High Interest Rates - Cause and Cure

Speech by: Darryl R. Francis, President
Federal Reserve Bank of St. Louis To The
Fourth Annual Trust Conference for Missouri Banks
Tiger Hotel, Columbia, Missouri
March 11, 1969

The current trend toward higher interest rates dates from about 1965. It began with, and has accompanied, the rapid price inflation. Within this upward trend of four years, interest rates on long-term highest-grade obligations have gone up about 50 per cent, and other rates similarly. There were peaks in the fall of 1966 and again last May, but in each case, after a slight decline, rates again surged upward. Now, they are at essentially the highest level in our history.

The main cause of the high and rising interest rates has been the great demand for loan funds relative to the supply of savings. Lying behind the demand for loan funds has been an excessive total spending and rising inflationary expectations.

Let us examine briefly the history of our recent inflation. For six years before 1965, price increases were relatively modest, averaging just over 1 per cent a year. During the year 1965 there was an acceleration of prices. By the end of 1965 average prices were rising at a rate of about 3 per cent a year, and in the last year and a half they have been increasing at about a 4 per cent rate.

Why have prices been increasing so rapidly? The basic factor has been growth of total private and Government spending more rapidly than the growth of the nation's capacity to produce. Since mid-1965 total spending has risen at a 7.5 per cent annual rate, and in the last year and a half at a 9 per cent rate. Capacity to produce, however, can only be expanded as the labor force grows, capital is invested, and as technology expands. The growth of capacity has been about 4 per cent per year. Since dollar spending has been growing twice as fast as production potential, prices have been bid up substantially.

Why has total spending increased so rapidly and excessively? Two chief explanations are frequently given. One is the condition of the Federal budget; the other is the influence of monetary actions. Beginning in 1964 Government expenditures relative to the tax structure increased rapidly for four years reaching a peak in about mid-1968. This rapid growth of spending was a result of the Vietnam conflict and enlarged domestic programs, while growth of revenue was restrained by the tax cuts in 1964 and 1965. According to the view that holds the Federal budget situation to be primarily responsible for total spending in the economy, the budget was providing a great and increasing stimulus to total spending and thereby to inflation from early 1964 to mid-1968. If the budget was a major cause of the rapid growth of total spending and of inflation, then a major cure would have been less Government spending or higher tax rates or both. This cure was finally adopted in some measure in June 1968.

Another explanation of the excessive growth of total spending, possibly alternative, possibly supplementary, is monetary influence. As a measure of monetary influence, I shall refer to the rate of expansion of the money stock. By the money stock I mean checking accounts of the public in commercial banks plus currency and coin held by the public. The money stock grew at a 3 per cent annual rate from 1960 to 1964, at a 4 per cent rate from 1964 to 1967, and now at more than a 6 per cent rate in the past eighteen months. Many students of these matters look upon this accelerating growth of money as the prime cause of the excessive total demand for goods and services. I am inclined to agree with this view, since it has provided a consistently better explanation of the course of total spending than at any other theory I know.

A combination of the two views--let us call it the "fiscal-monetary" view--emphasizes the interdependence of monetary and fiscal actions. In this view the excessive total spending resulted when budget deficits were financed by an excessive creation of the money supply. Although rapid monetary expansion usually occurs during those periods when the Federal Government is a large net borrower, it seems to me that such "even keeling" is not a complete explanation of the inflation of the past four years. The more rapid rate of increase of the money supply and the accelerated inflation began about two years before an unusual budget deficit situation began.

As a result of tremendous total spending and price inflation, businesses have made great demands for loan funds to increase their productive capacity. In attempting to obtain funds to increase their capacity beyond the limits permitted by the flow of saving, producers have competed vigorously for loan funds and bid up the price of credit, namely interest rates.

Producers and other borrowers have bid up the price of loan funds because of an increasing anticipation of more inflation in the future. When the public believes that costs of durable goods will be 3 per cent higher a year hence, it is reasonable to pay an interest rate up to 3 percentage points higher than otherwise, for example, 7 per cent instead of 4 per cent. The major way by which interest rates could be lowered would be for the public's demands for credit to be moderated and for its anticipation of inflation to be reduced.

