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Is U.S. Inflation Target Behind Low Bond Rates?

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WASHINGTON (Reuters) - The debate about whether the Federal Reserve should adopt an inflation target, like many other central banks have done, may be one factor Fed chairman Greenspan has overlooked in his puzzlement over why long-term U.S. interest rates remain so low, economists say.

Although Greenspan in his testimony to the Senate Banking Committee last week posited several reasons for buoyant bond markets, including buying by foreign central banks appetite and demand for long-dated paper to match mortgage liabilities, he admitted pricing was a "conundrum."

Some economists reckon the simmering debate within the Fed on whether to define, target and publicize a desired range for inflation may be one factor capping long rates over the past six months despite solid growth and several Fed rate rises.

Greenspan is a long-time opponent of committing the Fed to an explicit inflation target, favoring greater flexibility and discretion in monetary policy to cope with shocks to the system. So some say it is no surprise he skirted this as a possible factor in the bond puzzle.

But with his 18-year tenure the central bank's helm due to come to a close next year, speculation is bubbling on whether advocates of inflation targets will hold sway when he goes.

Investors believe adopting a target, as several leading central banks around the world have done over the past 10 years, makes long-term debt more attractive by anchoring inflation expectations and reducing the risk premium.

Evidence from countries with targets tends to back this up, showing the United States pays a price for the existing Fed model in long-term interest rate volatility.

Inflation targets reportedly came up for discussion at the Fed's last policy committee meeting earlier in February. The minutes of that meeting, due out Wednesday, are eagerly awaited for clues to Fed thinking on the subject.

Jim O'Neill, Chief Global Economist at Gilman Sachs, said he wondered if the recent drop in long rates at least partly reflects a belief the Fed is "close to adopting an inflation target, or at least as close as the Constitution will allow."

"If so, then it is quite likely the long end will continue to perform. If you look at other nations that introduced inflation targeting, there was a big drop in risk premia."

Since last June when the Fed began a string of rate rises, 10-year U.S. borrowing costs have fallen 60 basis points or 0.6 percentage points.

Not only was that fall in borrowing costs out of line with the Fed tightening, but it also flew in the face of robust growth rates, creeping inflation, slowing productivity growth and a weaker dollar.

"What he (Greenspan) was saying (last week) was the long end of the curve has shades of 'irrational exuberance'," said Paul McCulley, managing director and portfolio manager at the giant bond fund PIMCO, echoing Greenspan's 1996 warning about surging stocks.

Although McCulley said inflation targeting speculation would not fully explain the bond yield drop, he expects the Fed to adopt a target eventually.

"Once Greenspan leaves, I think they'll move to an inflation objective -- I don't think they'll call it a target," he said.

"The only reason that they haven't done it is because Greenspan hasn't wanted to do it. For me, the theoretical case is so overwhelming it really doesn't need any debate now."

Advocates say the need for an explicit measure of what inflation the Fed would tolerate has increased since the bank warned in May 2003 that inflation could go too low. If it is accepted there is a lower limit, a preferred ceiling is also necessary.

Fed governor Ben Bernanke has been the central bank's torch-bearer for inflation targets. While others feel it is an unnecessary shift, as Cleveland Fed President Sandra Pianalto explained on Tuesday, Fed watchers say there is a substantial body of support within the central bank.

A widely-cited internal Fed study from 2003, now being updated, examined a link between the behavior of long-term interest rates and the success of the central bank in anchoring inflation expectations in the economy at large.

The study concluded the U.S. Treasury bond market experienced "excess volatility" in the face of surprising economic data or unexpected interest rate decisions, and this was mostly due to shifting inflation expectations.

Crucially, it contrasted this to the UK bond market where it identified much less volatility in inflation expectations since the Bank of England, an inflation-targeter since 1992, became independent of political control in 1997.

In its annual report on the U.S. economy last year, the Organization for Economic Cooperation and Development (OECD) cited this study on long rates by Fed economists Refet Gurkaynak, Brian Sack and Eric Swanson, as a central cog in the debate.

The OECD said this and similar studies suggest quantifying an inflation target "could reap many of the benefits that inflation targeting has yielded for other countries."

Acknowledging it would need Congressional approval, the OECD said the Fed need not lose flexibility because it need not give time horizons to meet its long-term inflation goals.