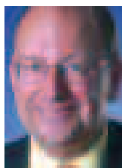


STEVEN BELL ASKS WHAT HAS HAPPENED TO THE GOOD CITIZENS OF THE BOND MARKET.

Where did the bond vigilantes go?

In the 1970s US economist Ed Yardeni coined the phrase, "bond market vigilantes". If the authorities failed to control the "crime" of inflation, he argued, the good citizens of the bond market would push up yields, induce a recession and so bring inflation down themselves. This clever metaphor was subsequently extended to budget deficits: if the politicians in Washington failed to keep their fiscal house in order, the bond market vigilantes would saddle up and chase bond yields higher. Voters would blame the politicians, who would find it harder to implement popular policies to cut taxes or raise spending, thus curbing profligate policymakers. In the last few years inflation has risen and fiscal deficits soared around the world, yet the bond market vigilantes seem to have hung up their guns and complacently allowed yields to fall and credit spreads to narrow. What is going on?

Long-term interest rates have fallen dramatically over the last 20 or 30 years in just about every country. Much of that decline is easily explicable in terms of a sustained fall in inflation. The clear, credible commitment of central banks around the world to keep inflation down is the principal reason why bond markets have largely shrugged off the recent increase in headline inflation associated with rising oil prices. In that sense the bond market vigilantes have good reason to retire: central banks are doing their job properly.

However, there are two puzzling aspects to this.

First, real interest rates are generally very low, with the fall occurring despite a rapid rise in global fiscal deficits.

Second, the US Federal Reserve has raised interest by a whopping 3% since last summer and the expectation is of more to come; yet US government bond yields have hardly budged. Alan Greenspan has called this the "interest rate conundrum".

A range of explanations have been offered for this phenomenon: huge savings in Asia, low investment returns, expectations of low economic growth, etc. The bond market vigilantes have been kept at bay by central banks pushing policy rates to very low levels in real terms, despite the impact of Fed tightening. The effect of this has rippled along the yield curve. If this explanation is correct and central banks raise real short-term rates to more normal levels, longer-term yields will rise even if inflation stays low. We might then see a return to an environment where governments that pursue profligate fiscal policies are punished.

Executive summary

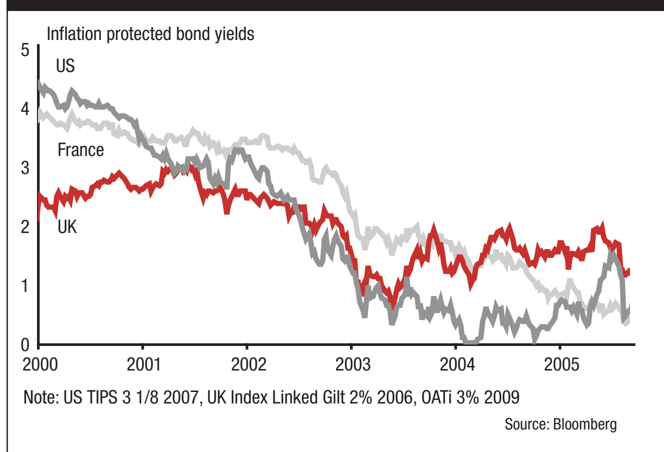
- In the last few years inflation has crept up and fiscal deficits soared, yet the bond market has allowed yields to fall and credit spreads to narrow.
- The data does not support many of the arguments put forward to explain Alan Greenspan's "interest rate conundrum".
- The answer to disappearing bond market vigilantes and the interest rate conundrum may lie in monetary policy.

REAL YIELDS *Figure 1* indicates quite clearly that the decline in the real yields of index-linked government bonds is a global phenomenon. Many economists have looked to Asia to explain this development. Asian savings are high and their central banks have accumulated truly staggering quantities of foreign exchange reserves, mostly invested in high-grade bonds, especially those from US Treasuries.

But while Asian saving may be high and rising, this increase has been offset by an even bigger decline in the rest of the world. As a result, global saving has been falling as a share of GDP *(see Figure 2)*: there is no savings glut.

