

Are Interest Rates Too High?

a speech given by

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America's affection for locust plagues, air pollution, governmental corruption, or swine flu is substantial compared to what it is for higher interest rates. If there were a Siberia for dissident economic policymakers, surely the proponents of higher interest rates would be sent there. In fact, Siberia might be considered far too pleasant a place for Federal Reserve officials who have recently allowed interest rates to rise to such "high" levels.

We are now hearing warnings that high interest rates threaten the well-being of various sectors of the economy, especially housing, and various groups, such as consumers. And much is made of the notion that the Federal Reserve is seriously risking another recession by allowing rates to rise. Interest rates, of course, cannot keep rising indefinitely without causing serious problems. But in our current economic climate, interest rates are not high at all. In fact, they are low.

Why "High" Interest Rates Are Low

The interest rates that banks, corporations, and the federal government announce do indeed look high. However, these rates (usually called nominal rates) are merely raw numbers. Nominal rates do not take inflation into account--and this is extremely important to borrowers and lenders. Both know that a loan in today's dollars will have to be repaid in next year's inflated dollars. If the interest rate on a loan exactly matched the rate of inflation, neither borrower nor lender would gain in purchasing power. The borrower would have essentially free use of the borrowed money, and the lender would gain nothing for the use of his funds. To a large extent, nominal interest rates are high simply to make up for the dollar's loss of purchasing power from one year to the next.

To calculate what happens to their purchasing power, borrowers and lenders need to subtract the rate of inflation from the nominal interest rate. This inflation-adjusted rate (usually called the real rate) has dwindled in recent years because inflation has accelerated.

What has happened to the rate for three-month Treasury bills is typical of all interest rates. As Chart 1 shows, the unadjusted, or nominal, rate of these bills has diverged greatly from the inflation-adjusted, or real, rate over the last ten years. The real rate has rarely climbed above zero since 1973.

When income taxes are considered, the rate is even lower. For example, for the average taxpayer who invests in Treasury bills and earns 7 percent, inflation reduces the purchasing power of his interest income by, say, 8 percent. In addition, he must pay income taxes of perhaps another 2 percent on that interest income. Consequently, the real after-tax return on his investment is minus 3 percent--i.e., he is losing 3 percent a year in purchasing power. It is an understatement to say that this is a low rate of return.

Money Not "Tight"

Since real interest rates are so low, it is no surprise that people are still willing to borrow money. In fact, they are leaping into debt at a rapid pace. Home buyers continue to seek mortgages in large numbers. Other consumers are also borrowing heavily; installment borrowing has been growing at an annual rate of about 20 percent during the past several months. Businesses, too, are eager to take the plunge. Their short- and intermediate-term borrowings over the last few months have also grown by an annual rate of nearly 20 percent.

While borrowers have been taking advantage of the low real interest rates, investors have been taking a beating. Why they continue to make their money available to borrowers is a matter of conjecture. Perhaps they have no good alternatives. Immediately spending the money may make planning for the future more difficult. Holding cash is very expensive since inflation, in effect, makes each dollar worth less without yielding any interest. Maybe investors feel that a little interest is better than none. But whatever their reasons, they are still buying bonds, still saving money, still offering large amounts of funds to borrowers--hardly the characteristics of "tight money."

High Interest Rates Do Not Cause Inflation

One reason so many people are worried about high nominal rates is that they fear that such rates intensify inflation. True, nominal interest rates have paralleled inflation rates for at least the last decade in the United States, as Chart 2 illustrates. But this does not mean that high interest rates cause inflation--the predominant relationship in fact is just the reverse.

A chain of economic events determines interest rates. For example, growth in the federal deficit often leads to an expansion of the money supply. This expansion of the deficit and of the money supply has two results. The first and most immediate result is that people expect more inflation. The second and more belated result is that in time there really is more inflation. People's expectations of greater inflation quickly produce higher interest levels as they seek to protect the purchasing power of their interest income. Through this chain of events, in other words, it's really inflation that causes higher interest rates, and not the other way around.

Some people believe that the more money there is, the lower interest rates will be. This has never been the case, at least not for long. In the United States, interest rates fell most rapidly not when the quantity of money was growing rapidly, but when it was shrinking--during the Depression years from 1929 to 1933. Interest rates rose most rapidly when the money supply was growing the fastest--in recent years.

All over the world, the story is the same. In the United Kingdom and Italy, nominal interest rates are even higher than they are here. In these countries the supply of money has been increasing very quickly. For comparison, in countries where interest rates are low, like Switzerland, the money supply is relatively stable.

