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Wall Street and Washington

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Wall Street's bond bears smile as they read their press clippings, count their profits and repeat their gloomy forecasts. They were right again in the first half of 1981. Interest rates on loans, bonds and mortgages continued to rise, with only brief pauses and short-lived reverses. True, the bears missed most of the often sizeable, monthly ups and downs of interest rates. But they got the direction right. And that's better than many of us did.

Washington's economists make no secret of their disappointment and puzzlement. Like all good economists they learned, or relearned, in the past fifteen years that interest rates rise and fall with inflation. Whenever inflation surged ahead, interest rates ran alongside -- and at times, anticipated the higher inflation. When inflation fell, interest rates tumbled. As recently as 1976, with inflation about 5%, the Treasury paid 5% or less on its short-term borrowing.

Inflation has fallen from more than 12% last year to less than 10% so far this year. But instead of falling by 2% or more as Washington's economists expected, interest rates rose. This time, however, it is the real rate of interest -- the difference between the market interest rate and the rate of inflation -- that has reached the highest level in fifty years.

In 1976, and in many other years, the real rate, before taxes, was about zero. This year, with broad measures of inflation expected to be down to 9%, or less, the Treasury paid nearly 14% to sell thirty year bonds and even higher rates on its short-term debt. A recent 16% interest rate on
Treasury bills gives the holder a real return, ignoring taxes, of 7% or more.

Washington is puzzled by high rates of interest, but Wall Street has few doubts. Wall Street's bears explain high current rates as a response to large prospective government budget deficits. The bears complain, correctly, that the administration has overestimated economic growth and tax revenues and underestimated the budget deficit for the next several years. They complain, incorrectly, that the deficit is the cause of currently high interest rates.

The Wall Street explanation of current interest rates is widely shared. At the Ottawa summit meeting of heads of state, several heads of foreign governments complained about loose fiscal policy in the United States. These officials would like to believe that a smaller budget deficit here would reduce interest rates around the world and permit them to finance their own large budget deficits at lower interest rates.

Frequent repetition does not make this argument correct. Even if the U.S. budget deficit in current dollars reaches $60 billion this year and $100 billion next year, current or prospective deficits cannot explain current interest rates. It is real rates that increased dramatically this year. To explain the rise in real rates, Wall Street's bears and others who believe that the budget deficit is the main explanation of the rise must show that the real deficit -- the deficit adjusted for inflation -- has increased. This has not happened. The real value of the deficit is below the peak levels reached in 1975 and 1976. To exceed its previous real value, the actual deficit would have to exceed $120 billion in 1982.
If not the U.S. deficit, perhaps a growing total budget deficit of major countries explains the rise in real interest rates in the capital markets of the world. This explanation has surface plausibility. Germany, Britain, Japan and the U.S. have had loose fiscal policies in recent years. France seems headed in that direction.

Surface plausibility is not a substitute for facts. The combined fiscal deficits of major countries reached a peak in 1976. The change since 1976 is in the wrong direction. The real value of the major countries' combined deficits has fallen 30% below the 1976 peak while real interest rates have increased from near zero to 7% or more.

The dominant influence on current real interest rates is monetary, not fiscal policy. Since 1978, many of the major countries of the world have reduced the rates of growth of money -- currency and checking deposits -- to reduce inflation. In 1978, the annual average rate of money growth was above the current rate of inflation in each of the countries that met with the United States at Ottawa. Monetary policy was inflationary. By 1980, each of the countries had reduced its rate of money growth below its rate of inflation. The average rate of money growth fell from about 15% to below 6% in the six countries. This year disinflationary monetary policies intensified in Germany and Japan.

The first effect of disinflationary monetary policy is an increase in the real rate of interest. A sharp rise in the real rate is often followed by a recession. During the recession borrowing declines and interest rates fall. If governments persist in their disinflationary policies, inflation falls and the decline in interest rates becomes permanent.
The Federal Reserve has joined the broad assault on inflation. By adding their heavy weight to the disinflationary policies in Germany, Japan and other countries, the Federal Reserve helped to send real interest rates soaring this year.

Past behavior and obstinate refusal to improve its operating procedure sustain doubts about the Federal Reserve's commitment to its disinflationary policy. The belief seems to be growing, however, that the Federal Reserve intends to continue, at least for a while, to reduce the growth of money. If the Federal Reserve does not disappoint us by returning to past inflationary policies, the best days for Wall Street's bond bears are likely to be behind them.