The New York Times
nytimes.com

April 20, 2004

OP-ED COLUMNIST

Questions of Interest

By PAUL KRUGMAN

"Yes, the republic is in danger," a friend said. "But what's going to happen to interest rates?" O.K., let's take a break from politics.

Over the past two years, interest rates have been very low. Last June the 10-year bond rate hit a 48-year low. Even three weeks ago the rate was still below 4 percent, a level last seen in 1963.

If the economy fully recovers — or even if investors just think it will — interest rates will rise sharply. In its World Economic Outlook report, to be issued tomorrow, the International Monetary Fund urges the Federal Reserve to prepare the economy for higher rates to "avoid financial market disruption both domestically and abroad."

But how far will rates rise? Let's not get into Greenspan Kremlinology, parsing the chairman's mumbles for clues about the Fed's next move. Let's ask, instead, how much rates will rise if and when normal conditions of supply and demand resume in the bond market.

My calculations keep leading me to a 10-year bond rate of 7 percent, and a mortgage rate of 8.5 percent — with a substantial possibility that the numbers will be even higher. Current rates are about 4.3 and 5.8 percent, respectively; you can see why the I.M.F. is worried about "financial market disruption."

Why 7 percent? Well, in the past 20 years the average yield on 10-year bonds has, in fact, been about 7 percent. Why shouldn't we think of that as the norm?

Some people say that unlike past interest rates, future interest rates won't include a premium for expected inflation. Indeed, over the past 20 years the average inflation rate was 3 percent, considerably higher than recent experience. But in the first three months of 2004, prices rose at an annual rate of more than 5 percent. That number included soaring gasoline prices, but even the "core" price index, which excludes food and energy, rose at a 2.9 percent rate.

More to the point, investors expect considerable inflation over the next 10 years. The spread between "inflation protected" bonds, whose payments are indexed to the Consumer Price Index, and ordinary bonds indicates an expected inflation rate of 2.5 percent during the next decade.

So you can't claim that interest rates will be far below historical levels because inflation is gone. And on the other side, we need to think about the impact of budget deficits.

That last sentence will send the deficit apologists to battle stations (sorry, I can't avoid politics completely). For many years, advocates of tax cuts have insisted that the normal laws of supply and demand don't apply to the bond market, and that government borrowing — unlike borrowing by families or businesses — doesn't affect interest rates. But there's no argument among serious, nonideological economists. For example, a textbook by Gregory Mankiw, now the president's chief economist, declares — in italics — that "when the government reduces national saving by running a budget deficit, the interest rate rises."

The Congressional Budget Office estimates this year's structural budget deficit — what the deficit would be if cyclical factors like a depressed economy went away — at 3.9 percent of G.D.P. That's almost twice the average during the past 20 years. Standard estimates say this should push up 10-year interest rates by around one percentage point.

Finally, there's the upside risk. As I've pointed out before, the twin U.S. budget and trade deficits would set alarm bells ringing if we were a third world country. For now, America gets the benefit of the doubt, but if financial markets decide that we have turned into a banana republic, the sky's the limit for interest rates.

Now for the obvious point: many American families and businesses will be in big trouble if interest rates really do go as high as I'm suggesting. That's why the I.M.F. is urging the Fed to get the word out.

And one suspects that the fund, which, like Alan Greenspan, tends to convey messages in code, is firing a shot across Mr. Greenspan's bow. A number of analysts have accused Mr. Greenspan of fostering a debt bubble in recent years, just as they accuse him of feeding the stock bubble during the 1990's. Just two months ago, Mr. Greenspan went out of his way to emphasize the financial benefits of adjustable-rate, as opposed to fixed-rate, mortgages. Let's hope that not too many families regarded that as useful advice.