

WHY NOT A ZERO INTEREST RATE?

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February 17, 1987

I am delighted to have this opportunity to speak to you this afternoon. A few years ago, I might have been somewhat reluctant to be here. At that time, besides mailing thousands of keys to Washington, homebuilders were circling their local Federal Reserve Banks and daring the Presidents to "step outside." I am relieved that times have changed and that I can speak to you today in relative safety.

Times certainly have changed over the past few years--both for homebuilders and for the nation. In the early 1980s, this country was going through back-to-back recessions, inflation was running in double digits, interest rates were up around 15 to 16 percent, and the unemployment rate was nearly 10 percent. Homebuilding was doing just as well--or, in this case, just as badly--as the nation. New housing units started had plummeted from 2.04 million units in 1978 to 1.07 million units by 1982. It's not surprising that homebuilders and others were upset about economic conditions and were looking for someone to blame. Like many others, they blamed the Federal Reserve.

Today, economic conditions are considerably better in many respects. Inflation is low, interest rates have fallen more than five percentage points, the unemployment rate is below seven percent, and we are in the fifth year of the current expansion. Homebuilders have had several good years and are looking forward, I trust, to another one this year.

And yet, despite the major turnaround in our economic fortunes, the Federal Reserve is still on the firing line, still being criticized for not doing enough, still being called on to stimulate the economy even more. And now, as was true in the early 1980s, these comments, calls to action and criticisms are fundamentally wrong. They are based on misperceptions of what the Federal Reserve actually does and what it can do to influence economic events. Because interest rates are of vital concern to you, to home buyers and to everyone else as well, I would like to discuss just what it is that the Federal Reserve can--and can't--do to influence them.

Over the past five or six years, interest rates have fallen considerably. Yet, we hear comments even today that rates are too high--that the Federal Reserve must push them down even further. Apparently, some people won't be satisfied until interest rates fall to zero! But before we applaud such a notion, let's consider two questions. Why have interest rates fallen so much in the past few years? And, what did the Federal Reserve actually do to "push them down?"

The easiest way to see how the Federal Reserve can influence market interest rates is to think of the interest rate as being composed of two parts. The first part is the rate of inflation that people expect to persist over the period ahead. If people expect that inflation will be 10 percent, interest rates will be 10 percentage points higher than if people expected zero inflation. The second component that determines what interest rates will be is the expected real interest rate--the after-inflation (also after-tax) rate of return that people demand in order to make it worthwhile for them to save and to lend. When market interest rates rise, they do so because either the expected inflation

rate or expected real interest rates have risen. When interest rates fall, they fall because either the expected inflation or expected real returns have declined.

Using this approach, it is easy to see why interest rates have fallen so far in recent years--the expected inflation component has plummeted sharply. Instead of the nine to 10 percent inflation we saw in 1980 and 1981, we now have three to four percent inflation; interest rates have naturally and understandably responded in kind.

Now, just what did the Federal Reserve do to encourage this decline in inflation? In the early 1980s, the Federal Reserve, despite public clamor for easier policy, acted to slow the growth of bank reserves and, consequently, to slow the growth of money. Money growth from 1980 through 1982 averaged 6.6 percent per year; this was considerably slower than its 7.9 percent annual growth over the three previous years. This slower money growth, operating with the usual lags, produced the low inflation and the low interest rates that we now see. Of course, there were other factors that aided and abetted the Fed's actions. Both the rising value of the dollar in foreign exchange markets through early 1985 and falling energy prices in 1986 contributed to lower inflation as well. The important thing to note, however, is that today's low inflation and low interest rates could not have been achieved by the looser monetary policy that the public was asking the Federal Reserve for in the early 1980s. It took tighter monetary policy to achieve them.

Today, however, people are asking the Fed, once again, to ease up; they want looser monetary policy in order to push interest rates even lower. Naturally, this clamor raises two questions. First, are current interest rates really too high? Second, why would anyone believe that easier policy would push interest rates down?

Well, are current interest rates too high? Too high for what? At the present time, short-term government securities are yielding about 5.75 percent; with expected inflation for 1987 running about 3.5 to 4.0 percent, the one-year, expected real rate of return, before taxes, is only about 2.0 percent. This real rate is essentially equal to its average value for the past 50 or 60 years; certainly, on historical grounds, short-term real rates are not unusually high. Long-term market interest rates are now about 1.5 percentage points above short-term rates. Some people have erroneously added this 1.5 percentage points to the short-term real rate of interest and concluded that long-term real interest rates are about 3.5 percent--which, in their opinion, is way too high.

However, this estimate is just wrong. To find out what the expected long-term real interest rate is, we have to subtract estimates of long-run inflation from long-term market interest rates. One recent survey indicates that inflation over the next ten years is expected to average about 5.0 percent. Subtracting this figure from the 7.25 percent yield on 10-year government bonds produces a 2.25 percent expected long-term real rate of interest. This long-term real rate is at the low end of the range by historical standards--in fact, it is virtually identical to the one-year real rate of return.

