Alan Greenspan: Central bank panel discussion

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, to the International Monetary Conference, People's Republic of China, Beijing, (via satellite), 6 June 2005.

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The pronounced decline in U.S. Treasury long-term interest rates over the past year despite a 200-basis-point increase in our federal funds rate is clearly without recent precedent. The yield on ten-year Treasury notes currently is at about 4 percent, 80 basis points less than its level of a year ago. Moreover, despite the recent backup in credit risk spreads, yields for both investment-grade and less-than-investment-grade corporate bonds have declined even more than Treasuries over the same period.

The unusual behavior of long-term rates first became apparent almost a year ago. In May and June of last year, market participants were behaving as expected. With a firming of monetary policy by the Federal Reserve widely expected, they built large short positions in long-term debt instruments in anticipation of the increase in bond yields that has been historically associated with a rising federal funds rate. But by summer, pressures emerged in the marketplace that drove long-term rates back down. In March of this year, market participants once again bid up long-term rates, but as occurred last year, forces came into play to make those increases short lived.

But what are those forces? Clearly, they are not operating solely in the United States. Long-term rates have moved lower virtually everywhere. Except in Japan, rates among the other foreign Group of Seven countries have declined notably more than have rates in the United States. Even in emerging economies, whose history has been too often marked by inflationary imbalances and unstable exchange rates, access to longer-term finance has improved. For many years, emerging-market long-term debt denominated in domestic currencies had generally been unsalable. But in 2003, Mexico, for example, was able to issue a twenty-year maturity, peso-denominated bond, the first such instrument ever. In recent months, Colombia issued domestic-currency-denominated global bonds. As rates came down worldwide, dollar-denominated EMBI+ spreads over U.S. Treasuries receded to historically low levels, before widening modestly of late.

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A number of hypotheses have been offered as explanations of this remarkable worldwide environment of low long-term interest rates.

One prominent hypothesis is that the markets are signaling economic weakness. This is certainly a credible notion. But periodic signs of buoyancy in some areas of the global economy have not arrested the fall in rates.

A second hypothesis involves the behavior of pension funds. As the inevitable increases in retirement populations approach, especially among developed countries, the underfunding of retirement plans has become a growing concern. Pension funds and insurance companies, are being pressed to make significant additions to longer-term bond portfolios. This demand for increasingly longer-term obligations is evident in the favorable reception given the fifty-year-maturity bonds recently issued by France and the United Kingdom.

But world demographic trends are hardly news, and recent adjustments to funding shortfalls do not seem large enough to be more than a small part of a complete explanation.

The heavy accumulation of U.S. Treasury obligations by foreign monetary authorities is yet another hypothesis that has been offered. And, doubtless, those purchases have lowered long-term U.S. Treasury rates. But, given the depth of the market for long-term Treasury instruments, the Federal Reserve Board staff estimates that the effect of foreign official purchases has been modest. Furthermore, such purchases seem an implausible explanation of why yields on long-term non-U.S. sovereign debt instruments are so low.

A final hypothesis takes as its starting point the breakup of the Soviet Union and the integration of China and India into the global trading market, developments that have permitted more of the world's lower-cost productive capacity to be tapped to satisfy global demands for goods and services.

Concurrently, greater integration of financial markets has meant that a larger share of the world's pool of savings is being deployed in cross-border financing of cost-reducing investments.

The enlargement of global markets for goods, services, and finance has contributed importantly to the favorable inflation performance that we are witnessing in so many countries. That improved performance has doubtless contributed to lower inflation-related risk premiums, and the lowering of these premiums is reflected in significant declines in nominal and real long-term rates. Although this explanation contributes to an understanding of the past decade, I do not believe it explains the decline of long-term interest rates over the past year despite rising short-term rates.

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Whatever the underlying causes, low risk-free long-term rates worldwide seem to be one factor driving investors to reach for higher returns, thereby lowering the compensation for bearing credit risk and many other financial risks over recent years. The search for yield is particularly manifest in the massive inflows of funds to private equity firms and hedge funds. These entities have been able to raise significant resources from investors who are apparently seeking above-average risk-adjusted rates of return, which, of course, can be achieved by only a minority of investors. To meet this demand, hedge fund managers are devising increasingly more complex trading strategies to exploit perceived arbitrage opportunities, which are judged - in many cases erroneously - to offer excess rates of return. This effort is particularly evident in the pronounced growth and increasing complexity of collateralized debt obligations. Although collateralized debt obligations are a powerful tool for enhancing risk management by separating idiosyncratic risks from systematic risks, the models used to price and hedge these instruments are just beginning to be tested.

I have no doubt that many of the new hedge fund entrepreneurs are embracing a strategy of pinpointing temporary market inefficiencies, the exploitation of which is expected to yield above-average rates of return. For the time being, most of the low-hanging fruit of readily available profits has already been picked by the managers of the massive influx of hedge fund capital, leaving as a byproduct much-more-efficient markets and normal returns.

But continuing efforts to seek above-average returns could create risks for which compensation is inadequate. Significant numbers of trading strategies are already destined to prove disappointing, a point that recent data on the distribution of hedge fund returns seem to be confirming.

Consequently, after its recent very rapid advance, the hedge fund industry could temporarily shrink, and many wealthy fund managers and investors could become less wealthy. But so long as banks and other lenders to these ventures are managing their credit risks effectively, this necessary adjustment should not pose a threat to financial stability.

I trust such an episode would not induce us to lose sight of the very important contributions hedge funds and new financial products have made to financial stability by increasing market liquidity and spreading financial risk, and thereby enhancing economic flexibility and resilience.

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The economic and financial world is changing in ways that we still do not fully comprehend. Policymakers accordingly cannot always count on an ability to anticipate potentially adverse developments sufficiently in advance to effectively address them. Thus our economies require, in my judgment, as high a degree of flexibility and resilience to unanticipated shocks as is feasible to achieve. Policymakers need to be able to rely more on the markets' self-adjusting process and less on officials' uncertain forecasting capabilities.

The U.S. economy's response to the terrorist attacks of September 11, 2001, is a case in point. That shock was absorbed by a recently enhanced, highly flexible set of institutions and markets without significantly disabling our economy overall. But that flexibility should not be taken for granted, and every effort should be made to preserve and extend it.

In this regard, the recent emergence of protectionism and the continued structural rigidities in many parts of the world are truly worrisome. In the end, I trust that we will all recognize our common interest in fostering global and domestic arrangements that promote the prosperity of our citizens.