Economic Policy Institute

# Briefing Paper

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## HIGH INTEREST RATES: IT'S NOT JUST THE DEFICIT

by Richard Medley

There is a rough consensus among economic policy analysts that U.S. interest rates must come down further in order to maintain economic growth and to prevent unemployment from rising. Lower interest rates will stimulate consumer spending and investment, and help to reduce the extraordinarily high value of the dollar that is behind much of our deteriorating trade balance.

Efforts to bring interest rates down have focused almost exclusively on reducing the Federal fiscal deficit. The explicit assumption of the federal budget debate is that lowering the expected FY '86 deficit by roughly $50 billion will automatically reduce real interest rates to a more traditional level -- i.e., a prime rate roughly two to three points above the rate of inflation. In 1984, this would have meant an average prime rate of 5.7-6.7 percent instead of the 12 percent prime that the economy actually experienced.

There is good reason to believe that the debate over how to lower interest rates has seriously overemphasized the role of the federal deficit. To begin with, there is nothing magic about the $50 billion deficit reduction figure. It was a number tossed off by Federal Reserve Chairman Volcker when pressed repeatedly to tell Congress how much of a deficit cut would be sufficient to convince the "markets" that the government was coming to grips with the budget problem. Furthermore, although a somewhat smaller deficit would exert some downward pressure on interest rates, the high budget deficits not the only factor which has raised interest rates. Other important and generally overlooked factors include:

1. The tight money policy of the Federal Reserve Board
2. Financial market deregulation which has contributed to increased risk, higher overhead costs and a destabilizing "bidding up" of interest rates by financial institutions

3. Continued demand for credit to finance mega-mergers.

Unless these other factors are addressed, it is likely that the income loss effects of reduced federal deficits will not be sufficiently offset by declining interest rates. According to market participants, Wall Street has already discounted and adjusted for the anticipated $50 billion deficit cut. If that is true, rates will get little further relief from the actual cuts, and the net effect of lowering deficits would be to retard economic growth and increase the unemployment rate. With low growth, of course, will come an eventual decline in interest rates as demand for credit falls. But even then, rates may not fall quickly enough and far enough to restimulate the economy without action by the federal government, as the 1981-82 recession experience showed.

## SECTION I
## THE UNCERTAIN LINK BETWEEN DEFICITS AND INTEREST RATES

There is no solid evidence of a substantial connection between lower federal deficits and lower interest rates. Even the most recent experience casts doubt on the linkage: federal budget deficits continued to soar throughout the winter of 1984 and spring of 1985 while interest rates dropped.

