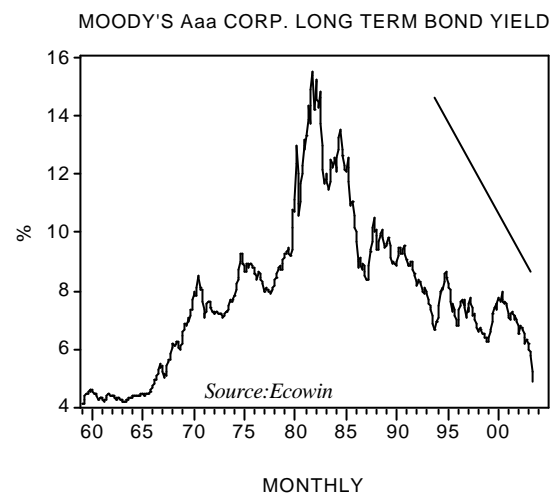
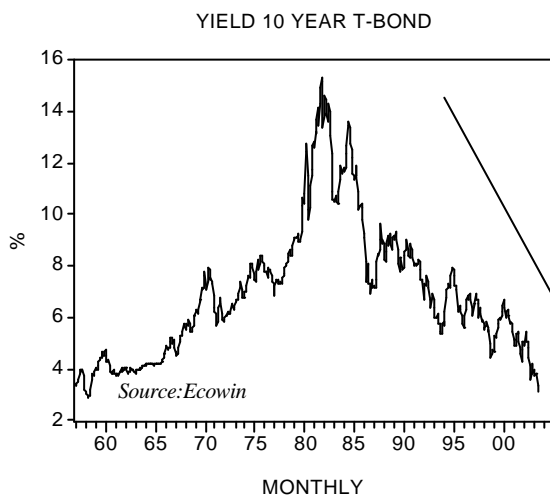


Commentary by Frank Shostak
June 18, 2003

What is behind the sharp fall in long term rates?

The yield on the 10-year T-Bond fell on Friday June 13 to 3.10% --the lowest level since June 1958 (see chart). Also, the yield on Moody's Aaa-rated corporate long-term bonds fell to 4.85% - the lowest level since February 1966 (see chart). Most experts are of the view that this sharp fall in long term rates is positive for economic activity since a fall in interest rates is a key driving force behind the formation of real fixed investment, which in turn sets in motion economic growth, so it is held. It seems therefore that the level of interest rates is the key determinant of real economic growth and hence the build-up of real wealth. But does this way of thinking make any sense?



The choices that any individual makes regarding the allocation of his real wealth towards consumption and towards savings is determined by his desire to maintain his life and well being. The improvement of life and well being requires various tools and machinery that must be funded through savings. Hence the more an individual saves the more funding is made available to build tools and machinery, which in turn gives rise to a greater variety and quantity of goods i.e. an increase in living standards ensues. The consequent expansion in real wealth permits in turn more consumption and more savings and thus a further improvement in living standards.

To make a long story short, the reason why an individual allocates his real savings towards the buildup of tools and machinery is his expectation that better tools will improve his standard of living. It is the desire to improve living standards that serves as a driving force behind individuals' decisions to allocate a portion of real wealth towards savings.

Thus out of his production of 110 loaves of bread a baker consumes 10 loaves of bread and saves 100 loaves. He then exchanges these saved loaves for the services of

an oven maker to improve his oven. With the enhanced oven the output of the baker rises to 150 loaves of bread. In short, his stock of real wealth is now 150 loaves of bread. The invested savings of the 100 loaves of bread gave rise to 150 loaves of bread i.e. a real return of 50%. With more real wealth at his disposal the baker can lift his consumption and savings. He can now directly consume 15 loaves of bread and exchange other 15 loaves of bread for various other consumer goods and save 120 loaves.

Now, the importance of projects that individuals aim at is dictated by the ultimate goal, which is to maintain life and well being. Thus with a limited stock of real wealth at his disposal an individual's top priority would be just to sustain life. This means that his entire stock of real wealth will be consumed daily without anything being allocated towards savings. With an increase in real wealth however, the individual can now consider less important goals as far as life and well being is concerned.

