Memorandum: Interest Rates and Ceiling Rates

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MEMORANDUM

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TO: Dr. Frederick S. Hamer, F.D.I.C.
FROM: Allan Meltzer

SUBJECT: Interest Rates and Ceiling Rates

This memo covers two separate topics. In the first, I discuss the
topics determining interest rates and the effect that I expect these factors
to have on interest rates in 1967. Then I consider the role of present ceilings
on rates paid to depositors by commercial banks and other thrift institutions.
The two topics are related in part because the rates are themselves related
in well functioning markets for money and securities and in part because
ceilings or other restrictions that prevent the rates paid by banks and
other institutions from adjusting disrupt well established patterns of
resource allocation and force individuals to search for new means of holding
assets.

Main Factors Determining Interest Rates and Their Effects in 1967

The level of interest rates that will prevail next year will be the
result of real and financial factors occurring during the year. Market rates
respond rapidly to most, but not all of the factors that influence their
movement. Hence, any attempt to predict the level of interest rates on a
particular date requires rather detailed forecasts of the position of the
economy and of financial markets near that date. Such forecasts cannot be
made with precision, so I will confine my effort to a discussion of the main
factors affecting interest rates and their expected effect during 1967.
The most useful fact about interest rate changes on which to base predictions is the striking cyclical conformity of most market rates. In mild cycles, interest rates rise during periods of rising economic activity and fall during recession. These movements are in large part a consequence of three forces: 1. Changes in the volume of financial assets offered by households and business and acquired by banks and other financial institutions; 2. Changes in the demand for money; and 3. Changes in the composition of the supply of money, i.e. shifts from currency to demand deposits or vice-versa.

These three factors are offset, in part, by two others — Changes in the monetary base reflecting Federal Reserve policy and Changes in the amount of interest bearing debt issued to finance government deficits and held outside the Federal Reserve and Treasury Trust accounts. These two factors have a pro-cyclical pattern during mild cycles. The growth rate of the monetary base — bank reserves and currency — generally rises in periods of economic expansion and falls in recessions. The government generally issues more interest bearing debt during recessions than during expansions. If these changes in the monetary base and in the government's interest bearing debt dominated movements of interest rates, interest rates would fall in expansion and rise in recession. Hence, we can be reasonably confident that the first three factors listed above dominate the movement of interest rates and provide the pro-cyclical pattern that we observe in all mild cycles during this century.

All of this, as mentioned, will be operating in 1967. I expect that industrial production will decline during the year and the total real output will rise less than in other recent years. The demand for currency will decline or, at worst, the rate of increase in the demand for currency will fall. These
Factors will produce a decline in interest rates. On the other hand, rising prices and the increased amount of Federal, State, and local government debt that must be absorbed by banks, financial institutions and others will work to raise interest rates. At a minimum, they will limit the decline in market rates.

The final item to be considered is Federal Reserve action. It is difficult to predict the action that the Federal Reserve will take and particularly difficult to make such predictions six months or a year in advance, since the Open Market Committee makes decisions at three week intervals. My forecast of Federal Reserve policy is based on the proposition that the Federal Reserve uses interest rates as a measure or indicator of its policy. If there is a rise in unemployment, they will desire lower market interest rates, and if these are not produced by the forces of the market, they will increase the growth rate of the monetary base to bring about lower interest rates.

On balance, therefore, I expect lower interest rates on the average in 1967. The size of the decline will, however, be moderate unless the recession or decline in the growth rate of economic activity is much larger than I believe is likely at present. Moreover, a fall in short-term market interest rates here relative to interest rates abroad will induce an outflow of short-term capital and of gold. To offset these movements, short-term interest rates will be maintained at levels high enough to reduce the gold outflow.
Conclusion: Market interest rates have started to decline for the reasons described above. I believe the decline in market rates will continue, but unless a serious recession develops, the decline in market rates for longer-term securities will be moderate. Short-term market rates will fall more than long-term rates as in most mild cycles but probably will not be permitted to fall much below 3-1/2% to 4% as a means of protecting the gold stock from short-term capital outflow. The last quantitative prediction is, of course, very tentative and is introduced to give some indication of the maximum range in which I expect short-term interest rates to move.

Ceilings for Interest Rates Paid by Banks and Financial Institutions

Present ceilings on interest rates are a serious distortion that interfere with the efficiency of well-organized markets. The problem that they were designed to correct was largely a result of: 1. Changes in Federal Reserve Regulation Q, 2. A decline in the growth rate of the stock of mortgages, 3. Restrictions that prevent various financial institutions from purchasing a variety of different types of assets and, 4. A very sudden change from an overly-expansive to an excessively contractive monetary policy.

The eventual effect of the restrictions on interest rates paid by banks and thrift institutions can only be a shift of funds from such institutions to non-regulated institutions during periods of relatively high interest rates. Indeed, the system of controls is predicated on the belief that individuals are responsive to changes in the rates paid by various types of institutions. If market interest rates remain near present
levels or return to higher levels, funds will shift at a much greater rate to
government securities and other types of debt whose rates are not controlled.
The effect of such shifts will be a smaller proportion of the public's
financial assets in insured financial institutions. I regard this change as
undesirable.

All financial institutions have displayed a substantial amount of
innovative
innovated ability in recent years. This suggests that if ceiling rates are
made permanent, individuals and financial institutions will find it profitable
to devise arrangements that circumvent the present set of controls.

The main point, however, is not that the controls can and will be
circumvented but that they are unnecessary and undesirable. A more appropriate
way of dealing with disruption caused by new allocations resulting from
changes in Regulation Q is to remove that regulation along with other
controls on interest rate movements. The more useful way to maintain
deposits in savings and loan associations when there is a decline in the
housing industry is to permit such institutions to purchase financial
assets other than mortgages.

Financial assets are close substitutes. At most, particular rates
can be controlled or maintained temporarily. Individuals learn to reallocate
their assets. It is both costly and unnecessary to force the public to
develop a new pattern of allocation for assets.