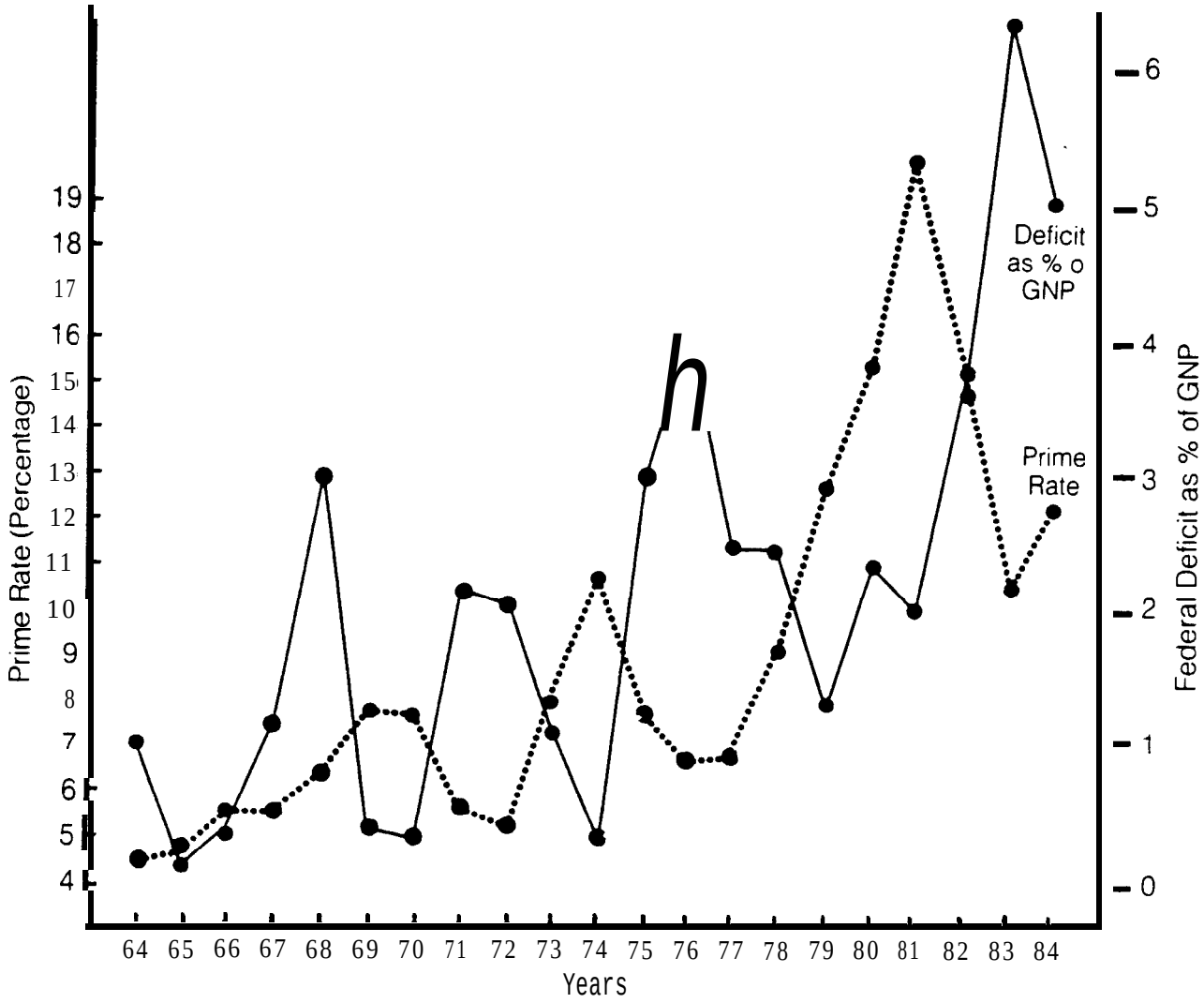
That lower deficits should have some effect on interest rates is a reasonable assumption, but despite aggressive efforts by those who are committed to reducing the deficit on other grounds, the link remains statistically weak. Even regression analysis done by economists like Martin Feldstein, for example, has turned up only minor historical connections between rates and deficits. [1]

The Congressional Budget Office, which has long been an advocate of lower deficits, admitted in its February 1985 Economic Budget Outlook that, "a variety of empirical studies have attempted to examine the effects of deficits on interest rates . . . Few have uncovered a clear pattern of correlation, let alone a causal link."'

Another study -- published by the conservative Federal Reserve Bank of St. Louis -- concluded that: "The actual pattern of deficits and interest rates over the past four years runs counter to the higher-deficit, higher-interest rate hypothesis." Analyzing the impact of higher deficits, the study found no measurable effect on long term interest rates when government deficits increased. [3]

Chart 1

Prime Rate And Federal Deficit As A Percent Of GNP




*Source: Federal Reserve Board Bulletin*
*Economic Report of the President, 1985*

Chart 1 shows that historically there has been, in fact, an inverse connection between interest rates and the federal budget deficit; that is, deficits have risen when rates have dropped. Much of that relationship, however, is a result of the business cycle and federal reserve policy. In years past, deficits were highest when the economy was in recession and there was little business demand for credit, while the Federal Reserve was pumping money into the economy to bring rates down further. The St. Louis Fed study found that even taking into account fluctuations in the business cycle, there is no statistically significant correlation between high deficits and high interest rates.

Table 1

[redacted] Interest Rates And The Federal Deficit [redacted]

