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# Issue Brief

ARE HIGH INTEREST RATES A THREAT  
TO SUSTAINED ECONOMIC RECOVERY?

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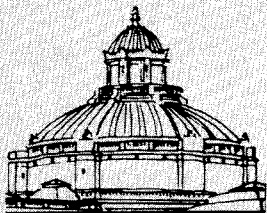
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## ISSUE DEFINITION

A major question that arises in Congress during its considerations of what policies promote and what inhibit the restoration of a healthy economy is the influence that interest rates exert. In particular, are high interest rates a threat to sustained economic recovery?

## BACKGROUND

The level of interest rates is generally thought to be an important determinant of the course of the economy. On the upswing of the business cycle it is typical for interest rates to rise eventually; first in response to growing credit demands and then, in the latter stages of the expansion, in response to restraint in the rate of growth of credit imposed by the monetary authority as it moves to keep inflation in check. The dampening effect on economic activity of a higher level of interest rates sets the stage for recession. Conversely, on the down-swing of the business cycle it is typical for the level of interest rates to fall eventually as credit demands inevitably retreat and as the monetary authority eases its grip on the supply of credit. As interest rates decline they tend to stimulate economic activity, thereby serving to brake the economy's fall and eventually spurring economic recovery.

It is this last role of interest rates -- fostering economic recovery -- which is germane to the current state of the U.S. economy. As the economy struggles to recover from a protracted recession, there is considerable concern as to whether interest rates have fallen to a level, and will remain at levels consistent with sustained economic advance. Relatively high interest rates are seen as hurting the prospects for economic recovery in several ways. They dampen significantly the demand for highly interest-sensitive output, such as housing and automobiles. They slow the pace of a necessary restructuring of corporate balance sheets from short-term to long-term indebtedness, an important precondition for the eventual rebound of business investment -- a key ingredient for the recovery's sustainability. Moreover, relatively high interest rates also increase the financial cost of new capital, providing a further disincentive to investment activity. Finally, in the current episode, high U.S. interest rates are thought to be an important contributing factor to the overvalued dollar, diminishing exports and stimulating imports and as a result exerting a dampening effect on the growth of the economy.

Of course, as already indicated, interest rates typically rise over the course of an economic expansion and help to slow the pace of economic advance through the channels just discussed. What is of concern in the current episode is that given their high level at the beginning of the recovery, interest rates would not have to rise much more before causing the economy to stall well short of a typical expansion.

## How High Are Interest Rates

The recent recession produced a sizable reduction in the level of most interest rates. At the short-term end of the market, yields on 3-month Treasury bills fell from a peak of 12.8% in April 1982 to close to 8% by the

end of April 1983. At the long-term end, yields on corporate bonds fell from a peak of 14.8% in June 1982 to about 11.4% by the end of April 1983. Similarly, the yield on new home mortgages fell from nearly 16.0% in May 1982 to nearly 13.0% by April 1983. In general, short-term interest rates have fallen further than long-term rates. This fall is, no doubt, in part the result of a typical shift in credit demands from short-term loans to long-term loans; but perhaps more importantly, the fall is also the result of a quicker reduction at the short end of the market than is the case at the long end of the ample inflation premium built into market interest rates in recent years. The markets suggest, investors believe, that there is still considerable risk that inflation will be higher than it is now. If the current inflation improvement is perceived to be long-lasting, one can expect further reduction of the inflation premium attached to long-rates and, in turn, very likely expect further reduction of these interest rates despite some resurgence of long-term credit demands.

From the standpoint of fostering sustained economic recovery are the current levels of interest rates too high? One way to answer this question is to compare current rates to those that prevailed at similar periods of previous business cycles. To assist in such a comparison yields on selected short-term and long-term debt instruments, at the trough of the last five business cycles, are presented in Table 1. As can be seen from the table, interest rates, particularly long-term rates, have been significantly lower, at the beginning of the 1961, 1970/71 and the 1975 economic recoveries than is the case today. Each of these recoveries was characterized by a sustained economic expansions of at least 4 years. By contrast, the 1980 recovery, with interest rates at about the same level as those present today, was followed by an expansion lasting only 1 year. Of course, during 1980 both monetary and fiscal policy were considerably more contractionary than is now the case.

