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Statement by

Lyle E. Gramley

Member, Board of Governors of the Federal Reserve System

before the

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I want to begin by setting forth very briefly my views on the present level of interest rates. There is no doubt that interest rates are extremely high in our country. There is also no doubt that the effects of high interest rates have been painful indeed for major sectors of the economy.

The Commerce Department now estimates that real GNP fell slightly in the second quarter, and most private forecasters think that this mild decline may be extended into the third quarter. High interest rates appear to be the principal source of the slowdown.

Credit-sensitive sectors of the economy are suffering:

> High mortgage rates have cut housing starts by one fourth from their level in late 1980. Many small homebuilders have gone out of business; others wonder how long they can hang on.
>
> Savings and loan associations, mutual savings banks, and some small commercial banks are experiencing severe difficulties. Their deposit flows have weakened markedly in recent months; more importantly, their costs of deposits have gone up much faster than the return on their assets. A few institutions have already failed, and the potential for future failures is mounting.
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> The auto industry has been hit very hard. Combined with large increases in car prices, the escalating cost of loans has depressed auto sales. Furthermore, the high cost of financing inventories has been a crushing burden for auto dealers.
>
> A large number of other small businesses, particularly those with large inventories to finance and heavy burdens of short-term debt, have suffered serious losses and cash flow problems.

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> The effects of high interest rates in the U.S. have been felt abroad--generating capital outflows, sharply rising debt service costs, and downward pressures on the currencies of many countries.

Why are interest rates so high? The proximate reason is that demands for money and credit have been strong at a time when the Federal Reserve has been trying to limit money growth in the interests of bringing inflation down. But the more fundamental reason is that inflation accelerated so much from the early 1960's until just recently, with periodic bursts into the double-digit range. Inflation permits borrowers to pay off loans with shrunken dollars. Since both debtors and creditors now understand this clearly, lenders require--and borrowers are forced to pay--an "inflation premium" that compensates for the erosion of purchasing power. Furthermore, since the rate of inflation has been not only high but also volatile, lenders appear to be requiring a risk premium to protect against capital losses in the event of yet another upward wrench to inflation and interest rates.

Still another reason why interest rates have had to rise to such high levels to ration a limited supply of funds is that some kinds of credit demands do not respond much to interest rates. The demands of the Treasury to finance huge deficits is the clearest case in point. Some private demands may also be rather insensitive to interest rates--for example, those of defense contractors, or

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high technology industries, or firms investing to comply with governmental regulations. The burden of adjustment, therefore, is shifted to others.

Pumping up the money supply is not the way to bring interest rates down. The experience of the past 15 years indicates that faster money creation can bring only a temporary respite to interest rates. Time and again, when monetary policy eased in the face of gathering financial strains or economic slack, the additional money created, and the temporarily lower interest rates, ultimately served to fuel inflation. Expansive fiscal policies added to the problem. Expectations therefore deepened that governmental action would never be adequate, or sustained long enough, to get the job done. One by-product of such attitudes is that financial market participants have become so sensitive that faster money growth may not lower interest rates even in the short run. For example, on Friday a week ago, the weekly release of monetary data indicated a $7 billion rise in the money supply; interest rates immediately rose substantially, on the expectation that inflation-driven demands for money and credit would collide with Federal Reserve efforts to contain them.

In the long run, the only way to reduce interest rates is to reduce inflation. That is what the Federal Reserve is trying to do, by reducing the growth of money.

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The process of reducing inflation--and bringing interest rates down--can be speeded up if the task is not left solely to monetary policy. We badly need to reduce government spending and Federal deficits. We also need to be much more attentive to the inflationary effects of other governmental policies--environmental and safety regulations, import restrictions, price supports, wage supports, and the like. These have been major contributors to worsening inflation.

The potential for a substantial improvement in the inflation rate is now at hand. The Consumer Price Index during the first half of this year rose at around an 8-1/2 percent annual rate, compared to over 12 percent in all of 1980. Food and energy costs have taken a beneficial turn in recent months; appreciation of the dollar in exchange markets has also helped, and idle capacity and weak markets are damping price increases in housing and other areas. Unfortunately, however, habits of wage and price setting behavior change slowly. In particular, wage increases are still far in excess of productivity gains, and have as yet shown little evidence of moderating. The hard core inflation rate--that determined by rising unit costs of production--still seems to be in the 9 to 10 percent range. A fundamental breakthrough on the inflation front will not be achieved until wage increases moderate or productivity improves.

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Given the fact that the economy has slowed, and inflation has shown some improvement, there is some basis for hope that interest rates may have already passed their peaks. But I cannot predict with any confidence that interest rates will ease substantially in the near term because it is by no means certain that a substantial further decline in inflation is just around the corner. I firmly believe, however, that staying with policies of monetary and fiscal restraint is essential to reducing inflation and, thus, to bringing an end to high interest rates.

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INFLATION AND INTEREST RATES IN SELECTED COUNTRIES

Country	Rate of Inflation in 1980 1/	Interest Rates in 1980-Q4 2/
Switzerland	4.1	5.0
Germany	5.3	8.8
Netherlands	6.7	9.3
Belgium	7.4	12.5
Japan	7.7	9.9
Canada	11.1	14.2
United States	12.6	15.8
France	13.6	11.5
Sweden	14.7	12.9
United Kingdom	15.3	13.8
Italy	21.5	16.9
Mexico	28.9	26.1
Peru	59.8	35.0
Brazil	86.8	64.4
Argentina	88.7	95.3

Sources: Bulletins of the respective central banks and government statistical releases.

1/ 1980 inflation is measured by the percent change in the CPI from its average 4th. quarter level in 1979 to that for 4th. quarter 1980.

2/ Interest rates are averages of the annualized rates on 3-month treasury certificates except for Germany (rate on 3-month deposits over DM 1 million), Japan (the Gensaki rate), France (3-month inter-bank rate) Peru, (administered rate on 3-month treasury certificates), and Argentina (rate on 90-day commercial assets).

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