Investment has also been on a declining trend although above saving since the mid-1990s. Asia accounts for an increasing share of global financial wealth and its central banks are the principal holders of that wealth. Those assets for which they have a preference should therefore have lower yields (although only in relative terms given

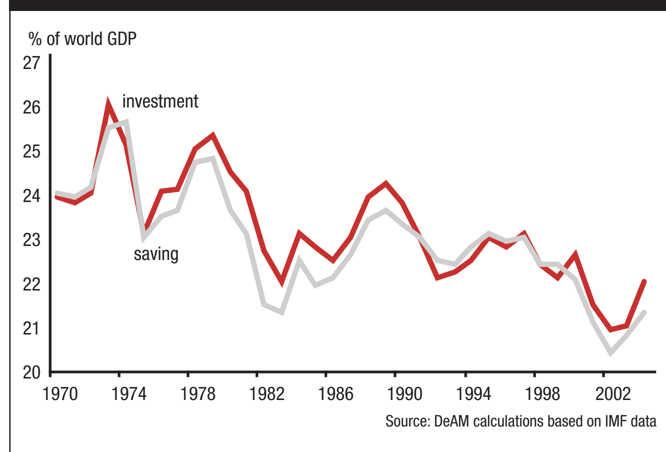
Figure 1. Real yields have fallen around the world



Note: US TIPS 3 1/8 2007, UK Index Linked Gilt 2% 2006, OATi 3% 2009

Source: Bloomberg

Figure 2. No evidence of a savings glut



Source: DeAM calculations based on IMF data

that global savings have declined). Asian central banks prefer to buy government and other high-grade bonds, particularly those denominated in dollars, and if they were really driving yields those bonds would outperform. Yet the opposite has occurred: credit spreads are very low by historical standards and have narrowed over the last two years, and US Treasuries have generally underperformed other government bond markets.

Many people have suggested the fall in real yields is due to ageing populations in the industrialised world, with individuals forced to save more for their retirement. But while the prospect of retirement causes a rise in saving, the reality causes a decline. Most people in the industrialised world have probably seen a decline in the expected level of their pension and been thereby encouraged to increase their savings. Expected long-term returns have declined and many pension programmes, funded and unfunded, look unsustainable, so this phenomenon should be relevant in some way. But, as we have already seen, that expected increase in saving has not occurred at the global level.

As Keynes pointed out, saving and investment are equal ex-post. They are brought into balance by movements in interest rates and income. The fact that both savings and investment have fallen suggests that the process began with a fall in investment, which depressed incomes and real interest rates, and which in turn dragged down saving.

As *Figure 2* shows, investment has picked up recently, although it remains much lower than in the previous three decades. A much stronger pick-up might have been expected given that profitability is very high against the background of highly supportive financial conditions and good economic growth. It seems that companies are enjoying higher returns on their current capital stock but fear that marginal returns on new investment will be low. My guess is that unless profitability falls – and profit estimates for this year have generally been revised up despite high oil prices – this will prove to be a temporary restraint and investment will rise.

CHANGING BEHAVIOUR There has been a massive expansion in global fiscal deficits. Since 1999 the aggregate OECD fiscal deficit has deteriorated by an estimated 3.5% of GDP. Only part of this reflects cyclical influences – the deterioration in the structural OECD deficit is 2.3% of GDP. Yet real bond yields have fallen. The bond market vigilantes have even failed to punish relatively profligate governments.

Figure 3 shows that those countries whose fiscal position has deteriorated most have seen the biggest declines in bond yields. This suggests that the discipline exerted by the bond market vigilantes has disappeared.

The key to the conundrum on interest rates and the disappearance of the bond market vigilantes lies in monetary policy. Central banks have pursued monetary policies that have reduced short-term interest rates to zero. The big decline in the early part of this decade more or less coincided with the sharp fall in real bond yields.

It should come as no surprise to see a link between short-term and long-term interest rates. After all, the expectations hypothesis suggests that long rates are something of an average of current and expected future short rates. But the magnitude of the link is remarkable.