TABLE 1. "Nominal" interest rates  
at business cycle troughs

<u>Economic troughs</u>	<u>3-month Treasury bills</u>	<u>Corporate bonds (Moody's Aaa)</u>
February 1961	3.2	3.3
November 1970	5.4	5.8
March 1975	5.6	6.3
July 1980	8.1	11.1

Some analysts, however, would maintain that given the very high inflation that has prevailed in recent years, a historical comparison of today's interest rates with those of periods that experienced far less inflation, and presumably, with far smaller inflation premiums built in, might not be very meaningful. What is preferred is a comparison of real interest rates, that is, nominal interest rates adjusted for inflation premiums. (The reader should be mindful that real interest rates are not directly observable and must be estimated. The accuracy of such estimates will likely be better for short-term rates than for long-term rates.) Estimates by Merrill Lynch Economics, of real short-term Treasury yields at business cycle troughs are presented in Table 2 below.

TABLE 2. "Real" Treasury yields at business cycle troughs

<u>Economic troughs</u>	<u>3 mo.-bills</u>	<u>20-year bonds</u>
February 1961	1.1	2.5
November 1970	0.9	2.2
March 1975	-2.8	-0.3
July 1980	-1.7	0.6
December 1982	3.0	5.5

These estimates suggest that real interest rates are, indeed, well above levels that have prevailed during the beginning of previous recoveries, even above those of the aborted recovery of 1980.

Perhaps a second comparison might be apropos to the concern about high real interest rates and recovery. Real interest rates, particularly at the long-term end of the market, are presently as high as real rates have been at previous peaks of the business cycle. That is, rates are at levels that have, in the past, been high enough to be a major force pushing the economy into a subsequent recession.

To be sure, even historical comparisons of real interest rates do not take into account a number of other factors that may have changed between recoveries of the past and the current upturn, making previous experience not fully comparable to the current circumstance. Two recent institutional changes, the virtual elimination of Regulation Q that previously limited the interest rates banks could pay, and the advent of interest bearing checking accounts as part of the basic money supply, may have the effect of pushing up the prevailing level of interest rates at all stages of the business cycle. (These other factors are discussed more fully below). It is also important to keep in mind is that real interest rates typically rise as inflation decelerates because inflation expectations in the financial markets tend to lag changes in actual inflation. Moreover, the unexpected degree of the recent decline in inflation might be expected to lead to an above normal, though temporary, boost of real interest rates. Nevertheless, aware of this development as well as and the possible differences between the current and previous recovery periods, many analysts believe that the present level of

nominal and real interest rates, particularly long-term rates, is still too high to permit a sustained economic recovery. These long-term rates are thought critical to an expansion sustaining resurgence of business investment.

#### Monetary and Fiscal Policy and the Level of Interest Rates

Faced with the possibility that the present high level of interest rates could bring the on-going recovery to a premature end, some argue that monetary or fiscal policy, or both, should attempt to lower those rates sufficiently to assure a longer-lived recovery. The likely consequences of such policy actions are considered in some detail below.

An "Easier" Monetary Policy: The Federal Reserve has direct control over the discount rate (that is, the rate the Fed charges depository institutions for the loan of reserves). Through the buying and selling of financial assets the monetary authority can, however, exert indirect influence on other market interest rates. This indirect influence which is typically most pronounced and most certain for short-term rates also has an effect on long-term interest rates. Through the purchases of financial assets in the open-market the Federal Reserve can, other factors unchanged, augment the stock of money and credit and, as a result, lower market interest rates. This action will likely stimulate economic activity. But, there is also the risk that some part of this stimulus may at some point emerge as inflation.

A recent study by Data Resources, Incorporated (DRI) examined, using DRI's econometric model of the U.S. economy, the consequences through 1985 of the Federal Reserve's pushing down both real and nominal interest rates by 3 percentage points below rates that would otherwise be expected. ["Will Higher Interest Rates Kill The Recovery," Data Resources Review, May 1983] That analysis indicates that the following outcomes would likely occur.

--The economy would continue to expand through 1985, with real GNP up about 2.0% over the higher interest rate alternative.

