
Paradise Regained

By Martin Hutchinson *Wed, Feb 16, 2011*

A return to long-term interest rates of 5% to 6% will hurt Wall Street and McMansion owners in the short-run but help most Americans in the long run, says this columnist.

Emerging market central banks in China, India, Brazil and elsewhere are now raising interest rates fairly aggressively, and even in the United States long-term Treasury bond rates have risen significantly in spite of Fed Chairman Ben Bernanke's efforts to hold them down.

Given the continued rise in commodity prices, it's likely that these are just the first moves in a lengthy period of interest rate rises. In the medium term, this could raise real long term interest rates, net of inflation, to the 5%-6% levels of the early 1980s, necessary to quell inflationary forces and compensate for the lengthy and unjustified period of ultra-cheap money.

It's thus worth contemplating what such a world of high interest rates will look like.

Lower home prices

Much though one may wish for such a world, it has to be admitted that there will be some fairly severe side effects, albeit temporary ones. The incipient U.S. housing market recovery that began in spring 2010, which has since shown signs of petering out, will disappear altogether.

With mortgage rates at around 7-8% or quite possibly higher, the current generation of homebuyers will gasp when told what their mortgage payments will be. Congressional action to limit the home mortgage interest deduction may well increase the sticker shock further. The result will be further declines in house prices.

For most houses, prices will not collapse, but decline perhaps a further 10-15%. However there will be certain categories of house whose prices will collapse, notably the "McMansion," built in the post-1995 boom, mostly of shoddy materials, with gaudy features and very large living space, but normally not much land. Houses in this category that at the top of the boom sold for \$1.5 million will find a demand only at the \$500,000 level, as the economics of home-buying will simply not support mortgages of the size necessary for the original purchase.

Consequently some quite wealthy people, who had overstretched to buy their dream houses, will find themselves not merely underwater but drowned, as their mortgage will exceed the value of their house by \$500,000-\$750,000.

Treasury funding crisis

A second adverse affect of a high interest rate world will be on the Federal budget and to a lesser extent on state budgets. The Congressional Budget Office's budget projections to 2021 assume a 10-year Treasury

bond rate ranging no higher than 5.4% during that decade. In a high interest rate environment this is clearly far too optimistic.

Furthermore, the increase in interest rates will affect the U.S. Treasury's borrowing costs quite quickly, because in the last decade Treasury has foolishly allowed the average maturity on its debt to decline to a mere 4.5 years. Thus, even if the current efforts to cut public spending bear some fruit, the deficit will soar again once the high interest rate period hits.

As a corollary of this, Treasury may find bond funding has become much more difficult to obtain. Investors will be looking at capital losses of 20-30% on their longest term Treasury bond holdings, and even the mildest mannered central bank may come to feel that there must be a better way to invest. Hence the advent of the high interest rate environment may well coincide with a Treasury funding crisis.

Of course, the Fed can always buy up all the paper that Treasury issues, as it is doing currently, but in an environment where inflation is a real problem it's likely that some combination of the authorities and the markets will have prized Bernanke's tiny frozen hands off the Fed tiller, so that avenue may no longer be available.

This situation is unlikely to result in a full U.S. default, but it will undoubtedly make for a very unpleasant couple of years.

Disappearing spreads

The U.S. Treasury's problems will mostly require an unprecedented degree of self-discipline among the Executive and Legislative branches. However the rise in interest rates will also cause huge problems for the U.S. banking system and more particularly for the "shadow" banking system of hedge funds, private equity funds, etc.

Many banks and hedge funds have invested heavily in mortgages or mortgage-backed securities, relying on Bernanke to keep short-term interest rates low enough to maintain a satisfactory "spread" between their short-term borrowing costs and their long-term mortgage income. As interest rates rise, this spread will disappear and the value of their mortgage portfolios themselves will decline. First Pennsylvania Bank went bust this way in 1980; the casualty list is likely to be much longer this time.

