Paul Krugman - New York Times Blog

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Bond Vigilantes and the Power of Three

Matthew Yglesias picks up on a point I've tried to make at some length recently: the popular story about how an attack by bond vigilantes can cause an interest rate spike and turn America into Greece, Greece I tell you, is incoherent. (Here's a 2010 example from Alan Greenspan — the piece in which he declares it "regrettable" that the vigilantes haven't yet attacked, but grudgingly concedes that low rates might persist "well into next year", that is, into 2011. So what has he learned from the failure of his prophecy? Nothing, of course). It's not just that there have so far been no signs of the bond vigilantes; it's that even if for some reason the vigilantes did attack, it's very hard to see how they could cause a recession in a country that retains its own currency and doesn't have large amounts of debt denominated in foreign currency.

I've been trying to think about other ways to make this point, and also to help people understand the interest rate fluctuations we have actually experienced; here's one stab at it.

Think of a simplified world in which there are three kinds of assets: short-term securities, long-term government bonds, and foreign assets, as shown schematically here:

Individual investors can shuffle their portfolios among these three assets; however, asset prices will rise or fall to match supply and demand for each asset. What are these asset prices? Well, there are three prices that might do the job: short-term interest rates, long-term interest rates, and the exchange rate. At any given time, however, one of these is fixed, leaving it up to the other two to do the adjusting. Which two? That depends on the monetary regime, as I'll now explain.

The United States has independent monetary policy and a floating exchange rate. The Fed uses its independence to set the short-term interest rate, basically at zero these days. So long-term rates and the exchange rate do the adjusting.

Now, there have been some sizable fluctuations in long-term rates over the past few years, and every time those rates have gone up there have been press reports claiming that they are about debt fears. In reality, however, it's quite clear that the driving force has been fluctuating optimism about the prospects for recovery, and hence for an eventual rise in short-term rates.

If you think short-term rates are heading up, then other things equal long-term bonds become less attractive; better to park your money and wait for better yields. So the desired portfolio shift looks like this:

In such a case long-term rates rise – but because this rise is driven by greater optimism about the future, it's hard to see how it can have a contractionary effect on the economy.

Incidentally, this seems to me to be a big problem with the story Brad DeLong tells about bond vigilantes in the very early 1990s. He argues that the wide gap between short-term and long-term

rates reflected market expectations that deficits would eventually cause higher inflation, which in turn would cause the Fed to raise rates. This could be true. But why would such expectations be a drag on the economy? Yes, nominal rates would be higher than otherwise; but real rates would, if anything, be lower. It's not at all easy to tell a coherent story in which the effect of future expected deficits on today's interest rates is contractionary – I know, because I've tried.

Now, the big fear now is that we'll have a quite different type of vigilante attack, in which fear of default leads to a general flight from our nation's assets, sort of like this:

How does this play out?

Well, if you're Greece, the exchange rate is fixed – or actually nonexistent, because you don't have your own currency. So what happens is that both short-term and long-term interest rates rise. How can short-term rates shoot up, when there is also a relationship between the quantity of money and short-term rates (which is why central banks can peg these rates)? The answer is that as funds flee the country, the money supply plunges. Here's what happened to Greek M1:

But that can't happen in the United States, where the Fed retains control over the money supply and of short-term interest rates. So what would happen instead would be a plunge in the exchange rate. And this would actually have an expansionary effect on the U.S. economy.

The point is that the analogy with Greece is just completely wrong; the difference in our monetary positions means that even if the bond vigilantes did attack, they would probably help, not hurt, our economy in the short run.