--The unemployment rate would fall faster, and by 1985 would be about one percentage point below that of the high interest rate alternative.

--Interest sensitive sectors would receive a particularly strong boost. In 1984 and 1985 housing starts are up between 300,000 to 400,000 units, auto sales are up 600,000 to 800,000 units and business fixed investment is up \$5 billion to \$11 billion. The latter outcome, however, is not the direct result of lower interest rates but of a faster pace of real output growth that stems from the lower interest rates associated with monetary stimulus.

--By 1985 inflation as measured by the price deflator for GNP, would be up about 1/2 of a percentage point over that rate in the high interest rate alternative.

In general, the DRI simulation study gives credence to the position that lower interest rates would help support sustained economic recovery, but

these gains are accomplished at the price of more rapid inflation. Although DRI can, in the context of their econometric model, lower substantially both nominal and real interest rates, it is not at all certain that in actual practice the Federal Reserve can accomplish this feat, particularly a sizable reduction of long-term real rates over which it may have very uncertain influence. In fact, to the extent that such monetary stimulus increases inflationary expectations it may push up interest rates. Nevertheless, the results suggest that high interest rates will likely produce a slower paced recovery than would occur if those rates were, somehow, lowered by a stimulative monetary policy.

#### A "Tighter" Fiscal Policy:

An assertion that is often made is that the prospect of large future budget deficits is keeping interest rates high and in so doing is increasing the risk that the incipient recovery will not survive. In this view deficit reduction is seen as a necessary step towards lowering interest rates and keeping the expansion going.

It is certainly the case that Federal deficits, being a significant component of the overall demand for credit and money, exert upward pressure on interest rates, both real and nominal. Moreover, as private credit demands rebound with economic growth, the presence of large deficits will likely have a strong elevating effect on market interest rates. (These "other factors" are discussed more fully below.) It is also true, however, that deficits produce a direct stimulative effect on economic activity, which tends to raise output and employment. Conventional economic analysis and a wide body of empirical evidence suggest that deficit reduction will contribute to lowering interest rates but it will also push the level of output and employment below what it otherwise would be.

A simulation study of deficit reduction policies was recently completed by the Congressional Research Service (CRS) [Report No. 83-47E, Reducing the Federal Deficit: The Macroeconomic Effects of Expenditure Cuts U.S. Tax Increases, Jan. 25, 1983] In that study two polar strategies are examined: deficit reduction by (a) expenditure reduction and by (b) tax increases. Both strategies are structured to reduce the budget deficit to approximate balance by 1988. Although the magnitude of the effect on economic activity differs between the two deficit-reduction routes, with expenditure reductions having a greater effect than tax increases, they are singular in the direction of their effect on economic variables. In general, the CRS study indicates that:

--Deficit reduction would lead to lower nominal and real interest rates.

--Deficit reduction policies slow the rate of growth of real GNP, and the speed of reduction in the unemployment rate.

--Lower interest rates contribute to increases in production activity in interest rate-sensitive sectors such as housing.

--Business fixed investment is reduced despite lower interest rates, as reduced output growth exerts a strong negative effect.



These results (largely consistent with standard macro economic analysis) indicate that deficit reduction would likely slow the pace of economic expansion over the "near term." These results do not lend support to the argument that large deficits and the likely attendant elevation of interest rates threaten the occurrence of a sustained and protracted recovery.

Despite the predictions of conventional macroeconomics, some economists are expressing concern that prospective deficits of the unprecedented size now generally foreseen may be creating problems for the process of economic recovery that go beyond the realm of conventional macroeconomics. It is speculated that if deficits of that size are, indeed, realized, then they would create a situation in which an unprecedented share of the Nation's flow of savings would be channeled to the Federal sector, a change so great that the very structure of the U.S. economy might be altered. Uncertainty about the implications of this very different economic future may be reflected in an uncertainty premium added to most current interest rates, inhibiting economic activity now. Or, it is reasoned, if those large projected deficits are not expected to be realized, but rather reduced by policy action, then uncertainty arises over just how that reduction will be achieved; which expenditures will be cut and by how much and which taxes are to be raised and by how much? With these budget actions expected but not specified, uncertainty about the future can be said to remain a concern with an inhibiting effect on current economic activity. A wide spectrum of economic views suggests that a major problem with economic policy at present is that it is characterized by a great amount of uncertainty. The budget outlook remains unclear and the pattern for monetary policy beyond 1983 remains clouded. Such uncertainty may indeed be elevating the level of interest rates, and may have an inhibiting effect on economic activity now and in the future.

