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### INTEREST RATES

Let me turn now to discuss briefly a point on which there seems to be a great deal of misunderstanding - interest rates and their role in a free economy. The subject has come in for considerable attention recently as the President has asked the Congress to remove the present 4 1/4 per cent ceiling on Treasury bond rates and the 3.26 per cent ceiling on Savings bond rates. He also has asked for an upward revision in the Federal debt ceiling and certain technical changes which would facilitate debt management, but these requests are better understood and less controversial.

I do not want to set up a series of straw men for me to knock down subsequently, but it is almost necessary to do so if I set forth what I regard as the major misconceptions re interest rates. These are:

1. High interest rates are bad and low interest rates are good because the latter promote easy credit and thus benefit the common man, hold down costs in general and particularly hold down government expense on borrowed money.
2. Financial institutions, particularly large ones, favor high interest rates and really can control them.
3. The Treasury, as a big borrower, could set any rates it wished. It is paying higher rates than it should pay.
4. Federal Reserve policy is designed deliberately to foster high rates. This policy is wrong and rates should be lower.
5. Savers do not care about interest rates; they would save anyway.

Note that if you take the first point about low rates being better than high rates, the other points obviously call for corrective action.

Speaking broadly, the interest rate is nothing more or less than price, namely the price of borrowed money. As a price, the rate reacts to the same sort of influences as other prices in a free market economy -

influences that operate through the demand for and the supply of funds available in credit markets. An increase in the demand for goods and services tends to increase the prices of those items, and an increase in the demand for funds tends to increase interest rates. Similarly, increases in the supply of funds tend to cause interest rates to decrease. This is true under our present market arrangements. It will remain true so long as credit markets remain free and borrowers and lenders are permitted to manage their affairs with a minimum of interference and regulation.

On the demand side the principal impact on interest rates in this country reflects the actions of four groups of borrowers: individuals, corporations, state and local governmental units, and the Federal government. The total debt of these borrowers has about doubled in the past twelve years, from approximately \$446 billion to about \$880 billion. Of this increase in the last twelve years most of it has come from individuals, corporations, and state and local governments. Individual borrowings have jumped from \$60 billion to \$240 billion; corporate borrowings from \$110 billion to \$298 billion; state and local governments from \$16 billion to \$59 billion. The Federal government debt rose only \$23 billion, from \$260 billion to \$283 billion in that same period.

On the supply side funds come from two sources; savings or money creation. From the borrower's point of view it doesn't make any difference from which source he gets his funds, but the difference between the sources is of crucial importance from the standpoint of achieving price stability and sustainable economic growth. I'll say more about that in a minute.

Now there has been a lot of argument among economists about the factors that determine interest rates. But no economist really argues against the demand-supply relationship. The arguments are over what causes the demand factors and the supply factors to change. Certainly lenders like high rates

and borrowers like low rates. The real point is what their actions and their expectations do to the demand for and the supply of funds.

Historically, high level economic activity - prosperity - increases the demand for funds. High income and good rates of return stimulate savings. Thus we associate high prosperity and high interest rates. In recession demand is low and even though savings may be large the demand-supply relationship shifts to oversupply and rates tend to be low. Given the high level of demand for funds that has doubled total debt, it is no wonder that rates have moved up in the last twelve years. Given the high level of Federal Government demand to finance a deficit, there is no wonder that rates on Governments have moved higher in the last year. As a matter of fact, the major factor in increasing rates in the past year seems to have been the high level of Government borrowing competing for funds against high demand from the other sources - individuals, corporations, and local governments.

You will recall that I spoke of two sources of supply - savings and bank credit. The former comes from income and does not increase the supply of money - merely the supply of funds available to lend. A dollar saved is obviously a dollar not spent. The demand for current output of goods and services is not increased in the total.

This is not the case with new bank credit for it does increase the money supply and thus add to the total amount of funds. It is in this area that the Federal Reserve works - its policies lead to more or less new bank credit - new money - additions to the total supply of funds.

The only part of the original argument that really is correct is that the Federal Reserve has some influence over interest rates. It does have because it has some influence over the supply of funds created by bank credit. Its job is to see that these funds do not get out of balance with the needs of the economy.

Now the Federal Reserve does not favor high rates or low rates. It favors rates low enough to promote adequate borrowing and high enough to promote adequate saving. These rates change with changing conditions in a free market. Unless they change they cannot measure and equate demand and supply. So the Federal Reserve does not strive for any given level of rates but merely for a level of bank credit which leads to a given pattern of rates determined by the market.

In a situation like the present, if the Federal Reserve were to promote more bank credit, the supply of funds would increase. For a short time rates might fall. But the money supply would build up and would lead to price increases. This would raise total demand for funds and rates would rise. Again more bank credit would be created, again fund supply would rise, again prices would rise, and again demand for funds would raise rates. This is the familiar inflation spiral. The point is, of course, that you can never catch up. The point is that Federal Reserve action to lower rates artificially in the short run would lead to higher rates in the long run.

Now, one last point on interest rates and I will have finished this discussion. Who gets the benefit of higher rates - how much does it raise costs and how much does it add to financial institution revenues and take away from individuals and government.

Well, interest rates are a minor factor in costs. In 1957, for example, interest costs of all manufacturing corporations amounted to 4/10 of one per cent of sales or \$4 on every \$1,000 of selling price. That is not very much. Most people do not stop borrowing because rates move up, they stop because the supply of credit is curtailed.

In 1946 our total Federal interest payments were \$4.7 billion. Last year they were \$7.6 billion, or about \$3 billion more. Who got this increase? Well, half of it went to Government investment accounts (Social

Security, etc.) or to the Federal Reserve which has a very large portfolio. In the former case it went directly to Government and to the people. In the latter case 9/10 went to Government since Federal turns back 90 per cent of its earnings to the Treasury.

A quarter of the difference - \$700 million - went to individuals, mostly to holders of Savings bonds. Almost all of the remainder - \$800 million - went to businesses, local or state governments, or miscellaneous investors.

Commercial banks collected just \$100 million more; mutual savings banks no more and insurance companies \$200 million less. In 1946 these financial institutions got 45 per cent of Federal interest payments; last year they got 26 per cent.

Well, what was to be a minor digression has turned out to be a major speech. It is important to recognize some of the real facts about interest rates, however. The President's request is not a capricious one - no borrower wants to pay more than he has to. The Government has to compete for funds with other borrowers. It gets rates lower than most borrowers - it always has and probably always will because its credit is good. But it cannot get rates lower than people are willing to lend money.