Thus with very limited real wealth an individual can only just stay alive. With a larger stock of real wealth he can have various other things that make his life more enjoyable. Consequently, his required return on investment will be now lower (since these things are of lesser importance as far as life sustenance is concerned). In other words, as individual's real wealth expands less important goals can be accommodated (with life and well-being serving as the standard of evaluation) which in turn implies that lower returns on investments will be accepted.¹

Things are not much different when a baker, Tom, lends his bread to a baker Sam. Tom is ready to lend Sam the 100 loaves of bread for 150 loaves in a one-year time. Sam agrees on this deal because he believes that an oven he can secure for the 100 loaves of bread will generate 160 loaves. Observe that it is the lender that sets the interest rate. However, it is up to a borrower to decide whether the asked interest rate is a good deal for him.

In order to secure the fundamental return, which is associated with the improvement in life and well being, a lender must consider also the risk involved in lending his real savings. Hence the higher the risk the higher the overall return on the invested real savings that the lender will demand, all other things being equal. Also, note that the supplier of a given stock of real savings may discover that the interest he set doesn't generate enough borrowers, as a consequence he will be forced to lower his interest rate if he wants to dispose of his supply of real savings.

Furthermore, below a certain level of interest rate the lender will not agree to exchange his real savings in order to prevent an undermining of his life and well being. Likewise the borrower will not agree to borrow above a certain level of interest rates that will lead to a deterioration of his living standard.

The introduction of money does not alter the essence of what we have said so far. Instead of lending bread Tom the baker will lend Sam \$100, which Sam will use to acquire an oven. On the maturity date Sam will exchange his 160 loaves of bread for \$160 and repay Tom \$150. Also, in the world of money with the expansion of real wealth there will be a fall in interest rates.

¹ Jorg Guido Hulsmann the QJAE volume 5 number 4 provides an interesting approach to interest rate determination

Trouble emerges, however, when money is generated out of "thin air". This type of money undermines the pool of real savings and hence reduces the range of goals that can be achieved. This in turn implies higher real interest rates. Moreover, the dilution of the pool of real savings also raises the risk factor. Consequently, all this leads lenders to ask for a higher return on their loaned money.

It follows then that an injection of money out of "thin air" leads to a higher real interest rate, all other things being equal. Furthermore, as monetary pumping increases this raises prices of goods and services. In order then to protect his real interest rate the lender will now demand compensation for a fall in the purchasing power of money.

We can then conclude that the fundamental driving force of interest rate determination is the desire to maintain life and well being. It is this ultimate goal that provides the standard of evaluation regarding the allocation of real wealth towards various subsidiary goals. The higher on the evaluation scale a particular goal is the higher the required return on investment will be. The importance of other factors, like risk, and inflationary expectations are always assessed with regard to the fundamental real interest rate.

Now, the effect from monetary injections on real wealth is not instantaneous--it operates with a time lag. In contrast the effect of monetary pumping on credit markets is immediate. Hence once new money is injected as a rule it first goes to credit markets. This in turn bids up the prices of bonds thereby lowering nominal interest rates. It is only after a time lag that the new money starts to undermine the stock of real wealth and hence the pool of real savings, which in turn starts to exert upward pressure on real and nominal interest rates.