#### Are Interest Rates too High?

The presumption to this point has been that interest rates may be too high to allow a sustained economic recovery. Arguments can be mustered, however, that may call that this contention into question, if not refute it. First, as mentioned above, it is likely that a number of recent institutional changes may have elevated the "normal" level of interest rates that would prevail over the course of the business cycle. That is, the equilibrium level of interest rates will be higher on average at all stages of the cycle, suggesting that higher rates, currently, need not be any more constraining to economic activity than significantly lower rates under an earlier institutional regime. A very important institutional change is the virtual elimination of Regulation Q that had previously restricted the rate most banks could pay depositors. This change has led to far less non-price rationing in credit markets, particularly the residential mortgage market, than took place before. The drop in such rationing means that the price of credit, the interest rate, plays a larger role in allocating a limited supply among unlimited demands. Interest rates likely must now rise higher than in earlier periods to clear the credit market. Thus, higher interest rates will usually allow the same volume of credit extensions, and possibly the same level of economic activity. Another institutional change of some significance is the widespread emergence and rapid growth of interest-bearing checking accounts as part of the basic money stock (i.e., the money stock that is used primarily for economic transactions, not savings). These new accounts have made it less necessary to hold money balances in a non-interest bearing account and thereby have likely increased the average rate of interest at which any given stock of money would be held than was the case

previously.

Second, it is not necessarily the case that high interest rates will dampen expenditure and, in so doing, lead to a slower pace of economic advance, or worse, induce a decline. Interest rates, particularly long-term rates, are high now because investors (the market) expect them to be high in the future. That does not explain, however, why those rates deter expenditure now. Herbert Stein, former Chairman of the Presidents Council of Economic Advisors, has argued: if high interest rates are seen by borrowers as arising out of conditions which would point to strong demand and elevated profits in the future, they would likely be willing to make capital investments despite high current interest rates. In other words, the very conditions that prompt lenders to expect high rates may be the same conditions that justify borrowers incurring those rates, as the size of expected return will compensate for the higher cost of borrowing. Admittedly, this argument is more pertinent to the expenditures for business investment and housing which generate a realizable future income stream than for consumer durable purchases which do not.

Third, even if relatively high interest rates do dampen the growth of final demand in the economy, and if it is also true that sustained recovery depends on sustained disinflation, then maybe high interest rates are a necessary condition for a slow but steady non-inflationary expansion. Otto Eckstein, president of DRI, the economic forecasting firm, has recently speculated perhaps interest rates in previous recoveries were too low in the sense that they were the consequence of a too rapid rate of money and credit growth. Eckstein suggests that this expansion of money and credit by the monetary authority led to a fast paced growth of aggregate demand, and also the eventual emergence of an inflation problem. Moving to check an accelerating inflation, the Fed frequently attempted to rein in the growth of money and credit, which action helped elevate interest rates, precipitating a credit crunch, setting the stage for the next recession.

In contrast, perhaps relatively higher interest rates associated with a more moderate growth of money and credit would avoid this collision between accelerating inflation and Federal Reserve policy, possibly leading to a slower but more stable and long-lived economic expansion. There is, however, no modern precedent to suggest whether such a "slow but steady" process would lead to a greater net gain than the customary process. If pursued, it would be an interesting experiment.

These three arguments, of course, do not in any way provide conclusive evidence that "interest rates" are not too high for sustained recovery. But they do suggest a possibility that the incipient recovery can be sustained with what would be historically high interest rates. Charting the economy's future path is always problematic. This being the case, some forecasters are suggesting that the expansion will endure despite high interest rates. In the June 10, 1983 issue of Blue Chip Economic Indicators, a survey of the outlooks of 44 economic forecasters, it is reported that the average expectation of the surveyed forecasters is a recovery that will last 40 months with real growth averaging about a 4.0% annual pace. Such an outcome would, indeed, have to be characterized as a sustained recovery.