It is clear, on Chart 3, that Italy and the United Kingdom--the countries that have had fast-growing money supplies--have had high inflation coupled with high interest rates. In contrast, Switzerland and West Germany--countries with more modestly expanding money supplies--have had only moderate inflation coupled with low interest

rates. The conclusion is almost inescapable: a rapidly growing money supply leads to more inflation and higher interest levels.

When our money becomes continually more plentiful, its price goes down. That is, a dollar can be traded for fewer yen, fewer marks, and fewer goods and services. But while the price of the dollar declines, the price of credit--the interest rate--escalates; it costs more to borrow a dollar for the simple reason that people who lend money want to get a fair return after inflation, and people who borrow money are willing to pay this rate.

Inflation: Economic Enemy Number 1

Today's high nominal interest rates, in short, are a result of high inflation, not a cause of it.

The chain of events determining both inflation and interest rates starts with large government deficits, rapid growth in money, and a host of laws, rules, and regulations that lower the efficiency and competitiveness of the American economy. The way to reduce inflation as well as nominal interest rates then is to cut the federal deficit, rein in the money supply, and avoid or even reduce the special statutory and regulatory actions that so aggravate inflation. This will require the determination of the Federal Reserve System, the Administration, and Congress, and it won't be easy.

The problem is that the alternative to a more tightly controlled money supply and a reduced federal deficit is continued inflation and even higher interest rates in the long run. In that event, the public just might send us to Siberia--or someplace very much hotter.

