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Why Interest Rates Will Fall in 1982

By John Rutledge

It is now said that the federal deficit for fiscal 1982 will be roughly $100 billion. This has sparked a furious debate between Wall Streeters, who say such large government borrowing *must* push interest rates higher, and supply-siders, who believe tax cut-induced increases in household savings will more than offset rising government borrowing needs, and hence *must* push interest rates lower.

This fight represents a lot of wasted ink. It reminds me of the scene from the movie in which Frankie Avalon and Annette Funicello are frantically trying to brush those pesky ants from their picnic blanket, while a creature emerges from the surf in the background. Remember how we screamed ourselves hoarse trying to warn them? "Look out, Frankie!" "Turn around, Annette!" They just wouldn't listen.

In my view, the obsession of both Wall Streeters and supply-siders with analyzing credit *flows* has led both to forget who the real star is in the interest-rate story.

Major changes in U.S. interest rates are usually caused by changes in how the public wants to hold its net worth. The point of this article is that the drop in inflation in the last 18 months is forcing households to restructure their wealth in a way that will force reductions in interest rates in 1982.

Flow-of-Funds Focus on Savings

Both sides of the debate use a flow-of-funds framework to forecast interest rates. This framework views financial markets as a kind of farmers' market, where households bring their savings (credit supplies) and government and corporations bring their borrowing needs (credit demands). Interest rates are the price that equates credit demands and credit supplies. This is the source of the current fixation on deficits and savings.

Wall Streeters fear that mega-deficits will piggyback the growing calendar of corporate debt issues to explode credit demands. Savings won't be able to increase fast enough to meet these needs. After a brief dip, due to the recession, short-term rates will climb to new highs by late 1982. Long-term rates won't budge from current levels because institutional portfolio managers translate large budget deficits into fear over rising future inflation.

Supply-siders believe the tax cut will increase the after-tax real rate of return on investment income, inducing households to increase savings. These increased savings, they argue, will provide more than enough credit to satisfy government and corporate appetites for funds, letting interest rates fall during 1982. And savings will continue to grow, so exploding interest rates shouldn't be a big problem through the '84 elections.

The debate, then, has largely degenerated into a doctrinal dispute over the degree to which private savings will be stimulated by Mr. Reagan's tax cuts. To both groups, the key question is by how much and how quickly personal savings will respond to changes in the after-tax real rate of return.

Forced to choose between the Wall Street and supply-side views, I would go with the supply-siders. There is ample evidence that households do respond to changes in relative prices—witness the phenomenal growth of the money-market funds (from $11 billion in 1978 to $150 billion in 1981). Moreover the evidence, though not conclusive, bears some resemblance to the supply-side view. Since Mr. Reagan took office, real after-tax rates of return *have* stepped up households' savings (i.e., they have stopped spending money). Since mid-August, interest rates have fallen sharply.

In adopting the flow-of-funds framework of interest-rate forecasting, both sides neglect the fact that, in addition to owning stocks, bonds, bank accounts, money-market certificates and other *financial assets*, households also own condominiums, land, used cars, gold and countless other *tangible assets*. This stock of existing goods, or tangible assets, has been produced and stockpiled over many years, and in a real sense represents the nation's collected real wealth.

The stock of tangible assets in the U.S. is enormous. At today's prices, the total stock of houses, cars, collectibles and other tangibles is worth about $7 trillion. That's more than twice the total value of the goods and services the U.S. economy will produce this year.

I believe that failing to recognize the existence of the *stocks* of tangible assets renders *flow*-of-funds analysis almost worthless for forecasting interest rates.

To private investors, tangible assets are substitutes, or alternatives, to financial assets. They ask: Should I buy a condominium or should I put my money into a T-bill account? Should I sell some of my shares of stocks to buy gold coins?

To consumers, tangible assets are substitutes for buying currently produced goods and services. Should I buy a new car, or is my current car good enough for one more year? Since the amounts in question are so huge—$7 trillion—even a moderate shift in the way households want to hold assets can have a huge effect on both credit markets and durable goods sales.

The key to understanding the influence of tangible assets on interest rates is the concept of "asset market equilibrium." An individual is free to hold his wealth in any combination of assets he chooses. One person with a net worth of $40,000, for example, may choose to hold $20,000 in gold coins and $20,000 in currency. Another person, with the same net worth, may choose to hold a $100,000 house, financed with an $80,000 mortgage loan, $12,000 in furniture, automobile and personal effects, and an $8,000 savings account.

