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FINANCIAL FAQs

COLLISION COURSE?

The Federal Reserve and foreign investors seem to be on a collision course. As the Federal Reserve has pushed up short-term interest rates 3.75 percentage points to 4.75 percent since June 2004, long term fixed rates have barely budged, so that short-term rates now equal long-term interest rates.

One of Ben Bernanke's first speeches as Fed Chairman was to the Economic Club of New York, in which he attempted to explain Alan Greenspan's "conundrum" –or the Fed's inability to push up long-term interest rates.

This conundrum has been a concern to financial markets when it becomes what is called an inverted yield curve, since it has presaged a recession when lasting for any prolonged period, as it did in 2000.

Bernanke argued that the lower long-term yields could be caused by two, not mutually exclusive factors. If it is due to the perception that it is now less risky to buy longer-term yields than in the past, then investors are being irrationally exuberant—hence fooling themselves. Complicating this scenario is a surging demand for longer-term fixed rate instruments from foreign investors who perceive it a safe haven from geopolitical uncertainty, as well as a temporary place to put their excess savings until their own economies require the monies to be repatriated for domestic investment.

The net effect is to keep interest rates lower than the Fed likes, so that "the effect is financially stimulative and argues for greater monetary policy restraint, all else being equal."

But, on the other hand, if the lower rates are because investors have expectations of future economic weakness, then the Fed may have to reverse policy and lower interest rates in the future. "For example, some observers have pointed to factors that may create a longer-term drag on the growth of household spending, including high energy costs, the likelihood of slower growth in house prices, and a possible reversal of recent declines in saving rates.. If these drags on the growth of spending do materialize, then a lower real interest rate will be needed to sustain aggregate demand and keep the economy near full employment."

Which way is Bernanke leaning? He doesn't think that an inverted (or level) yield curve, per se, is an indication of economic weakness. That is because in previous episodes when an inverted yield curve was followed by recession the level of interest rates was quite high, consistent with financial restraint. "This time, both short-and long-term interest rates—in nominal and real terms—are relatively low by historical standards."

So we must wait and see. "…policy makers should monitor bond yields carefully in judging the current state of the economy—but only in tandem with the signals from other important financial variables; direct readings on spending, production, and prices; and a goodly helping of qualitative information," he said. "Ultimately, a robust approach to policymaking requires the use of multiple sources of information and multiple methods of analysis, combined with frequent reality checks."