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HIGH INTEREST RATES: CAUSES AND EFFECTS

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Introduction

This paper describes the major market and policy forces that determine the general level of interest rates. The discussion is related to the recent economic experience of high interest rates and inflation, but may be generally applied to any economic environment.

Until the decline that began in April, 1980, market interest rates had risen almost continuously for three years and had reached record high levels. When interest rates are high there is typically concern that certain sectors of the economy bear a disproportionate share of the effects of high interest rates; the impact of high interest rates on these interest-sensitive sectors is also discussed below.

Interest Rates are Prices

Interest rates are prices and are therefore primarily determined by the interaction of demand and supply in the market; in this case, the commodity in question is money as it is borrowed and lent, rather than bought and sold. The demand for borrowed money represents the desires of businesses, households, and governmental units to acquire credit to finance expenditures. The supply of money available for borrowing depends on the amount of savings flowing into banks and other financial institutions and into financial markets. The interaction between the demand for borrowed money and the supply of it determines the level of interest rates; anything that affects either the demand or supply of borrowed funds will therefore indirectly impact on interest rates. Inflation and expectations have important effects on interest rates, via their impact on the demand and/or supply of credit. In addition, the actions of the Federal Reserve strongly influence the supply of money available for lending and borrowing. Each of these factors will be discussed in the sections that follow.

The Impact of Inflation

Since inflation reduces the purchasing power of money, inflation and the expectation that it will continue causes lenders to demand higher interest rates on loans. This is because lenders want to be compensated, not only for sacrificing the use of their money and assuming a risk in lending, but also for the expected decline in the purchasing power of their money during the life of the loan. In addition, there is a tendency for borrowers, also expecting the value of the money to decline before they repay the loan, to be willing to pay higher rates to borrow money. The willingness to pay higher rates to borrow is reinforced if the borrower uses the money to buy something that is apt to increase in value with the inflation (such as a house). Therefore, inflation and inflationary expectations can press interest rates upward.

Because of the impact of inflation on interest rates, economists distinguish between the market interest rate and the real interest rate.

The real interest rate is the market rate, adjusted for the rate of inflation. It is therefore possible, when inflation rates are high, for market interest rates to be quite high, while real rates remain relatively low.

The Influence of the Federal Reserve

The actions of the Federal Reserve also have important effects on interest rates and on the availability of money to borrow. While the Federal Reserve does not have the power to set interest rates in general, it has control of one rate, the Federal Reserve discount rate; and, changes in the discount rate can influence other market rates.

The second major monetary policy tool the Federal Reserve has is the power to change reserve requirements. Reserve requirements are the percentage of deposits member banks must keep on reserve. When, for example, reserve requirements are increased, banks are required to keep more reserves and therefore have less money available to lend out; by altering the availability of money and credit, interest rates may be affected.

The Federal Reserve can also strongly influence market interest rates through its open market operations; there are two paths through which this influence works. First, open market operations have a direct impact on the market rate on U.S. Government securities, which will in turn impact on other market rates. Second, Federal Reserve open market operations change the level of reserves available to the banking system, directly affecting the amount of money banks have to lend out, and therefore the rates banks charge on loans. For example, an open market sale of securities by the Federal

Reserve will tend to increase rates on Government securites and will reduce the amount of reserves in the banking system; with less reserves, banks have less money available to lend and there is a tendency to raise loan rates. The total effect of such a policy action is therefore a reduction in money and credit availablity and upward pressure on market interest rates.

Anti-inflationary, or contractionary, monetary policy is aimed at reducing the level of total spending in the economy. According to economic theory, a reduction in aggregate spending will diminish the upward pressure on prices, to the extent that prices are being pulled up by excessive spending.

Anti-inflationary monetary policy works by limiting the amount of money available for borrowing and/or increasing real interest rates. As money and credit become scarcer and interest rates rise, borrowing is discouraged and total spending declines. Anti-inflationary monetary policy therefore entails some degree of money and credit stringency and some increase in real interest rates for some period of time. The degree of stringency, the levels to which (real and market) interest rates must rise, and the period of time required for the policy to have its desired effects, are all difficult policy issues. Once restrictive monetary policy is effective in stemming inflation, upward pressures on interest rates should abate and credit market conditions should ease.

The Effects of Expectations

Since interest rates are primarily market-determined, they can be influenced by actions of either borrowers or lenders. It is likely that the behavior of market participants is governed by a wide variety of economic and psychological factors; it is believed that expectations about the future course of the economy have an important influence on the actions and reactions of borrowers and lenders. Their actions are then reflected in interest rate movements. For example, businessmen expecting the economy to expand, may increase their borrowing to finance their own expansion; or, consumers expecting inflation, may increase borrowing to buy before price increases occur. Either of these actions would add to the demand for credit and would help push up interest rates.

