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The Fed must reassure markets on inflation

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The interest rate on 10-year US Treasury bonds almost doubled in six months, rising from 2.26 per cent last December to 3.98 per cent in mid-June, before decreasing slightly in recent days. This sharp rise happened despite the Federal Reserve's quantitative easing policy aimed at lowering long-term rates by buying \$300bn (£21bn, £18bn) of Treasuries and promising to buy more than \$1,000bn of mortgage securities.

The higher Treasury bond interest rates have pulled up mortgage rates, especially since April. That has weakened aggregate demand by depressing home-buying and reducing house prices. The fall in house prices in the past six months cut household wealth by some \$1,500bn, leading to lower consumer spending. The lower home prices also caused more defaults and weakened bank balance sheets.

There is no single reason for the sharp rise in rates, and what matters is not just how investors see the economic future but also what they think other investors will come to believe. Someone may sell long-term Treasuries because he believes inflation will rise, or because he thinks others will soon sell bonds because they think inflation will rise.

The simplest explanation for the higher 10-year rate is that many investors now expect inflation to rise. Although economic weakness and excess capacity are keeping current inflation low, the explosive rise of bank reserves created by Fed policy provides fuel for future inflation. The prospective decline of the dollar is also a potential source of inflation.

Comparing the interest rates on 10-year Treasuries with the interest rates for 10-year Treasury inflation protected securities (TIPS) supports this inflation explanation for the rise in long-term nominal rates. In mid-December, the 10-year Treasury yield was 2.26 per cent and the yield on 10-year TIPS implied a 10-year expected inflation rate of just 0.19 per cent. By mid-June Treasury yields were up to 3.98 per cent and the yield on TIPS was slightly down, implying that 10-year expected inflation had jumped to 2.07 per cent. Analysed this way, the entire increase of the interest rate was due to the rise in investors' expectations of 10-year inflation, or to that plus an increase in their willingness to pay for protection against a rise in the risk of inflation.

But such an explanation is deceptively easy. The changing spread between the yields on Treasury bonds and TIPS reflects not only changes in inflation expectations but also the response to investors seeking safety. Those scared by Lehman Brothers' collapse wanted the safety and liquidity of ordinary Treasury bonds, causing their yields to fall sharply while yields on TIPS rose slightly.

Treasury yields rose by this month to their level a year earlier because improving market conditions meant investors were no longer willing to pay for the extreme liquidity of Treasuries. Inflation was thus not the only, and perhaps not even the main, reason for the rise in rates.

Why did the Fed's massive buying of long-term Treasury bonds not hold down the bond rate? The answer is that bond markets are less impressed by the \$300bn of Fed purchases than by the official projection of \$10,000bn of government borrowing over the next decade, with a deficit in 10 years' time above 5 per cent of gross domestic product. The resulting crowding out of private investment will require higher future interest rates, and that is reflected in current long-term rates.

A further reason long rates remain high is a fear that foreign buyers may not be willing to continue buying dollar

bonds to finance a large US current account deficit.

In short, higher long-term interest rates reflect investors' concern about future inflation, future fiscal deficits and the future willingness of foreign investors to purchase US bonds. These long-term concerns can have adverse effects on the prospects for recovery during the coming year. The immediate challenge to the US government is to reassure investors about both the risks of inflation and the projected growth of fiscal deficits.

It would be wrong for the Obama administration and Congress to reduce the fiscal stimulus in 2009 or 2010, since there is no clear evidence of a sustained upturn. But it would be equally wrong to allow the national debt to double to 80 per cent of GDP a decade from now. Increasing taxes even more than proposed would weaken demand in the near term and hurt economic incentives in the long run. The fiscal deficit should therefore be reduced by curtailing the increases in social spending that the president advocated in his election campaign.

The Fed must also be careful not to tighten too soon. But it needs to reassure markets that it will prevent the excess reserves of the banks from financing a surge of inflationary lending when the economy begins to expand. It must make clear now that it will be willing to do so even if that involves big rises in short-term rates.

The writer is professor of economics at Harvard and president emeritus of the National Bureau of Economic Research. He chaired the Council of Economic Advisers under President Reagan and is a member of President Obama's Economic Recovery Advisory Board.