Chart 1

Three-Month Treasury Bill Rates

Semiannually, 1967-1978

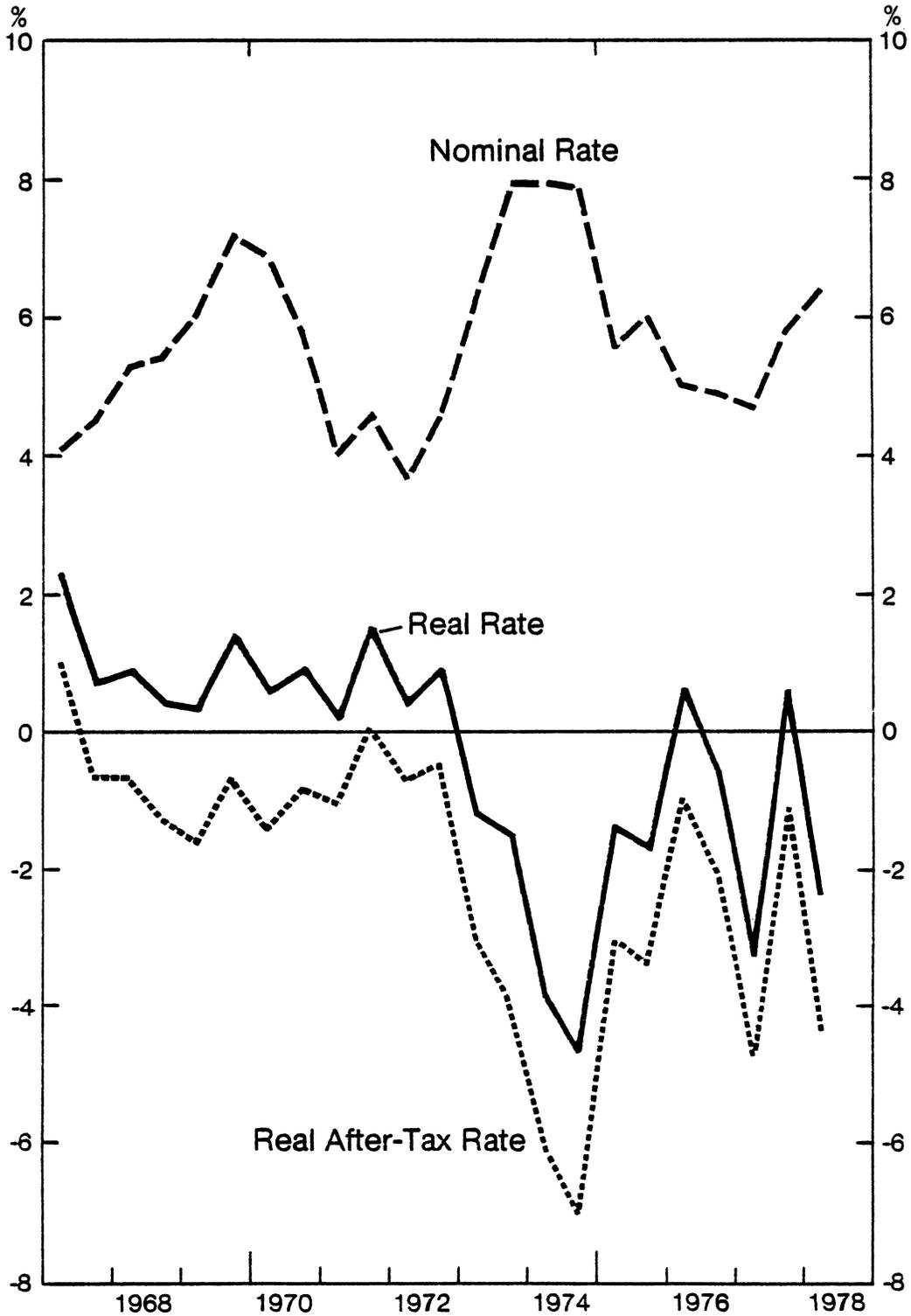


Chart 2

Inflation and Interest Rates

Annual Rate of Growth in the Consumer Price Index and
Rate of Interest on the Three-Month Treasury Bill

