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## The Great Interest Rate Wave

*What's caused such a wide swing in interest rates?*

By HENRY KAUFMAN

Amid the daily news about economic woes, it is useful to ponder the long view. And the long view shows that we now stand at the tail end of the greatest secular swing in interest rates in U.S. history. Interest rates are a barometer of economic conditions. So where have they been, and what can they tell us?



Secular swings are long-term movements that span years or decades and are punctuated by shorter cyclical movements. The pattern observed in the nearby chart -- which shows yields on the U.S. Treasury's 30-year long bond over the last six decades -- is unmistakable. The upward move began in 1946, when long bonds were yielding about 2.5%, and ended October 1981, when they peaked at 15%. Thereafter, yields on 30-year bonds fell irregularly to a low of 2.69% early this year, which probably marks the end of this extended wave.

The magnitude of this long up-and-down yield movement dwarfs by a very wide margin all four previous secular swings in American financial history. The cumulative change in the postwar trough-to-peak-to-trough swing was 25.3 percentage points. In the prior four secular swings, the largest change was just 5.6 percentage points, and that occurred in the much shorter period from 1810 to 1824. Indeed, the current secular swing is much longer than any previous wave.

This does not mean, however, that economic conditions at the beginning and end of the great swing are similar. They are, rather, similarly extreme. As Mark Twain once put it, history doesn't repeat itself, but often it rhymes.

In 1946, World War II had just ended and Americans -- after 16 years of depression and wartime constraints -- were eager to spend, their accounts flush with wartime full-employment savings. In the financial markets, banks were highly liquid, holding a large volume of U.S. government obligations and very little of private debt. The financial system already had been restructured by Congress during FDR's New Deal. At the same time, fresh memories of the depression caused banks and borrowers alike to spurn aggressive financial risk-taking.

Today, in contrast, even though the long government bond yield is nearly as low as it was in 1946, the financial scene is strikingly different. The private sector is overloaded with debt. The federal government continues to issue an unprecedented volume of new obligations. Our financial institutions are overleveraged and dependent on government largess for their survival. Whereas the nation stood on the brink of an unprecedented economic boom in 1946, today wealth is contracting massively and the economy is grinding through a severe recession.

So interest-rate movements, in their extreme highs and lows, reflect extremes in financial and economic conditions -- the restoration of global peace, the struggle to break the back of 1970s stagflation, and today's toxic combination of a deep recession with massive private-sector debt overload -- that are hobbling financial institutions.

The current interest-rate trough reflects several weaknesses in today's financial markets that also are undermining the broader economy, from the failure of monetary policy makers to recognize the impact of financial and structural changes on market behavior, to serious lapses by credit rating agencies, to the inability of the senior management of financial institutions to stay within reasonable risk parameters.

Which raises the question: Why are we so poor at managing our key economic institutions while at the same time so accomplished in medicine, engineering and telecommunications? Why can we land men on the moon with pinpoint accuracy, yet fail to steer our economy away from the rocks? Why do our computers work so well -- except when we use them to manage derivatives and hedge funds? The answer lies in methodology. In science and technology, we rely on the scientific method: experimental design with dependent and independent variables and with reproducible results.

Economists and financial experts like to fancy themselves as exact scientists as well. Back in the 1960s, when we landed on the moon, economists emulated the terminology of Space Age navigation. They spoke of "midcourse corrections" and of bringing in the economy for a "soft landing." Since then, quantification and modeling have only grown thicker in the economics profession, where econometricians and other "quants" employ complicated analytical techniques and mathematical formulas.

By the 1980s, many economists had embraced the theory of "rational expectations," which essentially held that markets were all knowing and infallible. All of this infused the profession with an aura of authority, authenticity and accuracy.

The computations were correct, but far too often the conclusions drawn from them were not. This is because the models rely on historical data but fail to take into account the profound impact of structural changes in our economy and in financial markets that have unfolded in the postwar decades.

These structural changes -- including securitization, globalization and the explosion of debt -- have altered financial behavior in ways that the econometric models miss. In the decades since World War II, they have liberated financial risk-taking, as markets learned to game the system beyond the parameters of quantitative models. That is a critical difference between now and the last time interest rates were comparably low six decades ago.

Let's hope that is about to change. A central goal of new financial legislation should be to rein in extreme financial behavior. To inject some restraint into the rampant securitization that contributed so much to the current crisis, loan originators should be made responsible for a portion of repackaged loans. Off balance sheet activities should be brought back onto the balance sheet. Credit derivatives should be limited to a small proportion above the outstanding credit obligations. Financial conglomerates, which by their sprawling scale and scope are vulnerable to conflicts of interests, should be given special scrutiny by regulators.

These and similar measures will help induce financial institutions to balance their entrepreneurial drive with their fiduciary responsibilities. And if that happens, the next secular swing in interest rates should be more moderate than the great interest wave we have just ridden.

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