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St. Louis Fed's Poole: High Real Interest Rates Not Cause For Alarm

NEW YORK, N.Y. Current high real interest rates quoted or "nominal" rates minus expected inflation are not holding back economic growth. Instead, they result from an economy in the midst of a robust economic expansion with optimistic prospects.

That was the theme of a speech by St. Louis Federal Reserve Bank President William Poole to a meeting of the Money Marketeers, a New York University-based group of economists, traders and other financial market participants. The September 21 session was held at the Marriott Financial Center hotel.

Poole clarified that he was speaking about the average level over time of the real, or inflation-adjusted, rate of interest, not the nominal federal funds rate for which the Fed determines an intended range at each meeting of the Federal Open Market Committee.

Poole acknowledged that nominal interest rates in the United States are high today relative to the trend rate of inflation. For example, he noted, the interest rate on one-year U.S. Treasury securities is presently about 5 percent. Since inflation is trending at about 2 percent, the real rate on one-year T-bills is about 3 percent. That compares, he said, to an average inflation-adjusted return on one-year T-bills of less than 2 percent over the past 50 years. Poole does not believe this is evidence that monetary policy is too tight that the Fed is choking off economic growth.

"In the current economic expansion, characterized by a high rate of investment spending and the potential for rising productivity growth, a high real interest rate is exactly what we should expect," Poole said.

Poole said he was pleased that the real rate of interest in the bond market is high "because it is high for all the right reasons. Funds invested in the bond market have to compete with funds invested in productive businesses. We know that business investment spending is strong; that in recent years, corporate earnings have grown smartly; that the stock market valuations reflect confidence in the future; and that economy-wide productivity growth has surged since 1995. These are all signs of a high return on invested capital. We have a lot to celebrate in this economy, and the high real rate in the bond market reflects the fundamentals we celebrate."

On a "less sanguine" note, Poole said, the issue of inflation uncertainty makes it difficult to separate inflation expectations from the real interest rate. He said a risk premium associated with this uncertainty could cause measured real rates to be high. "When we subtract reasonable estimates of expected inflation from market interest rates, we are left with a measure that combines the true, underlying real rate and a component that compensates for the risk associated with uncertainty about future inflation. The measured high real rate might therefore reflect the llingering legacy of past inflation and fears that those dark days might return." He said that minimizing the probability of unexpected inflation rate fluctuations "will continue to be an important objective of monetary policy. Ultimately, the only true way to enhance credibility in this regard is through sustained high performance."

Poole pointed out that, while high today, real interest rates not long ago were near zero. Real rates were low in the early 1990s, he said, as the economy emerged sluggishly from the 1990-91 recession. An even more significant period of low real rates was in the late 1970s, he added, when inflation was accelerating and economic growth was stagnant.

"Given the choice of living in a world with low real interest rates, reflecting some combination of high inflation and low economic growth, or a world with high real rates, reflecting rapid growth and an optimistic outlook, I have no problem deciding which to choose," Poole said. "I doubt that anyone else has any problem making this choice, either."

See speech