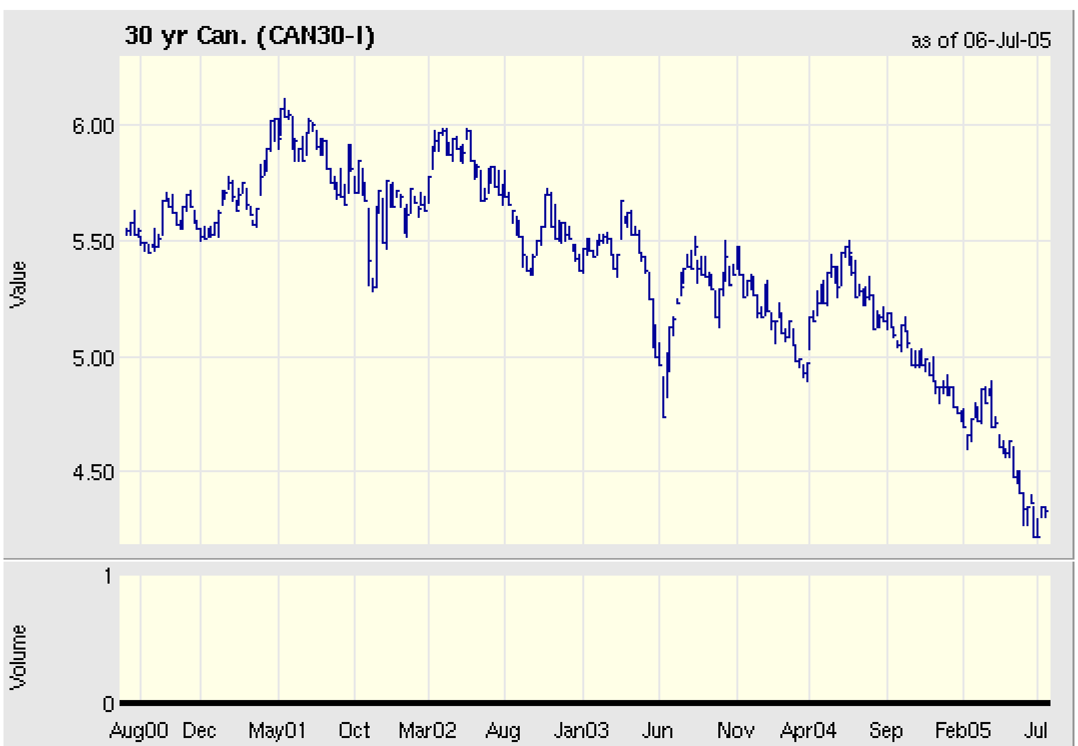
Alan Greenspan, Chairman of the US Federal Reserve, spoke in a recent session of US Congress of a '*conundrum*' in US markets. When one of the most important men in the world speaks of a puzzle, it is worth thinking about. But first, we need a little primer on interest rates.

Short-term interest rates are set by the Central Bank: the Bank of Canada here and the Federal Reserve in the US. The central banks are owned by the Government but are quite independent: the governor, David Dodge, can pretty much do as he likes without political interference.

The objective of the Bank is to keep short-term interest rates at a level that will encourage economic growth without igniting too much inflation. If rates are too high, the economy will slow down and a recession may result. If rates are too low, money becomes so cheap that it floods the system, and when the supply of money increases too fast, the value of each dollar depreciates and you have inflation.

Long-term interest rates are set in the bond market, where the willingness of investors to lend money to a government or company is decided through supply and demand. The bond market is widely considered to be more 'intelligent' than the stock market, since most of the participants are professionals. If investors perceive risk that they may not get their money back, they require higher interest as compensation. So bond investors are interested in the ability of the borrower to repay the money, but they are *very* interested in inflation, since inflation will determine what the money can buy 20 or 30 years from now. Long bond investors *really* hate inflation.

So the risk of future inflation can be seen in longer-term interest rates. If the bond market gets even a whiff of inflation, it will immediately drive longer term rates up to compensate. High long-term rates are bad news, since all kinds of loans including mortgage rates are set from the bond market. High long rates can choke economic growth just as powerfully as short rates. Not only that, but since long-term rates are set by market forces, they are not under the direct control of any government (or anybody).



Source: Globeinvestor.com

In fact the economic power of the bond market is so great that James Carville, President Clinton's economic advisor, is famously reputed to have quipped that he wants to 'be reincarnated as the bond market, because then he can intimidate anyone'.

You can see how there is a balancing act between short and long-term interest rates, economic activity, and inflation: if short-term rates are too low, inflation will increase, scaring the bond market, which will boost long-term interest rates, choking off growth.

Now to get to the conundrum we need a quick review of recent history (as usual).

The story of the last few years goes like this: the stock market boom of the late 1990s ended with the crash of the technology and growth stocks in 2000 – 2002. This crash erased about US$10 trillion of value from investors' hands, an unprecedented destruction of wealth that threatened to destabilize the world economy. To offset the negative impact of the stock market losses, the US Federal Reserve (the 'Fed') dropped interest rates to 1% - the lowest in most of our lifetimes.

There was a small recession in US growth in 2001, but it was mild and brief and economic growth has continued at a healthy pace, driven by the US consumer (those who didn't own tech stocks, anyway) who has been taking advantage of low rates to borrow. In fact, there seems to be good evidence that Florida and UK real estate is experiencing a bit of a bubble. Greenspan would like to avoid trading a stock market bubble for a real estate bubble….

So here is the conundrum: in the past when an economy is recovering from a recession, inflation usually picks up. We would therefore expect an uptick in long-term interest rates around here somewhere, as the bond market caught a whiff of inflation. But as the chart of the Canadian 30-year bond shows, long-term interest rates have been dropping for the past 4 years and are now at 45-year lows (as they are in the US). So even as we've been experiencing good economic growth, inflation expectations have been falling. The chart is telling us that the prospect of inflation is as low as its been in 45 years.

Greenspan is saying that he needs to be careful with his strategy of gradually increasing short-term interest rates. Rates may be very low now, but they may be high enough. He does not want to increase rates too much and risk a recession by blowing up over-leveraged consumers, yet he doesn't want to leave rates too low and risk future inflation – or a bubble in Florida real estate.

The bond market is telling us that economic growth will be modest. If oil stays north of $50, it will keep the brakes on economic growth, so that Greenspan will be able to stop increasing short-term rates without risking inflation. Inflation is not in the cards. Inflation will return only when people have forgotten its corrosive power and governments print money again. Interest rates will stay lower than we expect for longer than we expect. Greenspan will risk inflating a bubble in Florida real estate before he'll risk his reputation by putting the US into a recession.

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