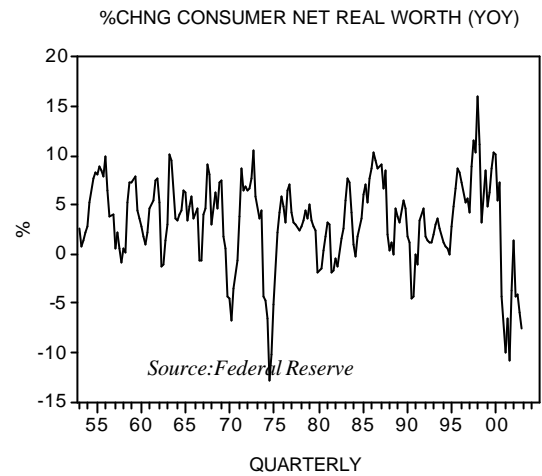
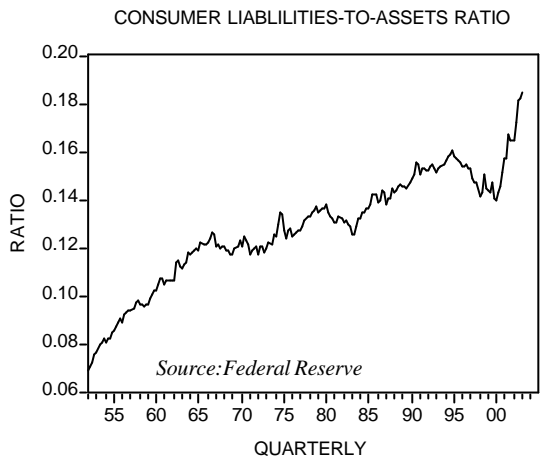
The central bank, however, doesn't stop there, it continues with its monetary pumping thereby suppressing any upward tendencies in interest rates. It follows then that the central bank can be always ahead in the race with the pool of real savings. As long as the stock of real wealth is expanding and price inflation appears to be tame monetary policy seems to be successful in maintaining interest rate at low levels. Once, however, the central bank tightens its stance as a result of emerging price inflation the support behind the artificial lowering of interest rates falls apart and the state of real wealth asserts itself.

If the stock of real wealth starts to shrink on the account of the aggressive artificial lowering of interest rates by the central bank this will harm the pool of real savings and in turn real economic activity. In response to this banks' lending out of "thin air" is likely to be curtailed and the rate of growth in the money stock follows suit. In short, the support behind the artificial lowering of interest rates disappears and the state of real savings starts to assert itself as far as interest rates are concerned.

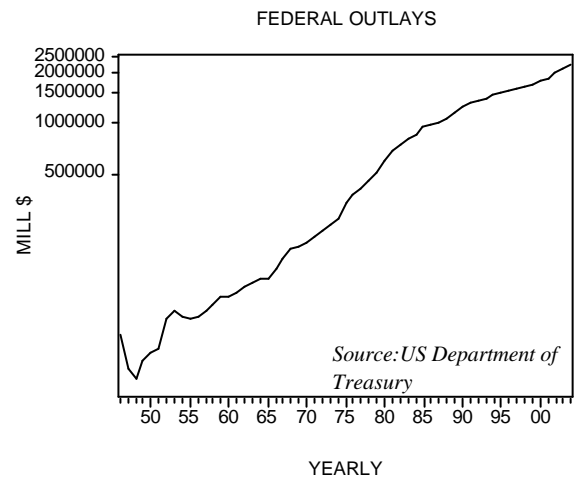
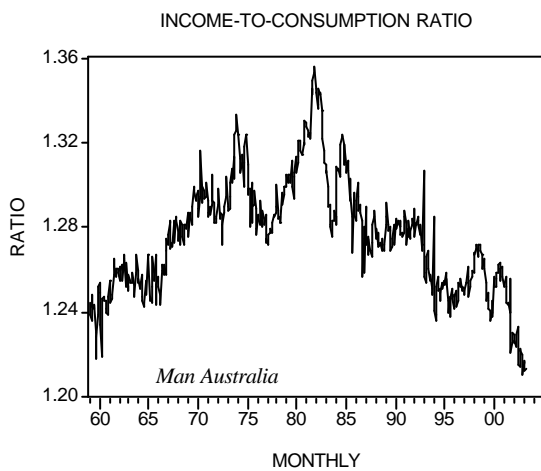
Contrary to popular thinking it is not the rise in interest rates that weakens economic growth but the availability of real savings. Interest rates as such are an indicator as it were. Consequently, an artificial lowering of interest rates cannot grow the economy if real savings are not there to fund real economic expansion.