In short, interest rates are a price - the price for the use of funds. We thus see that if rapid monetary expansion has contributed to excessive demand and inflation, it has also contributed to the high and rising interest rates. Superficially, and for a very short period, rapid monetary expansion may help to hold down interest rates. But more fundamentally, rapid monetary expansion makes for high and rising interest rates.

Where do we stand now with respect to prospects for total spending, inflation and interest rates? Last June, in pursuit of fiscal restraint the Federal budget was revised by the 10 per cent surtax and the agreements to cut $6 billion of planned Government spending. However, eight months later it is not clear that much effective restraint has been achieved. Total spending in the last quarter of 1968 increased at about the same rate as the average for the past four inflationary years and early estimates of spending in the first quarter of 1969 indicate a continuation of the trend. Fiscal actions, as a tool of economic stabilization, may not have been fully discredited by recent developments, but many analysts are beginning to question their supposedly great potency.

Retail sales were about unchanged from August to February, but there was a similar slowing of sales in the last half of 1967 and this proved to be no lasting evidence of restraint in the economy. Personal consumption expenditures increased at a 7 per cent annual rate in the last half of 1968, about the average rate of growth of the past three years.

Moreover, price inflation has not abated. Over-all prices rose at a 4 per cent annual rate from the third to the fourth quarter, and indications are for a similar mark-up in the first quarter of 1969. Interest rates have risen to new highs with the continued, and possibly expanding, expectations of inflation. Yields on seasoned highest-grade corporate bonds have risen from 6 per cent in the early fall last year to about 6.7 per cent most recently.

Soon after the fiscal package became law last summer, a decision was made to ease monetary policy in order to prevent too drastic a cutback in economic activity. It now appears that this was a serious mistake. There has been no fiscal "overkill;" in fact, there has been little change in the steep upward trend of total spending.

About the middle of December a decision was made to turn monetary policy again toward restraint. But despite this intention, the figures do not yet give clear evidence that there has been success in exercising monetary restraint. Total reserves of member banks have increased at a 7 per cent annual rate in the last 3 months, about the same as over the past year. The monetary base has continued to grow at about a 6 per cent rate. The money supply, when allowance is made for an extraordinary build-up of Treasury deposits, has grown at only slightly less than the 5.6 per cent rate of the past year.

There are two factors which afford some basis for hope that we may see some slackening in the growth of total spending. First, we are now nearing the time for peak impact, if any, of the tax and Government expenditure decisions of last June. In the next month, the Government will collect a sizable volume of retroactive tax payments, since the withholding rates were not increased as much last year as were the tax rates. Second, late last summer and during the early fall there was little growth of the money supply despite the decision to ease. If monetary influence operates with a lag, as many analysts believe, we might now get some moderating effect from the monetary behavior of six months ago.

But the probabilities are, it appears to me, that effective restraint on total spending, inflation and interest rates depends upon action to be inaugurated now. That action would consist of keeping the rate of growth of the money supply to well below the six per cent rate of the past two years. A 3 per cent rate of growth might be a good target. Achieving such a rate of growth should be significant and effective though not nearly so extreme as in the period from April 1966 to January 1967, when the money supply did not increase at all.

Effective restriction on the rate of increase of money should be accompanied by relaxation of the ceilings which banks are permitted to pay on time deposits. Restrictions on interest rates charged and paid by banks at a time of generally rising interest rates squeezes the banks out of the financial process to the detriment of their customers, both depositors and borrowers.

As market interest rates have risen rapidly in the past four years in response to large demands for loan funds and inflation, interest paid to small savers has lagged behind. While the yield on corporate bonds has risen from 4-1/2 to 6-3/4, the maximum rate allowed to be paid on savings accounts under Regulation Q has been unchanged at 4 per cent since 1964. Since consumer prices were rising at a 1.7 per cent annual rate in 1965 and at a 4.2 per cent rate in 1968, it may be considered that the purchasing power of interest rates permitted by Regulation Q to be paid on savings deposits moved from 2.3 per cent a year in 1965 to below zero in 1968.

As market interest rates have risen above the rates banks are permitted to pay on deposits, banks have been losing deposits, with funds flowing from saver to user through other channels. This does not limit the amount of total credit and total spending, but creates great difficulties for banks in discharging their role as an intermediary. Such regulations not only place great strains on bank liquidity, but tend to discriminate against consumers, real estate purchasers, and local businessmen who must rely on their local institutions for credit, and tend to favor large businesses, Governments, and others that can borrow in central money markets. If the banks are not impeded in their intermediary function, they can readily adjust to the necessity for limitation on the creation of money and at the same time, more satisfactorily serve the urgent credit needs of their customers.

