

Monetary Restraint, Interest Rates, and Inflation*

The recent run-up of short-term interest rates has revived old controversies on the role of interest rates in controlling inflation. Two questions, in particular, are being debated with growing frequency: one, do increases in interest rates help reduce inflation, or do they only make inflation worse; and, two, can the Federal Reserve achieve a tighter monetary policy and fight inflation without such high interest rates by a more direct means of limiting bank credit expansion, such as increasing reserve requirements.

To many people the pro-inflationary effect of higher interest rates seems much more obvious than the anti-inflationary effect. For any business firm that must refinance its indebtedness, or raise new debt capital, an increase in interest rates inevitably means that its cost of doing business goes up. And rising business costs lead to rising prices. The same is true for governments—higher interest rates mean higher government outlays—and that of itself can be inflationary. And for individuals who borrow money, higher interest rates raise the cost of living directly.

As against all this, it must be remembered that interest rates are not just another cost of doing business, they are the price of money and credit. That means that higher interest rates are the inevitable price to be paid in the first instance when the growth of money and credit is reduced from excessive, inflationary rates. Excessive money growth in the vernacular is too much money chasing too few goods. Once

monetary restraint succeeds in reducing inflation, interest rates can come down again.

The general cost-raising, the inflationary, effect of higher interest rates is relatively small. For nonfinancial corporations as a whole, interest payments come to about 3 percent of total costs. Thus, for example, if interest rates were raised by one fifth, let's say from 10 to 12 percent on average, and all debt had to be refinanced at the higher rate, *total* business costs would go up by 0.6 percent. Of course, in real life not all borrowing would be refinanced at the higher rate right away, so that the price-raising effect would be substantially smaller (the volume of long-term corporate debt is much larger than short-term debt). Estimates for the period since 1975 show that business costs have been raised by less than 1 percent, cumulative, over this period as a result of higher interest rates. Over the same period the cost of living has gone up by 38 percent.

In contrast, in evaluating the anti-inflationary effect of a jump in interest rates, it is the higher cost of *new* projects that becomes relevant. The increase in the cost of financing new projects reduces their profitability, and this tends to tip the balance in favor of postponing them. If that happens, total demands in the economy are reduced.

More broadly, the case that increases in interest rates are anti-inflationary rests on the proposition that whatever the immediate source of inflation—budget deficits, wage increases larger than increases in productivity, excessively high expectations by people in general, a jump in oil prices—inflation is a monetary

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phenomenon. One does not have to be a monetarist to believe that. Our financial history and that of other countries shows that there is an inevitable relationship between money and inflation. Too much money either starts inflations or continues them.

When the central bank begins restricting the growth of money by supplying less money than the public wants at existing interest rates, then interest rates go up over the near term. This happens whichever way the central bank controls the money supply. The Federal Reserve's instruments for controlling the money supply are open market operations and changes in reserve requirements. Both affect the money supply by changing the volume of reserves available to commercial banks to expand bank credit. Open market operations do this directly—net sales of Government securities reduce the volume of bank reserves. Increases in reserve requirements do this indirectly—by requiring the banks to hold a larger volume of reserves for a given amount of deposits. In either case, as the banking system has less reserves available to support the expansion of loans and deposits demanded by the economy at current interest rates, interest rates increase.

Even complete direct controls over the volume and terms of all financial transactions—the freezing of interest rates and allocations of credit by the authorities—would not do the trick of holding down interest rates: black markets would spring up for borrowers willing to pay higher interest rates to get the funds they could not obtain at the official rates.

One way a central bank in an inflationary situation could try to prevent interest rates from rising would be to provide more and more reserves to the banking system to satisfy the demand for money and credit at unchanging interest rates. The money supply would explode and inflation would get worse. With inflation accelerating, the attempt by the central bank to hold interest rates down would not succeed for very long. As inflation gets worse, interest rates inevitably go up.

As inflation rates increase, borrowers are willing to pay more for obtaining credit. If you expect inflation to be 10 percent over the next few years, borrowing at 10 percent seems costless. At the same

time, lenders increase the minimum rates at which they are willing to lend. And, as borrowers and lenders expect inflation to get worse, interest rates quite naturally escalate. A climate of high inflationary expectations affects not only the financial markets but markets for goods and services too. Sellers increase their prices and buyers try to increase their purchases and are willing to pay higher prices.

Since expectations play such an important role in keeping inflation going and making it worse, breaking inflationary expectations is an essential part in the fight against inflation. The Federal Reserve obviously cannot beat inflation through its efforts alone, nor can it break inflationary expectations by itself. But Federal Reserve actions can influence, and have influenced, inflationary expectations in a major way. In periods when the Federal Reserve was perceived as being too weak in its resolve against inflation, inflationary expectations have accelerated. When Federal Reserve actions paralleled its anti-inflationary pronouncements, inflationary expectations have moderated.

In conclusion and to summarize, temporary increases in interest rates—at least short-term rates—are an inevitable consequence of restricting the growth of money and credit, whichever instruments of monetary restraint the Federal Reserve uses. The short-term rises in interest rates do have some cost effects leading to higher prices, but they are relatively small. And, in the longer run, attempts to avoid short-run increases in interest rates by pumping out excessive supplies of money and credit succeed only in accelerating inflation—and in the process raising all interest rates. Monetary restraint works through the slowdown in money and bank credit growth as the Federal Reserve reduces the availability of bank reserves. It also works through the direct effect of higher rates on borrowers' willingness and ability to borrow and on lenders' willingness and ability to lend. And, finally, it works through the general dampening and eventually breaking of inflationary expectations.†

† For an outline of the Federal Reserve System's October 6 measures to help curb inflation, see article on current financial developments on page 43.