Paul Krugman - New York Times Blog

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Bond Bubble Brouhaha

Brad DeLong is puzzled by Martin Feldstein's mental contortions as he tries to come up with a reason to raise interest rates in a depressed economy. So am I. But I'm also puzzled by Feldstein's underlying economic analysis, in which he treats it as totally obvious that we have a massive bond bubble.

Now, maybe we do have a bond bubble. But the arguments Feldstein uses are one that I thought every sensible economist — a group I thought included Feldstein — had dismissed as bogus years ago. Feldstein writes:

Historically, the real interest rate on ten-year Treasuries has been above 2%; thus, today's rate is about two percentage points below its historical average. But those historical rates prevailed at times when fiscal deficits and federal government debt were much lower than they are today. With budget deficits that are projected to be 5% of GDP by the end of the coming decade, and a debt/GDP ratio that has roughly doubled in the past five years and is continuing to grow, the real interest rate on Treasuries should be significantly higher than it was in the past.

In the words of Charlie Brown, aauuuggghhh! Why do we have large fiscal deficits? Because of the collapse of private demand, especially housing. The private sector's financial surplus has surged; government deficits have risen in counterpart through the operation of automatic stabilizers, mainly revenue but also unemployment insurance and other safety-net programs.

This is a situation of weak demand for funds, not strong demand; it's a situation in which you would expect bond yields to be lower than normal, not higher — and you'd be right.

One consequence of the economy's weakness is that the Fed is keeping short-term interest rates down at the zero lower bound — and they're likely to stay there for years to come. Take the CBO's latest economic projection for unemployment and inflation, and apply a simple Taylor rule. Here's the path for short-term rates that this implies:

So years of zero rates, and still fairly low rates thereafter; the implied 10-year rate is about 2. And if you believe that the CBO is overly optimistic, as it has been consistently through this crisis, you can justify an even lower rate. So why does Feldstein think that the 10-year rate might go to 5 percent any day now?

The thing is, Feldstein has invented a puzzle — how can rates be so low? — where there really isn't any puzzle. He then grabs hold of an answer to his imagined puzzle — it must be the quantitative easing! — that assigns vastly more importance to Fed bond purchases than I think can be justified by any evidence I see. And out of all that he manages to conjure up an argument for tightening monetary policy in the face of still-disastrous unemployment.

Bizarre; and not what I expected from Feldstein.

Still, let me say something nice: at least it’s better than the Stockman screed.