Borrowers and lenders also frequently formulate plans based on what the Federal Reserve has done or what they anticipate the Federal Reserve will do in the near future. If, for example, there is an expectation that monetary policy is going to become tighter, borrowers may be encouraged to borrow sooner and lenders may try to postpone lending in anticipation of the higher interest rates that frequently accompany more restrictive monetary policy. Both of these reactions, the former increasing the demand for credit and the latter decreasing the supply of it, will put upward pressure on interest rates, regardless of whether the Federal Reserve actually changes its monetary policy stance.

Summary of Causes

Upward pressure on interest rates can therefore come from a number of sources. A high demand for credit by borrowers can push interest rates up, inflation adds upward pressure and anything that limits the supply of money and credit available for lending is also likely to cause market interest rates to climb. Because of their effects on interest rates and on the supply of money and credit, Federal Reserve actions can have important influences on interest rates. Anti-inflationary monetary policy, in order to be effective, generally will be accompanied by high or rising real and market interest rates for an uncertain period of time.

Broadly speaking, there are two dangers associated with high interest rates. One potential danger is that high interest rates and a general scarcity of money and credit will so severely restrict borrowing for consumer spending, construction, and business investment to cause, or worsen, a recession. Second is the problem that certain groups or sectors within the economy may bear a disproportionate share of the impact of high interest rates and credit shortages. This latter issue is discussed below.

Sectorial Impact of High Interest Rates

It is commonly believed that when money and credit tightens and interest rates rise, certain groups of borrowers are more seriously affected than others. Small businesses, public utilities, State and local governments, and consumers are all types of borrowers that are typically believed to be seriously affected. Also, all participants in the mortgage market and construction industry, including borrowers and lenders of mortgage credit, construction companies and workers, are frequently hit hard by scarce and expensive credit. There are several channels through which these groups may be forced to bear a disproportionate share of the adverse effects of high interest rates and tight credit; these will be discussed in the paragraphs that follow.

Cost of Borrowing: As interest rates rise, some groups of borrowers may simply not be able to afford to borrow money. Small businesses, consumers, public utilities, State and local governments, and certain types of mortgage borrowers are believed to be highly sensitive and vulnerable to increases in the cost of credit.

For small businesses, many of which operate with small profit margins, increases in the cost of borrowing money can cut so heavily into profits that they can no longer afford to borrow money.

Since consumers typically borrow money to purchase durable goods such as a car or household appliance, increases in the cost of borrowing may force them to postpone or abandon plans to borrow and spend. This is especially likely to be the case during inflationary periods, when rising prices are already putting pressure on consumers' budgets.

Interest costs are such a large proportion of monthly mortgage payments that interest rate increases can cause substantial increases in monthly payments. Therefore when interest rates rise, many would-be home buyers are priced out of the market. State and local governments and public utilities are also frequently priced out of the market for borrowed money when interest rates are high; in addition, in some cases State and local laws put limits on the rates that governmental units and public utilities are allowed to pay to borrow money.

Credit Rationing: Credit rationing is the term applied to the procedures that banks follow to allocate credit among potential borrowers when the supply of money and credit is limited relative to the demand for it. To ration credit, banks may upgrade their standards for risk and credit-worthiness. They might also simply decide not to extend certain types of loans or choose to lend to certain preferred customers or types of customers. It is frequently claimed that credit rationing discriminates against consumers, small businesses, and State and local governments, while large, corporate customers receive a larger proportion of the smaller amount of available money.

Usury Laws: In some States, usury laws encourage the allocation of credit away from certain types of borrowers. Usury laws put ceilings on the rates that lenders can legally charge on loans; usury ceilings are most frequently applied to mortgages and consumer loans. When market rates rise above the legal ceilings, there is a profit incentive for banks and other lenders to allocate scarce credit to other types of loans.

Disintermediation: Disintermediation refers to the withdrawal of funds from financial intermediaries as more money is attracted into financial markets by high interest rates. This occurs whenever market rates rise above those legally payable on deposits, making market instruments, such as Treasury bills or commercial paper, more attractive to investors than deposits at financial institutions. Disintermediation reduces the amount of money available for all types of financial intermediaries to lend out, but in previous periods of tight credit and high interest rates, savings and loan associations and mutual savings banks have experienced serious withdrawals of funds. Since these institutions are heavy mortgage lenders, disintermediation, by draining money from these institutions, reduces the amount of money available for mortgages.

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