In terms of present underlying real fundamentals there is very little support for low real interest rates. Thus the consumer liabilities - to -assets ratio climbed to a new record high of 0.185 in Q1 from 0.182 in Q4 2002 (see chart). Year-on-year

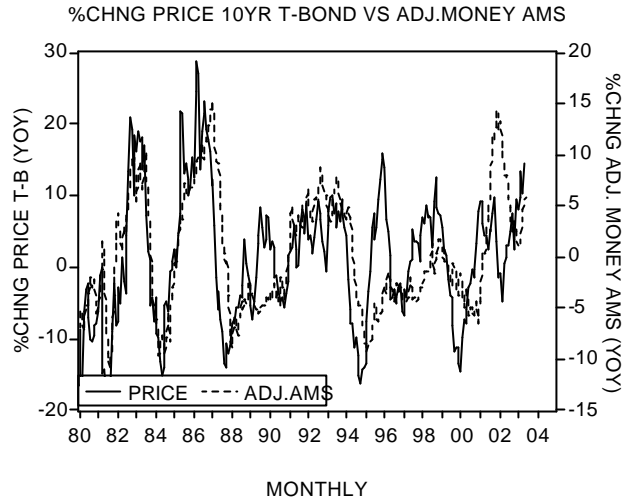
consumers' real net worth fell by 7.5% in Q1 after a fall of 5.9% in the previous quarter. This was the 4th consecutive quarterly decline (see chart).



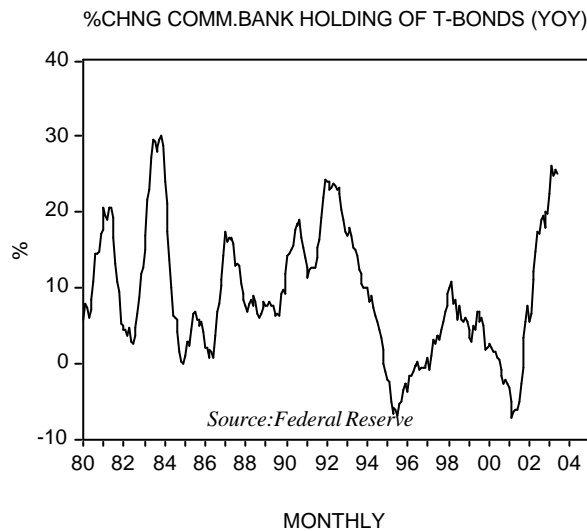
Also, the fact that the personal income to consumption ratio remains in free fall is another indication that the pool of real savings is in trouble (see chart). In addition to this, ever growing government outlays continue to undermine the formation of real wealth. For 2004 the President's budget outlays stand at \$2.229 trillion. This is an increase of 19.8% on outlays in 2001 budget, which President Bush inherited from President Clinton (see chart).



A further loosening in the monetary stance is likely to undermine the pool of real savings further and thereby put more pressure on real interest rates. As long as the bubble still holds and price inflation remains subdued market interest rates will continue to fall. In this regard, the yearly rate of increase in adjusted money AMS jumped from 0.9% in January to 6% in early June. This sharp increase in the growth momentum of monetary liquidity continues to provide support for the price of T-Bonds (see chart). After falling by 4.9% in March 2002 year-on-year the price of the 10-year T-Bond increased by 14.5% in May.



