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John Dessauer's market review and update as of Wednesday September 28, 2016

There is a debate raging among economists. Are central banks reacting to economic conditions, or pushing interest rates to zero and lower on their own initiative in a failing attempt to keep economic growth alive?

I am old enough to remember the 1970s and early 1980s when interest rates were sky high and popular common wisdom said they would never come down. Now, 45 years later, interest rates have not just come down - they are in several cases negative. What in the 1970s was unthinkable has become reality. Investors are buying bonds that, if held to maturity, will pay the bond holder less that what was paid for the bond.

Critics of the Federal Reserve and other central banks, including Republican nominee Trump, have a huge problem. Central banks control only short term interest rates. Interest rates on long term securities are determined by the market. In 2004 the U.S. Federal Reserve raised short term interest rates, expecting that interest rates on long term bonds would rise as well. They were wrong. Long term interest rates went down, not only in the United States, but on world markets as well. Alan Greenspan, who was Federal Reserve chair at the time, called the situation a "conundrum," or mystery. Conundrum or not, 2004 and beyond offer proof positive that something beyond central bank policy is driving interest rates down.

And talk about long term economic cycles - real interest rates have been falling since 1985. There was a short upward move in 1990, but that was quickly reversed. And interest rates are still falling. After the Brexit vote, the Bank of England cut interest rates to the lowest level in its 100 year history. Last week the Bank of Japan promised to keep interest rates on ten year government bonds near zero. Our Federal Reserve kept interest rates unchanged on September 21. Such a long term cycle cannot be explained by blaming central banks. Central banks do make mistakes. Paul Volker, when he was chair of the U.S. Federal Reserve, made a colossal mistake by raising interest rates in 1984. That set off a dollar surge that threatened to push the U.S. economy into recession. He was forced by the currency market to reverse course and bring interest rates back down. The experience of 1984 is also solid evidence that central banks do not have control of all markets. They are subject to the pressures from the currency market and other financial markets.

Ben Bernanke, before he became chair of the Federal Reserve, identified a worldwide “savings glut” as the cause for the long term decline in interest rates. In other words, it is a basic economic principle, “supply and demand” that has been at work determining interest rates. With interest rate still falling, logic says the supply or savings glut is still growing faster than demand. A brief look around the world confirms the continued growth in the savings glut.

The *Geneva Report* is an annual study from the International Centre for Monetary and Banking Studies and the Centre for Economic Policy Research. According to last year’s report there are two main factors at work causing the savings glut. First is

demographics in rich, developed economies and some emerging markets. Populations are aging while the average working life has not changed very much. The result is increased savings for retirement. The second factor is the integration of China into the world economy. Randall Kroszner of the University of Chicago put it this way: “A billion people with a 40% savings rate: that brings a lot more supply to the table.”

For a decade or more, most, if not all, of China’s savings was absorbed by domestic investment. As China’s economy has grown and developed, more and more of the savings has become available on world markets. China’s remarkable growth by itself explains the continued growth in the global savings pool.

There is another large savings pool not mentioned in the *Geneva Report,* namely the trillions of dollars held by American companies in offshore accounts. Businesses normally invest cash in projects to foster future growth of sales and profits. They are not doing that for the same reasons others are holding on to their savings. With growth slow, they do not see investment opportunities that provide an attractive risk/reward balance.

Larry Summers of Harvard describes the current global economy as in a “secular stagnation,” due to a chronic shortfall in demand. A growing supply of savings combined with a chronic shortfall in demand is the explanation for the extremely low interest rates we have today.

The solution is to stimulate demand. Central banks have certainly done their part. And it appears more and more that we may be running into the limits of what central banks can do. For the most part economists agree that it is time for governments to do

more. The classic answer would be a Keynesian approach, with governments increasing spending on all sorts of infrastructure projects. The problem is that governments in Europe, Japan and the United States have borrowed and spent too much. They are also running current deficits. Their debts keep growing, leaving little or no room for more borrowing to fund projects of any kind.

The solution is obvious, but far from easy to accomplish. There is plenty of money, but it is in the private sector. Instead of borrowing, governments could become partners with the private sector, offering investment opportunities to finance infrastructure projects. Imagine government sponsored - perhaps even guaranteed or tax free - bonds yielding 2%-4% in toll road, airport or other income producing infrastructure projects. In this low interest rate environment, investments of that sort might look appealing for the combination of income and safety to pension and mutual funds and even individual investors. While it may seem unrealistic to expect current government administrations to adopt such investor friendly policies, there are plenty of examples from the past where governments have done just that - partnered with the private sector. What is needed is change in government attitudes to become more business and investor friendly. The beggar the rich approach we hear from some politicians is the opposite of what is needed. Following that approach would mean a continuing shortfall in demand, sluggish to no growth, and low interest rates far into the future. In the wake of the Brexit vote in Britain we are seeing a definite shift in political attitudes, for the better. Elsewhere in Europe there are political rumblings, but it is too soon to determine their direction and effect. Americans may not like their choice in the presidential election, but

choose they will. As I wrote last week, more important than the White House will be which party controls the Congress.

Hopefully one or another leading government will show the way and adopt innovative ways of partnering with the private sector to finance enough infrastructure projects to stimulate demand. Success has a way of attracting attention.

Meanwhile we can expect interest rates to remain low, even if the Federal Reserve raises short term rates in December.

I will have the next market review and update for you one week from today on Wednesday October 5, 2016.

All the best,

John Dessauer

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