| Dependent variable | Period | Deficit and GNP measure | Constant | Change in the deficit ratio | $\bar{R}^2$ | SE | DW | p |
|---|---|---|---|---|---|---|---|---|
| Change in 3-month Treasury bill rate | II/1955–III/1983 | actual | 0.092 (1 10) | -0.419 (-3.81)' | 0.11 | 0.885 | 1.92 | — |
| | II/1955–IV/1969 | actual | 0 104 (1.89) | -0.213 (-2 41)" | 0.08 | 0.422 | 1.63 | — |
| | I/1970–III/1983 | actual | 0.090 (0.56) | - 0.530 (-2 85)' | 0 12 | 1.198 | 1.98 | — |
| | II/1955–III/1983 | htgh-employment | 0 077 (0.88) | - 0.277 (-1.98)' | 0.03 | 0.924 | 1.78 | — |
| | II/1955–IV/1969 | high employment | 0.107 (1 30) | 0.053 (0.50) | -001 | 0.418 | 1.73 | 0.35 (2.82) |
| | I/1970–III/1983 | htgh-employment | 0.051 (0 30) | - 0.394 ( – 1.66)' | 0 03 | 1.255 | 1.84 | — |
| Change in Aaa bond yield | II/1955–III/1983 | actual | 0.088 (1 89) | - 0.069 (-150) | 0.01 | 0.374 | 1.95 | 0.25 (2.67) |
| | II/1955–IV/1969 | actual | 0.079 (2.78) | - 0.047 (-151) | 0.02 | 0.146 | 1.77 | 0.34 (2.60) |
| | II/1970–III/1983 | actual | 0.103 (1 12) | - 0.079 (- 1.00) | 0.00 | 0.523 | 1.95 | 0.23 (1 74) |
| | II/1955–III/1983 | high employment | 0 085 (1 81) | - 0.031 (- 0.57) | -0.01 | 0.378 | 1.94 | 025 (268) |
| | II/1955–IV/1969 | high employment | 0 079 (2.66) | -0012 (-0.33) | - 0.02 | 0.149 | 1 74 | 0.36 (2.79) |
| | IV/1969–III/1983 | high employment | 0.096 (1 04) | - 0.038 (- 0.42) | - 0.01 | 0.527 | 1 94 | 0.23 (1 73) |

**NOTE** t-statistics are given in parentheses, * indicates a deficit measure whose coefficient is significantly different from zero at a 95 percent confidence level

Source: The Federal Reserve *Bank* of *St. Louis Review*

Table 1, taken from that report, shows that the correlation (reflected in column $\bar{R}^2$) between short and long term bond rates and the actual and "full employment" deficit is generally weak and sometimes negative.

The study considered the relationship between interest rates and deficits from 1955-83. It found a generally negative --instead of a generally positive-- relationship. This means that as the deficit, measured as a percent of GNP, rises, interest rates tend to fall. This relationship emerged largely because, in previous years, budget deficits tended to grow during recessions -- at a time when consumer and business demand for credit fell off. That counter cyclical pattern meant government demand for credit was greatest when private demand was lowest and vice versa.

In the St. Louis study, both 3-month Treasury bills and Aaa corporate bonds were used to measure changes in interest rates.

These changes were then compared with changes in the actual federal deficit-GNP ratio and with changes in the high employment deficit/GNP ratio. A range of lag time was also introduced to catch any delayed effects and the study concluded that no lagged values were statistically significant in either case.

High continuing deficits are a problem for the economy. They are contributing to an unhealthy dependence on foreign creditors and severely limit the options of the government in meeting new public needs.

But the deficits are also creating significant demand for goods and services, which is in turn stimulating jobs and investment. Even the most casual Keynesian would have predicted a booming economy in the wake of our recent $200 billion deficits. On the other hand, abruptly halting the deficit-led recovery could lead to a budget cut-led recession. Smaller deficits mean less money pumped into the economy. The current plan to cut $50 billion from the 1986 budget would mean $100-150 billion in lost output for America's businesses. Together with continued high trade deficits, it could spell slow demand, higher unemployment and low growth. Unless interest rates are quickly reduced in the wake of spending cuts, a recession will be all but inevitable.

## SECTION II
## NON-DEFICIT SOURCES OF HIGH INTEREST RATES

There are at least three major forces, besides the deficit, that are working to keep real interest rates high:

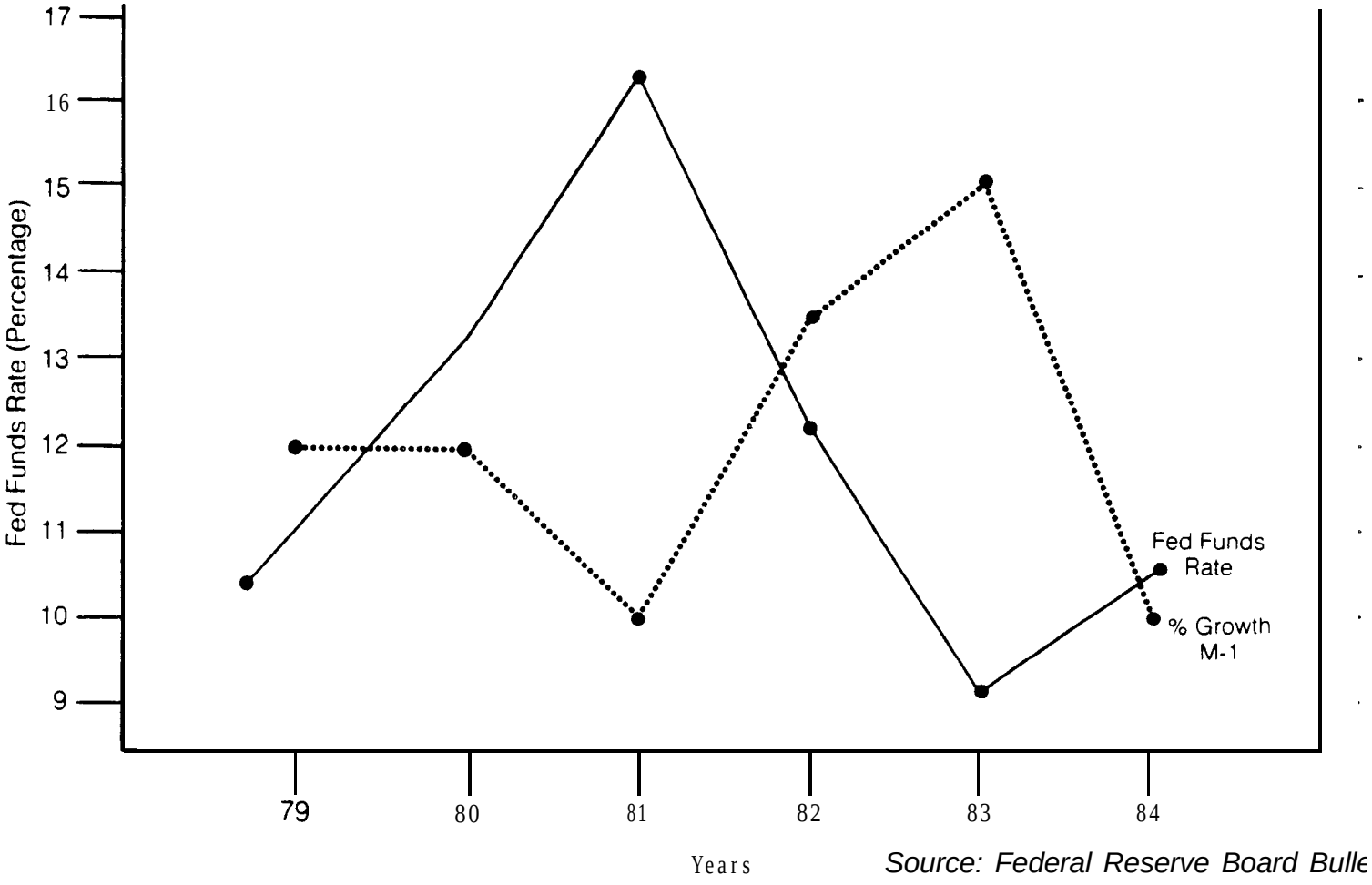
1. Federal Reserve Monetary Policy

Recent history has shown clearly the power of monetary policy to offset the effects of fiscal deficits on interest rates. For example, while deficits were low in 1979, 1980 and 1981, the Federal Reserve tightened the money supply, driving rates up. Then in the summer of 1982, as the deficits were climbing toward record levels, the Federal Reserve bowed to the combined threat of a still deepening recession at home, the stirrings of a debt crisis in the third world and a hint of legislation brewing in Congress to curb the Board's independence. The Fed loosened its grip on monetary policy. As a result, while the deficit rose during the recession in 1982, the recovery of 1983 and the expansion of 1984, interest rates fell substantially. Since that time, the Fed has made no dramatic shifts in monetary policy, although it has consistently maintained its stance of "non-accommodation" toward the current deficits (i.e., it will not attempt to expand the money supply enough to reduce rates significantly while the deficits stay in the $200 billion range.)