Semiannually, 1967-1978

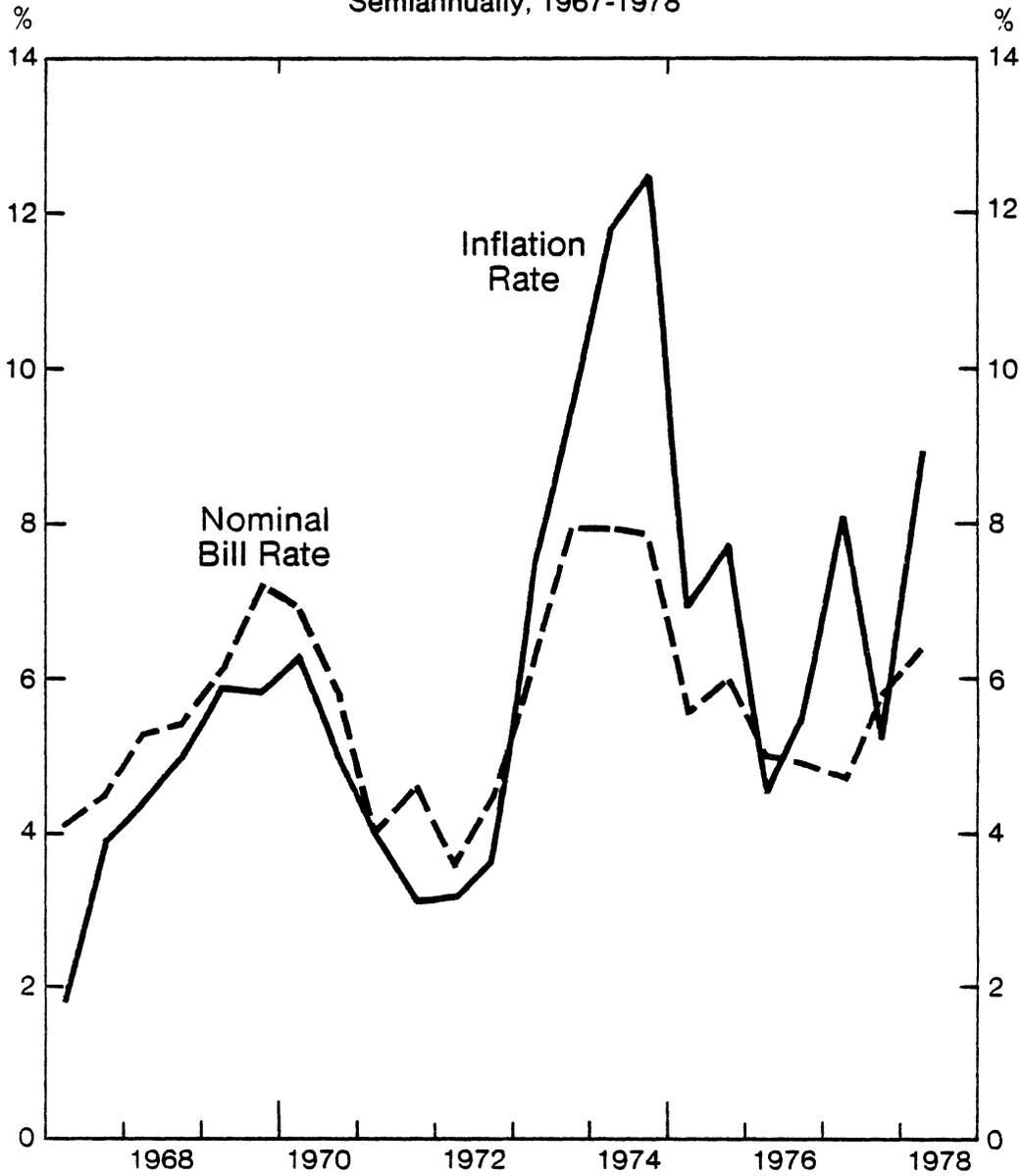
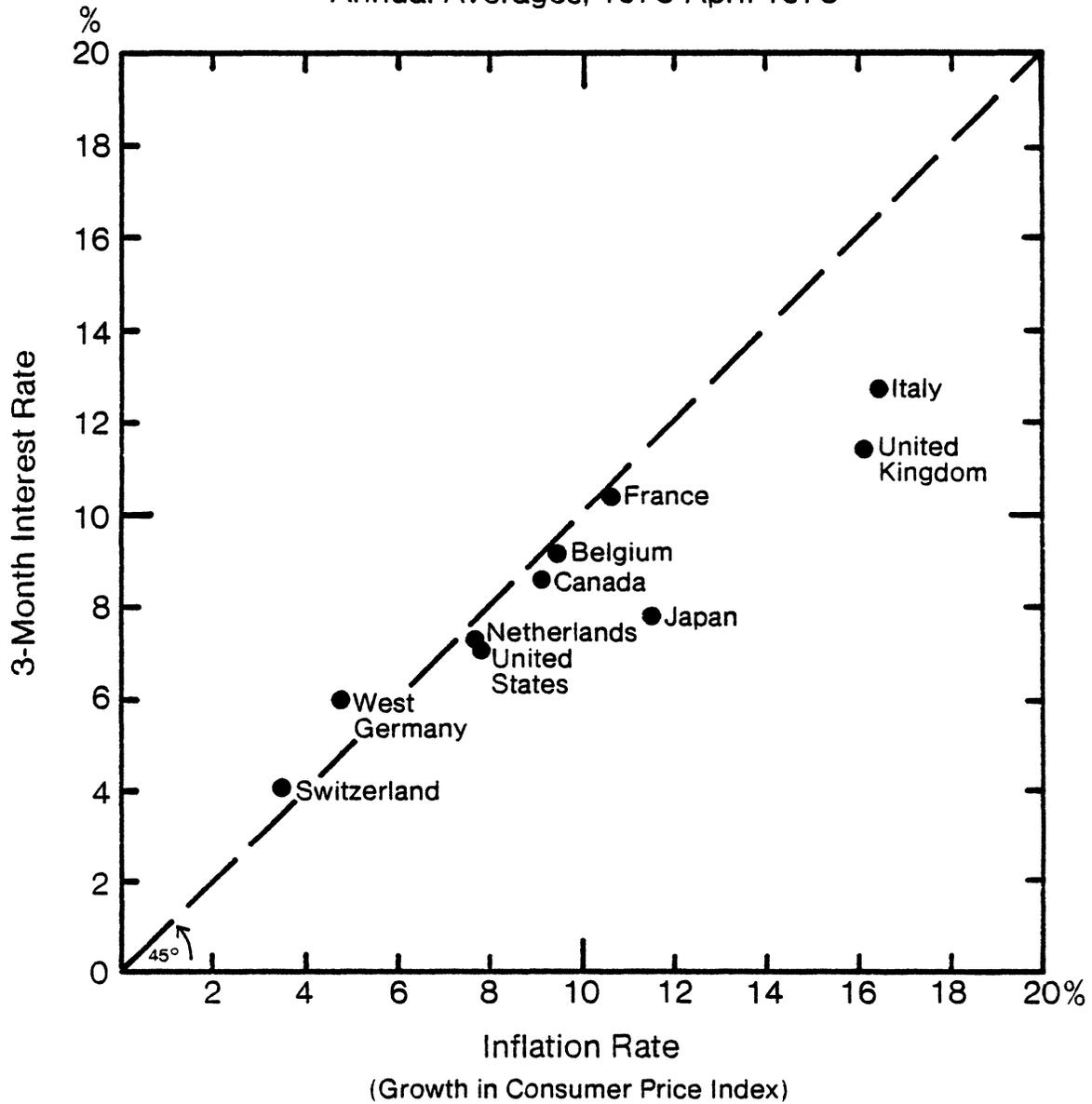


Chart 3

Inflation Rates and Interest Rates in Ten Major Countries

Annual Averages, 1973-April 1978*



*Switzerland = 1976-April 1978