

What's keeping long term rates down, and why

WASHINGTON – Nov. 28, 2006 – In February 2005, Federal Reserve Chairman Alan Greenspan called it a “conundrum” – wondering why long-term bonds resisted the Fed’s efforts to push interest rates up.

If anything, the mystery has deepened. Back then, it seemed that long-term rates might just be slow to rise. Now it looks like they could stay low for ... well, for who knows how long?

Forever?

That would be good news for anyone who expects to need a new mortgage someday. And it would be good for stock-market investors, as low rates on fixed-income holdings make stocks comparatively more attractive, shoring up share prices.

But it wouldn’t be so good for people who depend on interest-paying investments such as bonds and certificates of deposit.

So it would be nice to know what’s keeping long-term rates down, and whether things will stay this way.

The answer: The mammoth foreign investment in U.S. bonds.

At least that’s the view of two Virginia economists, Francis E. Warnock of the Darden Business School at the University of Virginia, and Veronica Cacadac Warnock of the School of Architecture in Charlottesville. Their paper, International Capital Flows and U.S. Interest Rates, was recently published by the National Bureau of Economic Research.

Many economists have noted that foreign investing influences interest rates in the U.S., but the new study appears to be the first to clearly measure the effect.

Were it not for foreign investment, the authors say, interest rates on the key 10-year U.S. Treasury note would be nearly one percentage point higher than they are – 5.6 percent instead of 4.6 percent.

And if foreign investors unloaded the mammoth holdings they already have, the 10-year rate would be about two percentage points higher than it is, they say.

If that happened, monthly payments on a standard 30-year mortgage might be 30 percent higher than they are, adding tens of thousands of dollars to the interest paid over the life of a typical loan.

To slow the economy and head off inflation, the Fed began raising “short-term interest rates in the summer of 2004. “Long-term rates are set by the marketplace rather than the Fed – but they were expected to move up as well because they are influenced by investor’s expectations about future Fed moves. If investors think short-term rates will be higher in a few years, long-term rates will rise.

They haven't. Today, the three-month Treasury pays about 5 percent and the 10-year about 4.6 percent. Normally, the 10-year pays 1 to 2 percentage points more to compensate investors for tying their money up.

Various factors have affected the supply-and-demand equation that determines long-term interest rates, including growing confidence among investors in the Fed's ability to keep inflation down.

Then there's soaring foreign investment. U.S. bonds, especially Treasuries, attract foreigners who want safety they often cannot find at home.

In 1978, foreigners held about \$39 billion worth of Treasury bonds, a modest 12 percent of the Treasuries in circulation, according to the authors. By the summer of 2005, foreign Treasury holdings were just shy of \$1.6 trillion, nearly 52 percent of the value of all Treasuries. China, Japan and Hong Kong are the big buyers.

High demand drives bond prices up, pushing bond yields, or interest rates, down. Think of it this way: Investors are so eager to park their billions somewhere safe, they're willing to settle for relatively low rates.

So, to some extent, we have the booming economies of East Asia to thank for our low rates.

Could it all unravel – foreigners dumping U.S. bonds and driving rates through the roof?

I'd never say never. But a sudden change doesn't seem likely. A wave of selling would amount to a huge increase of supply that would depress bond prices, undermining the value of those bonds foreign investors kept.

In hurting us, they'd hurt themselves.

That's the essence of globalization: we're all in this together.

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