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## An Economy Of Fear

**Kenneth Rogoff****July 06, 2005**

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**The global economy seems to be walking on water**, shrugging off soaring oil prices, policy paralysis in Europe, unsustainable borrowing by the United States and record housing prices. Is it because, as G8 leaders would have us believe, investors are in a buoyant mood, confident in their leaders' stewardship of the global economy? Or is a pathology of fear holding down long-term interest rates, thereby covering up a host of simmering problems?

The role of phenomenally low long-term (inflation-adjusted) interest rates in covering up a multitude of weaknesses in the global economy is all too apparent. Soaring house prices worldwide are propping up consumer demand in many countries, and, according to a recent study by the International Monetary Fund, continually falling long-term interest rates explain two-thirds or more of the global price rise. Europe has benefited less, but its economies would be a lot worse off if long-term interest rates climbed back to their 25-year average.

Similarly, Latin America has been booming in recent years, despite high debt burdens and a mixed record of policy reform. Low long-term interest rates have kept the region's debts manageable, while high consumer demand has helped bid up prices for the region's commodity exports.

Why hasn't the huge spike in oil prices cut the world to its knees, as it has on so many other occasions? Again, the answer is low interest rates. Ordinarily, a sharp rise in oil prices quickly translates into higher inflation expectations, followed by rising interest rates at all maturities. But this time, even as the U.S. Federal Reserve keeps hiking its short-term lending rate to keep inflation in line, long-term interest rates—which are far more important—have been magically declining.

Indeed, America has been the single biggest beneficiary of this freakish low interest rate environment, with everyone seeming to borrow money like it is going out of style. Homeowners, backed by rising house prices, are piling up debt. The federal government has thrown fiscal prudence out the window. The country as a whole is absorbing an astounding three-quarters of global excess savings. But, as long as interest rates remain low and growth high, Americans can laugh at predictions that their excesses are laying the seeds of ruin.

But if low long-term interest rates are helping so many economies walk on water, why are rates so low—and will they stay that way? Perhaps the situation is far more fragile than many policymakers would have us believe. Perhaps people have come to feel less, not more, secure about their long-term future, either because of fears about terrorism, a global pandemic, or a severe rash of financial crises.

I am not claiming that investors are hysterical, just that they may have become a bit more concerned about the long-term outlook. As a consequence, they are crowding into bonds and debt instruments that they view, rightly or wrongly, as safe vehicles.

Other convincing explanations are lacking. To be sure, emerging markets have been on an unusual

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savings spree, rebuilding reserves and improving balance sheets, but nobody expects this to go on forever. Even U.S. Federal Reserve Chairman Alan Greenspan, ordinarily the Oracle of Delphi on interest rate matters, has declared the current situation “a conundrum.”

History suggests that the global technology boom has yet to play itself out, with U.S. productivity gains likely to radiate out across the world, raising growth rates everywhere. Ordinarily, rapid global growth translates into high long-term interest rates—that is, unless, deep down, people have become nervous.

Suppose investors are worried about a small chance of catastrophe over the next five to 10 years. (According to experts on nuclear terrorism and pandemics, the dangers are real.) Suppose investors believe that growth will probably continue to be strong, but that maybe—just maybe—things will fall apart. In this case, it is entirely possible to have very low interest rates co-exist with strong growth.

True, some economists point to the halcyon days of the 1950s and early 1960s, when Europe, the United States and Japan prospered, but interest rates generally remained well below the rate of economic growth. Since that was a golden era for global growth, why worry if we are seeing the same phenomenon today?

What the optimists forget is that the 1950s and 1960s were also a period of massive insecurity. Many people realistically feared the outbreak of World War III—and with good reason, according to many historians. Back then, the specter of the Apocalypse helped keep borrowing cheap. Happily, investors’ darkest fears were not realized, and we can only hope for the same.

But if insecurity is a major undercurrent of today’s record-low interest rates, then G8 leaders should be more cautious in their self-congratulation. Investors’ collective psychology is notoriously fragile. If they ever calm down, interest rates will shoot up, and that could well bring the global economy’s simmering imbalances to a raging boil.

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