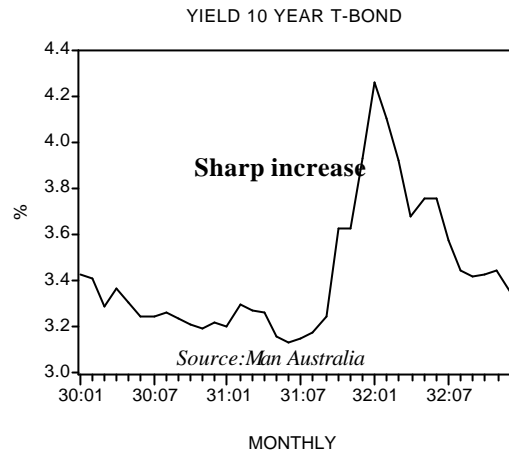
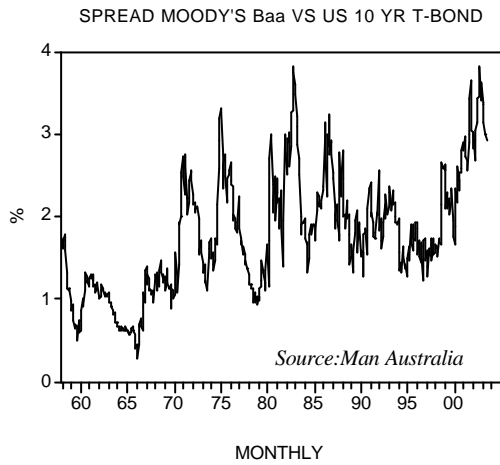
To pre-empt the possibility of price deflation the Fed is likely to boost monetary pumping by aggressive buying Treasury Bonds, thereby depressing long-term yields further. Another positive for T-Bonds is strong buying by commercial banks. In the week ending June 4 commercial bank holdings of T-Bonds increased by \$7.3 billion from the previous week. The yearly rate of increase of these holdings stood at 25.1% against 25.7% in April (see chart).



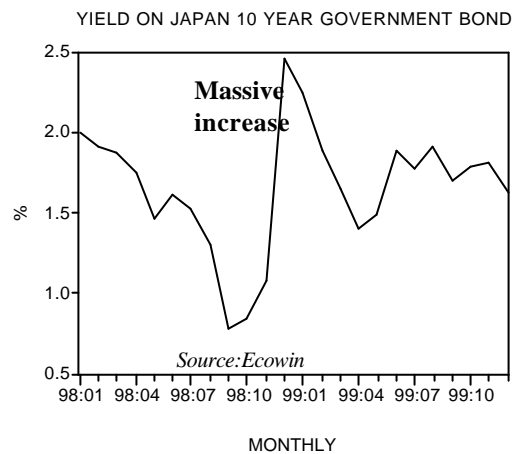
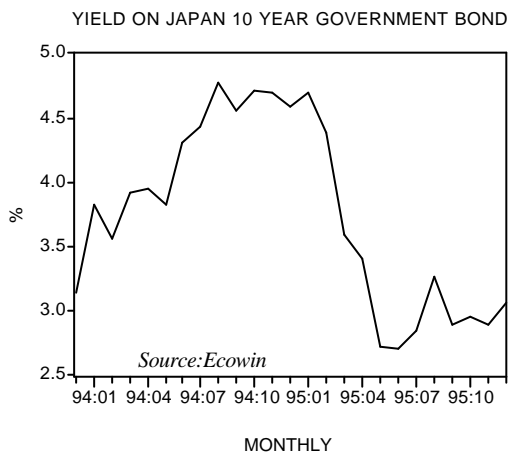
All this monetary pumping however will weaken the pool of real savings further and consequently will push real interest rates higher. Additionally the likely deterioration in real fundamentals runs the risk that the bust of the present stock market bubble will undermine the attractiveness of corporate bonds and thereby push their yields higher. The currently perceived risk on corporate bonds, as depicted by the spread between the Moody's Baa-rated long-term corporate bond and the yield on the 10 year T-Bond, while displaying softening at the margin remains at historically lofty levels (see chart).

Also, should the stock market plunge, a liquidity crunch may develop. To prevent insolvency investors are likely to attempt to mobilise cash by selling their most marketable assets like T-Bonds. However, this will depress their prices and boost their yields. A similar situation was observed during 1930's when the yield on the 10 year

T-Bond after falling to 3.13% by June 1930 climbed to 4.26% by January 1932 (see chart).



Also in Japan, after falling to 3.14% in December 93 the yield on the 10 year Government Bond jumped to 4.78% by August 94 (see chart). Furthermore, after falling to 0.785% by September 98 the yield on the 10 year Government Bond skyrocketed to 2.46% by December of that year (see chart).



To conclude then, while the present loose monetary policy is likely to provide further support to the T-Bond market, at the same time it continues to undermine the pool of real savings. Consequently, this will continue to exert upward pressures on real interest rates and at some time in the future will push nominal yields on long-term T-Bonds higher.

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