JOINT ECONOMIC COMMITTEE

ROBERT F. BENNETT, CHAIRMAN JUNE 29, 2004

INTEREST RATES AND THE ECONOMY

Long-term interest rates are at their lowest levels in over a generation and are likely to edge up in the near future. Many analysts are also concerned about the potential impact of inflation on interest rates. In recent Congressional testimony, Federal Reserve Chairman Alan Greenspan stated that "inflationary pressures are not likely to be a serious concern in the period ahead."[1] With inflation expected to remain at relatively low levels, an increase in interest rates can be viewed as a positive reflection of the economic outlook.

What is an interest rate?

An interest rate is the cost of borrowing, or the price for the use of someone else's money. It is the compensation required by lenders to offset both the risks associated with lending money and the foregone opportunities to invest in other assets.

> "Because long-term inflation expectations remain well-contained, an increase in interest rates can be viewed as a positive reflection of the economic outlook."

There are many different types of interest rates

Interest rates vary by the span of time over which borrowing and lending take place. Rates are often somewhat loosely divided into categories such as short-term, medium-term, and long-term rates. Federal government securities on which interest is paid include Treasury bills, notes, and bonds. Treasury securities are important because they reflect the cost of borrowing by the federal government, and have less risk than any other securities available in financial markets. An important, very short-term interest rate is the *federal funds rate*. This interest rate is closely controlled by the Federal Reserve.

The Federal Reserve can influence short-term interest rates…

The *Federal Reserve* influences short-term interest rates via the *federal funds rate*, which is the rate charged by banks that lend money to other banks. The Federal Reserve controls this rate by buying and selling U.S. Treasury securities in the open market. When it wants to increase the federal funds rate, the Federal Reserve will sell short-term Treasury securities in the open market, thereby decreasing the money supply and increasing the cost of money in the market. The Federal Reserve buys securities in the market when it wants to decrease the federal funds rate.

By increasing the federal funds rate, the Federal Reserve increases the cost of borrowing. Individuals and businesses are less likely to borrow funds when the cost of borrowing increases, and are more likely to do so when the cost decreases.

…while broad macroeconomic forces influence long-term interest rates

Long-term rates are determined by supply and demand -- factors over which the Federal Reserve has little direct influence. As the demand for funds increases, the price of borrowing can be expected to

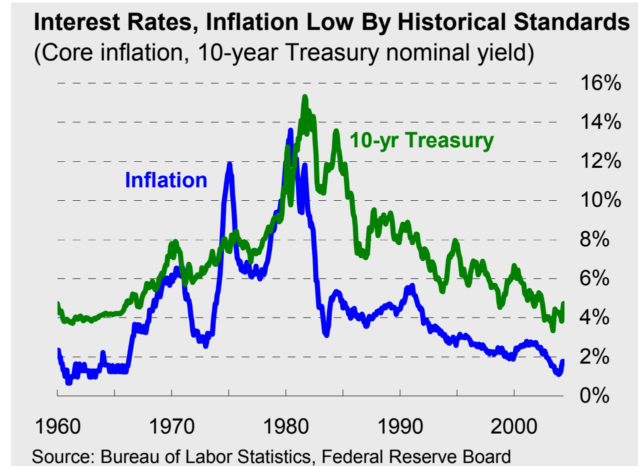
[1] Testimony before the Senate Banking Committee, June 15, 2004

increase as well. During periods of increasing economic activity, interest rates often rise due to the increased demand for borrowing.

Risk premiums are also factors that can influence long-term interest rates. Because lenders face certain risks when lending money, they must be compensated for assuming these risks. Riskier debt, hence, will have a higher cost of borrowing.

How does inflation affect interest rates?

Inflation and expectations of inflation are prime determinants of long-term interest rates. As the figure shows, high long-term nominal interest rates often coincide with high inflation as investors demand compensation for the expected erosion in the purchasing power of their returns. However, inflation is not the only story. Strong economic growth, too, puts upward pressure on long-term interest rates, reflecting robust demand for funds.



Interest rates are often referred to as either being *real* or *nominal*. A *nominal interest rate* is not inflation-adjusted, while a *real interest rate* is equal to the nominal interest rate less *expected inflation*. Real interest rates identify the actual purchasing power of the nominal return on a dollar of investment. Investors are generally more concerned about what they will be able to purchase with their dollars in the future rather than the number of dollars they receive.

Can federal debt influence long-term interest rates?

Long-term interest rates are determined in a global market for debt. Trillions of dollars are traded in these markets each month. The increased size and flexibility of both the U.S. economy and international capital markets has reduced the impact on interest rates of changes in U.S. government debt.

According to the Congressional Research Service, "Simply comparing changes in budget deficits to changes in interest rates is not a valid way to determine whether budget deficits affect interest rates because there are many other factors that simultaneously affect interest rates."[2]

Interest rates can be expected to rise over the next year as a byproduct of a growing economy

As the economy continues to expand and employment continues to increase, the demand for funds in financial markets will also grow. Given that forecasters see continued strong growth throughout 2004, long-term rates would be expected to increase even in the absence of federal deficits. Because long-term inflation expectations remain well-contained and long-term interest rates are near historic lows, an increase in interest rates can be viewed as a positive reflection of the economic outlook.

[2] Congressional Research Service, "Do Budget Deficits Push Up Interest Rates and Is This the Relevant Question?", May 13, 2003