Cheap money talks

By Paul Krugman
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What with everything else going on, from Trump to Brexit to the horror in Dallas, it's hard to focus on developments in financial markets — especially because we're not facing any immediate crisis. But extraordinary things have been happening lately, especially in bond markets. And because money still makes the world go 'round, attention must be paid to what the markets are trying to tell us.

Specifically, there has been an extraordinary plunge in long-term interest rates. Late last year the yield on 10-year U.S. government bonds was around 2.3 percent, already historically low; on Friday it was just 1.36 percent. German bonds, the safe asset of the eurozone, are yielding minus — that's right, minus — 0.19 percent. Basically, investors are willing to offer governments money for nothing, or less than nothing. What does it mean?

Some commentators blame the Federal Reserve and the European Central Bank, accusing them of engineering "artificially low" interest rates that encourage speculation and distort the economy. These are, by the way, largely the same people who used to predict that budget deficits would cause interest rates to soar. In any case, however, it's important to understand that they're not making sense.

For what does "artificially low" mean in this context? Compared to what? Historically, the consequence of excessively easy money — the way you know that money is too easy — has been out-of-control inflation. That's not happening in America, where inflation is still below the Fed's target, and it's definitely not happening in Europe, where the central bank has been trying to raise inflation, without success.

If anything, developments in the real economies of the advanced world are telling us that interest rates aren't low enough — that is, while low rates may be having their usual effects of boosting the housing sector and, to some extent, the stock market, those effects aren't big enough to produce a strong recovery. But why?

In some past episodes of very low government borrowing costs, the story has been one of a flight to safety: investors piling into U.S. or German bonds because they're afraid to buy riskier assets. But there's little sign of such a fear-driven process now. The premiums on risky corporate bonds, which soared during the 2008 financial crisis, have stayed fairly low. European bond spreads, like the difference between Italian and German interest rates, have also stayed low. And stock prices have been hitting new highs.

By the way, the financial fallout from Britain's vote to leave the European Union looks fairly limited, at least so far. The pound is down, and investors have been pulling money from funds that invest in the London property market. But British stocks are up, and there's nothing like the kind of panic some pre-referendum rhetoric seemed to predict. All that seems to have happened is an intensification of the trend toward ever-lower interest rates.

So what's going on? I think of it as the Great Capitulation.

A number of economists — most famously Larry Summers, but also yours truly and others — have been warning for a while that the whole world may be turning Japanese. That is, it looks as if weak demand and a bias toward deflation are enduring problems. Until recently, however, investors acted as if they still expected a return to what we used to consider normal conditions. Now they've thrown in the towel, in effect conceding that persistent weakness is the new normal. This means low short-term interest rates for a very long time, and low long-term rates right away.

Many people don't like what's happening, but raising rates in the face of weak economies would be an act of folly that might well push us back into recession.

What policy makers should be doing, instead, is accepting the markets' offer of incredibly cheap financing. Investors are willing to pay the German government to take their money; the U.S. situation is less extreme, but even here interest rates adjusted for inflation are negative.

Meanwhile, there are huge unmet demands for public investment on both sides of the Atlantic. America's aging infrastructure is legendary, but not unique: years of austerity have left German roads and railways in worse shape than most people realize. So why not borrow money at these low, low rates and do some much-needed repair and renovation? This would be eminently worth doing even if it wouldn't also create jobs, but it would do that too.

I know, deficit scolds would issue dire warnings about the evils of public debt. But they have been wrong about everything for at least the past eight years, and it's time to stop taking them seriously.

They say that money talks; well, cheap money is speaking very clearly right now, and it's telling us to invest in our future.