Higher interest rates will not just affect investors in mortgage bonds. Private equity funds buy companies and leverage the purchase, relying on the company's cash flows to pay debt service costs. As interest rates rise, debt service costs will rise, reducing the capital value of a given corporate cash flow and causing the fund's outflows to exceed its inflows in many cases. This will quickly cause a high mortality rate among the private equity fund community. Similarly hedge funds, many of which rely on excessive leverage of moderate but fairly predictable returns, will find a high interest rate environment very unpleasant indeed.

Positive effects

So far I have covered only the adverse effects of a high interest rate environment, most of which will be

fairly short-term although the fiscal discipline imposed on politicians will be with us over the longer term. However, as readers were perhaps guessing when I expounded the high mortality levels high interest rates would produce among hedge funds and private equity funds, a high interest rate environment will have a number of positive effects, most of which will be structural and long-term.

For a start, the culling of the private equity and hedge fund industry will decimate the excessive bonuses of Wall Street (because there will no longer be such an active market for top traders' services) and will sharply reduce the percentage of top graduates heading for these mostly unproductive activities. Leverage in the economy as a whole will decline; it will have become too expensive. The search for short-term gain will also decline, because it will be too expensive and difficult to collect together the money pools for such speculation.

More savings

These changes will over time greatly benefit the rest of the economy. It will at last encourage saving, since savers will be rewarded with positive real returns. Since saving will increase and consumption consequently diminish, the pressure of imports will also diminish and the U.S. balance of payments deficit will finally decline towards zero, reducing the country's vulnerability to foreign finance providers.

This combination of higher saving and a lower payments deficit will begin to recapitalize the U.S. economy.

One of the principal factors tending to weaken the earning capacity of the U.S. workforce has been the steady de-capitalization of the U.S. economy since 1995 through low savings rates, periodic asset price crashes and high payments deficits. Meanwhile the capital resources of competing emerging markets, particularly in East Asia, have increased.

With interest rates higher and the U.S. economy being recapitalized, the erosion of U.S. living standards will diminish and (if immigration laws are properly enforced) the 40-year decline in the living standards of the U.S. blue collar worker will come to an end.

More jobs

We come finally to the most important and unexpected effect of higher interest rates. We now have at last a control experiment, to compare the job-creating capacity of a high interest rate environment with that of a low interest rate environment, and the contrast is a stark one. Following the unemployment peak of 1982, when real interest rates were very high under the tender ministrations of Paul Volcker, the U.S. economy created 4.7 million jobs in the first fifteen months. This time around, in spite of massive "stimulus," both fiscal and monetary and Bernanke's gravity-defying monetary efforts, the first fifteen months after the peak in unemployment have seen the creation of only 930,000 jobs - one fifth the number, in a workforce almost 40% larger.

The explanation is quite simple when you consider the question from first principles. Low interest rates reduce the cost of capital, hence increase the propensity of employers to use capital-intensive technologies, substituting capital for labor wherever possible. Conversely high interest rates, by making capital more

expensive, increase the propensity of employers to hire more labor and train its existing workforce to produce more output rather than investing in capital-intensive equipment.

Thus a high-rate economy has a smaller proportion of capital inputs in the total – about 28% of total inputs in the 1980s versus 32% recently, according to the Bureau of Labor Statistics – and a lower productivity growth rate, about 1.2% per annum in 1979-84 and 2.4% per annum in 2005-10. While the Greenspan/Bernanke monetary policies have increased recorded productivity growth, therefore, they have reduced job creation, in this recession creating a pool of long-term unemployed that will remain a miserable underclass until they pass on, decades in the future.

Short-term pain, long-term gain: that's what we have to look forward to once interest rates rise to their proper level. However while the short-term pain will be concentrated on Wall Street, politicians and a few overenthusiastic homeowners, the gain will be more general. For the great majority of the American people, the long-term effects of higher savings, lower house prices and faster job creation will feel like Paradise Regained.

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