The record of monetary policy shifts and interest rate changes over the last several years is displayed in Chart 2. The evidence is clear that a tight money policy will keep rates high even with rapidly declining deficits.

Chart 2

Money Supply (M-l) Growth And Fed Funds Rate-




*Source: Federal Reserve Board Bulle*

2. Hot Money and Financial Market Deregulation

Hot money is a term for dollars that are particularly sensitive to small shifts in interest rates, moving restlessly from the stock marke‘t to money funds, to banks and into futures contracts -- sometimes in the same day. While there has always been some hot money in the markets, inflation in the 1970s turned many middle class savers into "sophisticated investors" who abandoned their five and one-half percent savings accounts for the money market

funds that offered almost double that rate.

Deregulation of the banking system accommodated the hot money market by freeing banks and savings institutions from restrictions on what they could pay depositors. Bank and thrift money market deposit funds shot up from nothing in December 1982 to more than $450 billion by March of 1985, while non-bank money market funds now stand at over $200 billion, up from barely a tenth of that in the mid-1970s.

The expansion of hot money markets created intense competition among financial institutions. As banks, savings and loans, insurance companies, stock companies and money funds all try to outbid each other for those hot dollars they have only one weapon: high interest rates. As a result, the cost of funds to American banks nearly doubled in two short years. And when these institutions pay high rates to get money, they must charge high rates to lend it out again.

The new world of deregulation and hot money has also helped create a "go-go" atmosphere of mergers, exotic new investments and risky loans that are dramatically raising the overhead costs of our banks and thrifts. For example, most institutions expect that the days of full interstate banking are almost upon us and many are doing all that they can to position themselves for that time. Small banks and thrifts are manipulating their loan portfolios, opening new branches and otherwise doing everything possible to make themselves attractive takeover targets for the Citicorps and Bank of Americas who will be looking to buy as soon as they can. Middle-sized regional banks are already buying small institutions, trying to become large enough to compete with the big New York, Chicago and California banks. Meanwhile the latter are crossing state lines to set up non-bank banks, loan production offices and similar institutions to establish an interstate presence.

Deregulation has led many banks and thrifts to spend substantial amounts of money on expansion and investment options that are beyond the expertise and experience of most of their officers. The entire industry has had its costs increased dramatically in the last five years. Even with more competition in the marketplace, interest rates are higher because it costs everyone more to acquire, hold and invest funds. The continued uncertainty over further deregulation and the jockeying for market position it has inspired have raised the overall cost of doing business for large and medium-sized banks who set the interest rates for the industry.

Deregulation has also brought with it substantially greater risk for financial institutions of all sizes -- from major money center banks with large outstanding loans to third world countries, to small government securities dealers frantically trying to paper over a chronic shortage of cash. And with greater risk comes more hedging, and that means higher loan rates and bank fees. In fact, publications that cater to financial institutions now give explicit

tips on ways to increase servicing fees that provide a higher effective interest rate than the one listed in the "truth-in-lending" disclosure forms.

Of course, these higher interest rates and fees are not spread evenly around the market place. Small businesses historically have paid higher interest rates than large companies, but in absolute terms, the differential between large and small business loans has grown since 1981. (See Table 2)

The rates for most large (business) loans are linked to money market rates. Those rates are set in competition with markets throughout the United States and Europe. On the other hand, most small business loans, consumer loans and so forth are still tied to the administratively set prime rate, which is consistently above the market rates paid by large business borrowers. As Professor Frederick Thayer told the House Banking Committee last year, "smaller depositors and borrowers seem inevitably to pay the price, of the two-way bidding wars for large depositors and borrowers." [4]

TABLE 2
COMPARISON OF RATES ON SMALL VERSUS LARGE BUSINESS LOANS*

| YEAR | RATE ON SMALL LOAN | RATE ON LARGE LOAN | DIFFERENCE IN BASIS POINTS+ |
|---|---|---|---|
| 1977 | 8.86 % | 7.15 % | 171 |
| 1978 | 10.27 | 9.43 | 84 |
| 1979 | 13.11 | 13.12 | -1 |
| 1980 | 15.84 | 14.81 | 103 |
| 1981 | 19.95 | 19.44 | 51 |
| 1982 | 18.39 | 15.78 | 261 |
| 1983 | 14.27 | 11.81 | 246 |
| 1984** | 14.52 | 11.88 | 264 |

* Source: Federal Reserve Board, Terms of Lending Survey. Small loans are commercial and industrial loans under $50,000; large loans are those over $1,000,000.