For some people, of course, any positive interest rates are too high. They would like interest rates to fall to zero. And, of course, this view is just silly. While we might be able to get inflation down to zero, the expected real rate of return must always be positive--people will not save, lend or invest unless they expect to get some positive return for their efforts. What is important for our purposes, however,

is to note that neither current market interest rates nor the implied real rates appear to be out-of-line, given existing inflation expectations.

However, just for the sake of argument, suppose you still believed that market interest rates were too high. Would easier monetary policy really push interest rates down further? The public certainly seems to believe so. Their perception, I think, goes as follows: if the Federal Reserve supplies more bank reserves, either by buying government bonds or by lending reserves through the discount window, banks will be able to make more loans. The greater supply of credit will produce lower interest rates, and the economy will boom.

This analysis is simple, straight-forward and, most likely, wrong. Faster reserve growth can push only one interest rate down; that rate, the Federal funds rate, is the one observed in the market for bank reserves. In order to affect other interest rates, however, faster reserve and money growth must reduce the public's views of expected inflation or expected real returns. For a brief time, faster money growth does indeed have an effect on output and employment—it tends to boost the economy somewhat. This means, in the short run, that faster economic growth is generally associated with rising inflation and higher real returns—which is essentially why market interest rates typically rise during upturns and fall during downturns in the economy.

In the long run, however, faster reserve and money growth simply produce higher inflation. And, unfortunately, there is no relationship or trade-off between inflation and real economic growth in the long run. In the past, we have had expansions with low inflation (the '50s and early '60s) and high inflation (the '70s). The important point is that,

popular opinion to the contrary, easier monetary policy will not reduce the public's inflationary expectations; if anything, it increases them.

Well, what about the other interest rate component? Will easier monetary policy reduce the expected real rate of return? Not likely. Real rates of return are affected by a host of factors, like changes in tax laws, changes in technology, changes in domestic and foreign savings behavior and so on. These are what economists refer to as "real factors," and monetary policy has little or nothing to do with any of them.

What, then, is the current outlook for long-term interest rates? Given present inflationary expectations, interest rates seem to be at appropriate levels—that is, they properly reflect both inflation expectations and a normal real rate of return. Should inflationary expectations come down further, then rates in turn could move lower in sympathy. Of course, the converse is also true.

In 1987, the inflation rate is expected to move up somewhat from that in 1986. First, energy prices have risen and apparently stabilized at a level substantially above their 1986 lows; further rises are possible. Also, the decline in the foreign exchange value of the dollar since early 1985 will cause prices to rise faster as well; imported goods become more expensive and domestic producers have more room to raise their prices. Recent weakness in the dollar suggests that there may be further price increases in store.

Some of the forthcoming increase in inflation arising from these factors is anticipated and already built into long-run inflation expectations and long-term interest rates. Accordingly, unless inflation turns out to be much higher than expected, long-term interest rates may

not move much at all. What is troublesome, however, is that the trend rate of money growth has risen sharply over the last two years and is now extremely high by historical standards. In the past, this has normally produced higher inflation down the road.

Now you may have heard or read that, based on the experience of the last five years, we do not have to worry about faster money growth anymore. Since 1982, the trend growth rate of money has steadily increased until it is now about 10 percent per annum. Historically, this rise in money growth would have produced an inflation rate of 10 percent as well. And yet, the inflation rate has actually declined--from about six percent in 1982 to three percent now. It is no wonder that some people feel money growth no longer matters for inflation.

During this period, however, there were some extraordinary factors that temporarily caused the growth of money and prices to diverge. The decline in inflationary expectations caused interest rates to tumble, making it less expensive to hold money. At the same time, there was a huge restructuring of real and financial assets, which required larger transactions balances to accomplish. Moreover, the existence of interest-bearing checking accounts encouraged people to shift their savings into accounts that are included in our money stock measure. These factors, along with some others, produced a decline in the velocity of money. In other words, during this period, there was more money in proportion to spending, or economic activity than historical patterns would have suggested. Although money grew faster, it did not have its usual upward influence on inflation.

At the same time, the dollar's rise in foreign exchange markets reduced the cost of imported goods as well as the prices of certain competitive domestic goods. Although the dollar's value began to decline in 1985, the lagged effects of its earlier rise continued to influence prices throughout most of 1986. In addition, the major decline in energy prices in 1986, with oil falling from almost \$30 per barrel to less than \$15 at its lows, brought down the rate of inflation as well.

In summary, then, during the 1982 to 1986 period, some extraordinary factors produced an apparent breakdown in the longstanding historical relationship between money growth and inflation. But these factors may well have run their course. If so, the present rapid money growth may eventually lead to higher inflation.

If that happens, monetary policy may have to move gradually to reduce the long-term growth in money from its present trend of 10 percent to a lower level. In other words, policy may have to be tightened, even if it means a somewhat slower economy, even if it means somewhat higher interest rates during the transition period--even if it means running the risk of having homebuilders, once again, circling their Federal Reserve Bank. However, I hope this time, if and when the Federal Reserve starts to slow down the growth of bank reserves and money, that you and the public will understand what we are doing and why. As I have tried to explain, it is the only way we can assure low interest rates in the long run.