As I see the alternatives, unless the rate of growth of money is kept significantly below the 6 per cent annual rate of the past two years, total spending will most likely continue to rise inordinately. Under such conditions inflation would most likely gradually intensify. Real output cannot rise much faster than a 4 per cent rate permitted by the projected growth in resources and knowledge since production is now about at capacity. If the rate of inflation accelerates, it would not be surprising if interest rates would rise further.

On the other hand, if monetary growth were significantly restricted to during the year, total spending would be likely to slow from the 9 per cent rate of the past year and a half. Under these conditions, inflation might moderate from the recent 4 per cent rate. Such a tempering of total spending and of inflationary pressures would probably cause interest rates to decline, after an initial upward adjustment resulting from the reduced supply of lendable funds. If growth in total spending is slowed moderately, growth in real output may temporarily fall below average rates attainable over the long run.

The case for beginning an attack on the excessive spending, inflation, and high interest rates immediately is strong indeed. Inflation gives the economy unusually high production and employment for a time, but continuation of such results would depend on continuous acceleration of inflation with ultimate tragic results for general welfare. As inflation accelerates, workers feel better, receiving larger wage increases, but the money illusion becomes clear when they find costs of living going up just as fast. Similarly, businessmen are temporarily fooled by rising sales at relatively favorable prices, but soon find wage and other costs rising in parallel fashion.

In real terms, inflation ultimately has two effects on the economy: it reduces total output by creating inefficiencies, and it redistributes income and wealth. The redistribution tends to enlarge the Federal Government whose receipts rise faster than inflation as a result of the progressive income tax. The redistribution also tends to encourage speculation in land, stocks and other commodities. Those severely discriminated against by inflation include holders of money, savings accounts, bonds, and other fixed dollar claims. Inflation reduces the real incomes of those on pensions and others with relatively fixed incomes. Inflation reduces the country's ability to compete in foreign trade. As we have noted, it also is a major cause of higher interest rates, which greatly affect home construction and other industries where interest cost is a chief factor in sales.

Many contracts to borrow are currently being made at interest rates that apparently assume interest payments and repayments can be made with continually depreciating dollars. Wage agreements also seem to be made on the assumption that dollars will continue to depreciate in value at recent rates. If public policy succeeds in reducing the rate of inflation, some of these contracts may prove to be unfortunate.

It is a myth that by means of inflation employment can be maintained permanently at a higher level than otherwise. Some temporary job opportunities are provided by accelerating inflation, but once the rate stabilizes, unemployment tends to return to its natural level determined by factors such as price rigidities, labor immobility, and lack of knowledge on job opportunities. Reducing inflationary pressures may cause some slowing in the growth of new jobs in a transition period, but once a new more stable trend of prices is achieved and maintained, unemployment will tend to move down to the equilibrium level.

We have argued that the excessive total spending and inflation not only cause great social injustice and economic inefficiencies but are the major cause of the high interest rates which we currently suffer. Interest rates rise, not because lenders arbitrarily raise the rates they charge or because the Federal Reserve discount rate rises, but because of a large demand for loan funds relative to supply. This is why yields on bonds rise, why bond prices decline, why rates on commercial paper rise and why the loan rates charged by banks increase. Upward movement of the prime rate is an effect, not a cause. It results from the supply and demand situation. The basic way to limit increases of bank lending rates along with other interest rates is to restrain total spending and inflation. The same is true of interest rates paid by banks and other financial institutions. So long as basic market forces push interest rates up, restraint on particular rates generally results in economic malfunction and inefficient allocation of funds.

In summary, there is something we can do to stop the rise of interest rates which has been going on for some four years. This is to be done by monetary and fiscal policies which will curb total spending and the inflation. After so long an inflation, rectification may involve considerable short run costs in terms of higher interest rates and a reduced rate of growth of real production. But this is the only way to make a transition to confidence in the dollar which will inspire saving, reasonable interest rates and a supply of funds to provide housing and other capital goods necessary to meet consumer demands and promote economic growth.