\+ A basis point is a standard financial term used in reference to interest rates. One hundred basis points equals one percentage point.

** For the first half of 1984; data not yet available for the second half of the year.

3. Credit Demand For Large Scale Mergers

Since the election of Ronald Reagan, the atmosphere for large scale mergers has been extremely positive, and the money spent by corporations to buy each other has increased substantially. In 1980, according to W.T. Grimm and Co., $44.3 billion was spent to finance mergers, while in 1984 $122.2 billion was consumed through corporate takeovers. (See Table 3)

TABLE 3
DOLLAR VALUE OF MERGERS, 1979-1984

| YEAR | DOLLAR VALUE (billions) | # OF MERGERS |
|---|---|---|
| 1975 | | |
| 1976 | | |
| 1977 | | |
| 1978 | | |
| 1979 | | |
| 1980 | | |
| 1981 | | |
| 1982 | | |
| 1983 | | |
| 1984 | | |

Source: W.T. Grimm and Co.

The change in merger behavior has not come only in number, but in size. With many takeover bids now in the multi-billion dollar range it is increasingly obvious that they cannot be consummated from internally available cash and retained earnings. Instead they are arranged through massive lines of credit with financial institutions, and --increasingly-- by "junk bonds" (unrated securities sold with increasing frequency to savings and loans looking for high returns.) The effect of lines of credit and junk bonds is to tie up money that might otherwise be used for productive investments, and to raise the general level of interest rates.

A recent article in the Federal Reserve Board's Bulletin noted that the Board's Senior Loan Officer Survey "suggests that almost 20% of the dollar volume of new lending in the first quarter of 1984 was to finance mergers and acquisitions."

Proponents of these mega-mergers argue that the effect on credit

markets is short-lived, because the borrowed money is used to pay off investors who quickly turn those payments into new investments. There are two problems with that argument.

First, even if the effect of each merger is only short-lived, the increase in the number and size of mergers keeps the financial markets in constant turmoil. As soon as one merger is complete there are several more waiting in the wings.

Second, well before the investors are paid off, while the companies are battling for control, billions of dollars in credit lines are being tied up by "commitments" from banks to supply the necessary cash whenever the lender demands it.

According to recent banking studies the effect of "commitments" on interest rates goes well beyond simply tying up credit -- the wave of commitments imposes substantial risks on banks which they seek to hedge by increasing interest rates and other related fees.

Thomas F. Brady, of the Federal Reserve's Division of Research and Statistics says that commitments "entail several risks":

- "First, they oblige the bank to stand ready over an extended period to provide credit at fixed markups above market rates, when its own future costs of funds are uncertain."

- "Second, by increasing the likely rate of future loan growth, commitments may require a bank" to increase its non-deposit capital, or to reduce its outstanding loans under unattractive circumstances.

- Third, depending on the comprehensiveness of the contract between lender and borrower, these kinds of commitments could endanger the safety and soundness of banks who are forced to provide loans for greatly weakened corporate customers. [5]

The increased risk for banks is, naturally, passed on to borrowers through higher interest rates and fees. Thus, mega-mergers not only raise rates by tying up available credit, they also raise the risk structure of our financial system.

## SECTION III
## POLICY DIRECTIOYS

To reduce upward pressure on rates, Congress should consider the following actions:

1. Congress and the Administration must insist on an explicit agreement with the Federal Reserve Board to match

significant deficit reductions with a looser monetary policy. If the Fed continues to fight the last war against inflation in the face of dramatic budget cuts, interest rates will stay up.

Congress should move toward making the Federal Reserve more responsible to business, investor and public concerns. One first step would be to begin immediate disclosure of its policy decisions, abandoning the Fed's present practice of waiting weeks before telling the rest of the world what its policy is. This only heightens the uncertainty and confusion surrounding monetary policy. Another immediate step would be to end the Fed's power to finance its own operating budget independent of the Congressional appropriations process.

2. Financial deregulation must be brought under control. This can be done without rebuilding the entire regulatory structure developed since the 1930s.

More than anything else, Congress needs to provide financial institutions with a stable set of ground rules that will stay in place during the foreseeable future. The current ad hoc deregulation and re-regulation creates too much nervousness and speculation among banks and investors, and creates an atmosphere which nurtures increasingly exotic and dangerous investments.