Figure 4 plots the real yields on UK bonds and real short-term interest rates in a scattergram. It suggests that a 1% decline in real short-term rates is associated with a 0.8% decline in long rates. This can only be consistent with the expectations hypothesis if investors expect today's low real short rates to persist long into the future. This seems implausible.

Although neither the Bank of Japan nor the European Central Bank needs to raise interest rates in the near term, they are likely to do so in the medium term, starting perhaps in 2006. With the world economy continuing to expand, monetary policy is gradually returning to a more normal setting. Australia and the UK may have led the way but the US is catching up fast and the ECB and Bank of Japan will follow.

Indeed, the uptrend in real short rates in already under way. Real bond yields have yet to react but this is not unusual: *Figure 4* shows there are frequently significant lags between movements in real short rate and real long rates.

If Asian saving or low investment was the explanation for low real bond yields, they could be expected to last for some time. But beware: the uptrend is imminent. Those who fear that bond markets will be undermined by rising inflation are only partly correct. It is central bankers' actions to pre-empt a rise in core inflation that are likely to do the damage – and this should ensure that real rates rise but inflation stays low.

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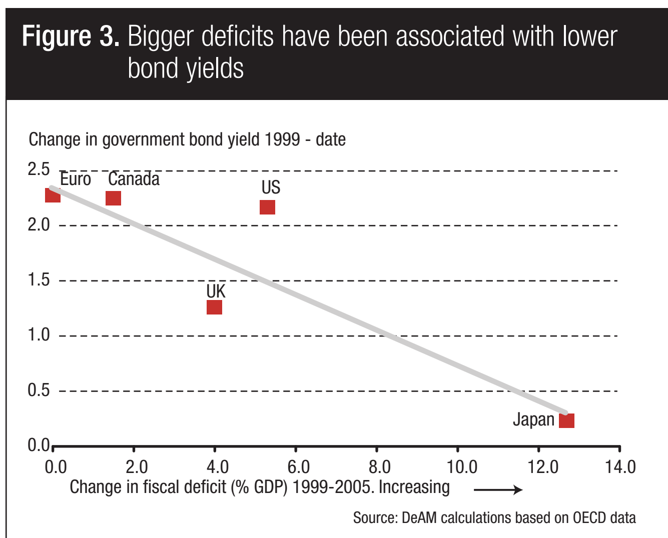
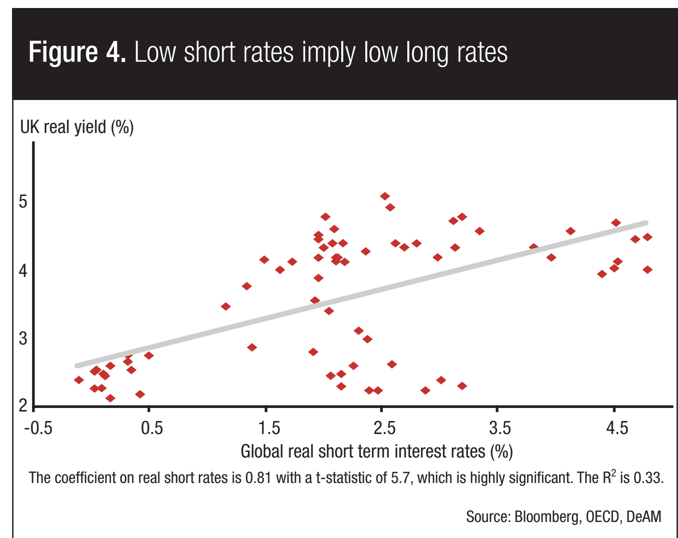
Figure 3. Bigger deficits have been associated with lower bond yields



Source: DeAM calculations based on OECD data

Figure 4. Low short rates imply low long rates



The coefficient on real short rates is 0.81 with a t-statistic of 5.7, which is highly significant. The R^2 is 0.33.

Source: Bloomberg, OECD, DeAM