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Where Are the Bond Vigilantes?

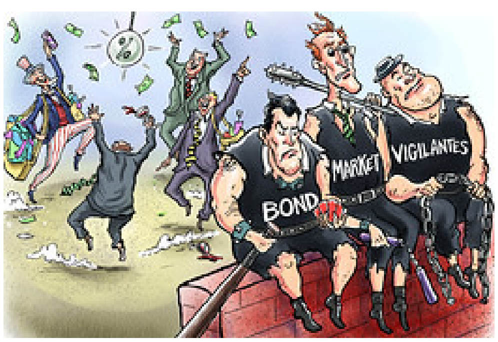
During the Clinton administration, interest rates served to discipline government spending. That vital check is now missing.

By RONALD MCKINNON

In past decades, tense political disputes over actual or projected fiscal deficits induced sharp increases in interest rates—particularly on long-term bonds. The threat of economic disruption by the so-called bond market vigilantes demanding higher interest rates served to focus both Democratic and Republican protagonists so they could more easily agree on some deficit-closing measures.

For example, in 1993 when the Clinton administration introduced new legislation to greatly expand health care without properly funding it ("HillaryCare"), long-term interest rates began to rise. The 10-year rate on U.S. Treasury bonds touched 8% in 1994. The consequent threat of a credit crunch in the business sector, and higher mortgage rates for prospective home buyers, generated enough political opposition so that the Clinton administration stopped trying to get HillaryCare through the Congress.

In the mid-1990s, Democrats and Republican cooperated to cap another open-ended federal welfare program—Aid to Families with Dependent Children—by giving block grants to the states and letting the states administer the program. Interest rates came down, and the Clinton boom was underway.



Chad Crowe

In contrast, after the passage of ObamaCare in March 2010, long-term bond rates remained virtually unchanged at around 3%. This was despite great doubt about the law's revenue-raising provisions, and the financial press bemoaning open-ended Medicare deficits and the mandated huge expansion in the number of unfunded Medicaid recipients. Even with great financial disorder in the stock and commodity markets since late July 2011, today's 10-year Treasury bond rate has plunged below 2%. The bond market vigilantes have disappeared.

Without the vigilantes in 2011, the federal government faces no immediate market discipline for balancing its runaway fiscal deficits. Indeed, after President Obama finally received congressional approval to raise the debt ceiling on Aug. 2, followed by Standard & Poor's downgrade of Treasury bonds from AAA to AA+ on Aug. 5, the interest rate on 10-year Treasurys declined even further.

Since Alexander Hamilton established the market for U.S. Treasury bonds in 1790, they have been the fulcrum for the bond market as a whole. Risk premia on other classes of bonds are all measured as so many basis points above Treasurys at all terms to maturity. If their yields are artificially depressed, so too are those on private bonds. The more interest rates are compressed toward zero, the less useful the market becomes in reflecting risk and allocating private capital, as well as in disciplining the government.

To know how to restore market discipline, first consider what caused the vigilantes to disappear. Two conditions are necessary for the vigilantes to thrive:

(1) Treasury bonds should be mainly held within the private sector by individuals or financial institutions that are yield-sensitive—i.e., they worry about possible future inflation and a possible credit crunch should the government's fiscal deficits get too large. Because private investors can choose other assets, both physical and financial, they will switch out of Treasurys if U.S. public finances deteriorate and the probability of future inflation increases.

(2) Private holders of Treasurys must also be persuaded that any fall in short-term interest rates is temporary —i.e., that the Fed has not committed itself to keeping short-term interest rates near zero indefinitely. Long rates today are the mean of expected short rates into the future plus a liquidity premium.

The outstanding stock of U.S. Treasury bonds held outside American intergovernment agencies (such as the Social Security Administration but excluding the Federal Reserve) is about $10 trillion. The proportion of outstanding Treasury debt held by foreigners—mainly central banks—has been increasing and now seems well over 50% of that amount. Since 2001, emerging markets alone have accumulated more than $5 trillion in official exchange reserves. And in the last two years the Fed itself, under QE1 and QE2, has been a major buyer of longer-term Treasury bonds to the tune of about $1.6 trillion—and that's before the recently announced "Operation Twist," whereby the Fed will finance the purchase of still more longer-term bonds by selling shorter-term bonds. So the vigilantes have been crowded out by central banks the world over.

Central banks generally are not yield-sensitive. Instead, under the world dollar standard, central banks in emerging markets are very sensitive to movements in their dollar exchange rates. The Fed's near-zero short-term interest rates since late 2008 have induced massive inflows of hot money into emerging markets through July 2011. This induced central banks in emerging markets to intervene heavily to buy dollars to prevent their currencies from appreciating versus the dollar. They unwillingly accept the very low yield on Treasurys as a necessary consequence of these interventions.

True, in the last two months, this "bubble" of hot money into emerging markets and into primary commodities has suddenly burst with falls in their exchange rates and metal prices. But this bubble-like behavior can be traced to the Fed's zero interest rates.

Beyond just undermining political discipline and creating bubbles, what further economic damage does the Fed's policy of ultra-low interest rates portend for the American economy?

First, the counter-cyclical effect of reducing interest rates in recessions is dampened. When interest rates dipped in the past, at least part of their immediate expansionary impact came from the belief that interest rates would bounce back to normal levels in the future. Firms would rush to avail themselves of cheap credit before it disappeared. However, if interest rates are expected to stay low indefinitely, this short-term expansionary effect is weakened.

Second, financial intermediation within the banking system is disrupted. Since early 2008, bank credit to firms and households has declined despite the Fed's huge expansion of the monetary base—almost all going into excess bank reserves. The causes are complex, but an important part of this credit constraint is that banks with surplus reserves are unwilling to put them out in the interbank market for a derisory low yield. This bank credit constraint, particularly on small- and medium-size firms, is a prime cause of the continued stagnation in U.S. output and employment.

Third, a prolonged period of very low interest rates will decapitalize defined-benefit pension funds—both private and public—throughout the country. In California, for example, pension actuaries presume a yield on their asset portfolios of about 7.5% just to break even in meeting their annuity obligations, even if they were fully funded.

Perhaps Fed Chairman Ben Bernanke should think more about how the Fed's near-zero interest rate policy has undermined fiscal discipline while corrupting the operation of the nation's financial markets.

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