It does little good for this country to go through the pain of wringing out the uncertainty caused by inflation only to replace it with a more virulent uncertainty caused by stop-and-go deregulation and widespread laissez-faire attitudes on the part of bank regulators.

Congress should prohibit new quasi-bank institutions like the "non-bank banks" that slip through normal regulations via loopholes. It should reaffirm the separation of normal business from the business of banking, and strengthen the supervisory powers of agencies like the Federal Reserve Board and the Comptroller of the Currency. Finally, Congress should make up its mind one way or the other about the basic question of interstate banking. The industry needs to get back to a stabilized environment that can take advantage of the current low inflation era. That can only be done when Congress steps in and stops the helter-skelter deregulation now in progress.

3. The allocation of substantial amounts of scarce capital to mega-mergers, unfriendly takeovers and similar activities must be restrained.

At a time when U.S. business should be emphasizing lengthening investment horizons, the mega-merger boom is making corporations even more obsessed with short term fluctuations in stock prices and dividends. The inefficiency of many corporate managers is a problem, but it is not solved by the hit-and-run activities of Wall Street raiders.

Although we cannot prevent takeover bidding that does not violate anti-trust laws, it makes little sense for the nation's banking system -- which is supported, insured and increasingly subsidized by the taxpayers -- to accommodate it.

To change the current incentive for mergers, Congress needs to make specific changes in both the tax and credit policies of the federal government. By introducing market-related disincentives in both areas, the government could discourage the shifting of funds that might frustrate less comprehensive approaches. For example:

- A prohibition against any federally chartered or insured institution investing in the new, risky instruments known as "junk bonds". These bonds are generally defined as those below investment grade and are frequently used by corporate raiders to finance hostile takeovers. Junk bonds not only encourage speculative investments by already weakened thrifts and banks, but they leave targeted corporations severely weakened by high levels of debt. This prohibition would also prevent banks from buying bonds which although unrated may be of high quality. This is a small price to pay for the elimination of high risk junk bonds from bank portfolios.

- On the tax side, a new, higher rate for mergers over threshold levels that do not promote economic efficiency. While exempting small businesses from this requirement, the Treasury Department could draw on the history of anti-trust legislation and on firm-level economic studies to create an index of efficiency much like that now used to measure the effect of mergers on competitiveness for anti-trust purposes. While no index will catch all inefficient mergers, the mere presence of such a screening device should have a chilling effect on frivolous raids and takeover attempts. If raiders can demonstrate that their divestiture plans have increased firm-level efficiency, they would not be subject to the higher tax rate, since there would be a net gain in efficiency for the economy as a whole. If raiders cannot make that demonstration, it is reasonable public policy to discourage the use of retained earnings or new equity offerings to finance such takeovers.

- An asset-based reserve requirement, which would alter the amount of money banks have to keep in non-interest bearing accounts depending upon the proportion of loans a bank has granted to corporations for hostile takeovers. By forcing banks to "sterilize" more money this plan would increase the disincentives of making such loans.

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There should be no illusion that interest rates will fall substantially simply because of a modest decline in budget deficits. There is no historical evidence for that assumption, and the recent structural changes in the banking system make the prospect even more unlikely.

In order to assure that interest rates fall enough to stimulate compensatory economic activity, Congress and the Administration must take additional positive action. If they do not, the effort to assume continued economic growth by cutting the deficit may be in vain.

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This Briefing Paper was prepared for the Economic Policy Institute by Richard Medley. An economic writer and commentator, Richard Medley was formerly chief economist for the House Banking Committee and for the Senate Democratic Policy Committee.

ENDNOTES

1. Martin Feldstein and Otto Eckstein, "The Fundamental Determinants of Interest Rates," Review of Economics and Statistics, October 1970.

2. The Congressional Budget Office, The Economic Budget Outlook: Fiscal Years 1986-1990, (February 1985, Washington, DC) p.83.

3. John A. Tatom, "A Perspective on the Federal Deficit Problem", The Federal Reserve Bank of St. Louis Review, June/July 1984, pp.5-16.

4, Additional support for this conclusion comes from Thomas F. Brady, "Changes in Loan Pricing and Business Lending at Commercial, Banks," Federal Reserve Bulletin, January 1985, pp. 1-13.

5. Ibid, p.2.