The evidence suggests that each percentage point drop in the inflation rate should send about $100 billion of the tangible assets people hold back into the financial markets as increased credit supplies.

Asset market equilibrium describes the state in which each and every asset holder in the economy has gone through his own process of portfolio selection, and now is holding the combination of assets which, at current market prices, he finds most desirable.

What happens if people desire more condominiums than exist? Individuals bidding for that scarce supply would force the price higher, and the attempted sales of bonds or other securities to fund the condo purchases would tend to force security prices down. These price changes tend to lower the yield on condos as an investment and raise the yield on bonds, causing people to reconsider their initial choices. Ultimately, both condo and security prices settle at levels which, again, make people content to hold the existing stock of assets.

This is not a new idea. James Tobin just received the Nobel Prize in economics for developing the notion of portfolio balance. Mr. Tobin's idea was that the prices (interest rates) of financial assets will go to

whatever level will make investors just content to hold the available stock of those assets. All we've done is add tangible assets—land and so forth—to the portfolio management problem faced by every household.

This addition radically changes the nature of financial analysis and interest-rate forecasting. It breaks the link between savings and credit supplies that plays such an important role in the flow-of-funds framework.

A household that owns at least some tangible assets can supply credit in two distinct ways: 1) by increasing savings—i.e., buying securities—out of its current income, or 2) by selling some portion of its tangible asset holdings to buy bonds, stocks or T-bills. The results are the same —increased credit supplies and lower interest rates.

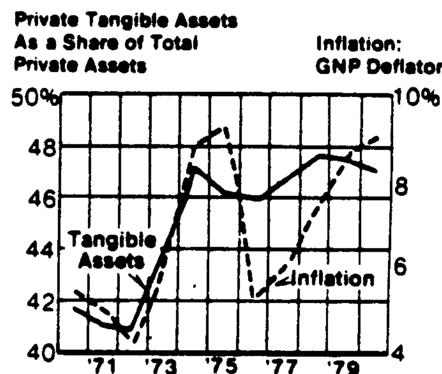
Thus, a general increase in the public's desire to hold financial assets—a desire to exchange tangible assets for financial assets—should be seen as an increase in credit supplies. Since the public's holdings of both tangible assets ($7 trillion) and financial assets ($7.3 trillion) are extremely large, a relatively minor change in their desired stocks of assets can overwhelm savings and budget deficits in its effect on interest rates.

In short, we should treat households as managers of portfolios of real and financial assets. Their decisions about which assets to hold and in what proportions to hold them will be based on the same criteria as the decisions of the professional money managers; namely, expected yield comparisons. The choice between tangible and financial assets forces households to compare the expected yields on financial assets — roughly, interest rates — with the expected yield on owning tangible assets. Often, the yield on tangible assets will include both a stream of services—e.g., you get to live in your house—as well as any potential for increased resale value of the asset—because housing prices go up—during the time it's held. At this stage inflation enters the picture for determining interest rates.

A sharp increase in inflation, for example, means an increase in the yield on real assets relative to paper assets. Like any portfolio manager, the people who run households are attracted to the high return on real assets and try to increase their holdings of houses and durable goods, using money obtained by selling securities. The result: upward pressure on prices for houses and durable goods, and downward pressure on prices for bonds and other securities, i.e., rising interest rates.

The following graph shows how people changed their holdings of tangible assets as the inflation rate varied during the 1970s.

At the end of 1972, for example, the inflation rate was below 5%, and about 41% of private-sector assets were tangible assets; this implies that financial assets made up about 59% of the assets of households and business firms.



Source: Federal Reserve Flow of Funds Accounts

Within two years, the inflation rate rose to nearly 10%. This increased the yield on tangible assets relative to financial assets, so people tried to cash in their stocks, bonds and bank accounts for money they used to buy houses, gold and antiques. The result: a 6% shift of private assets out of the financial markets and into tangible assets. That 6%, roughly a $400 billion shift, caused a major drying-up of credit supplies. Is it any wonder interest rates soared in 1974? Rising interest rates and rising prices for gold and real estate are not simply related events; they reflect the same shift in households' decisions about the safest way to hold onto their accumulated wealth. And the thing that sets off these decisions is inflation.

Turn the above argument on its head and you'll have the right analysis for 1982. In the last 18 months, U.S. inflation has slowed dramatically, undermining tangible asset yields. Residential real-estate prices across the country are falling. At the same time, T-bill rates and other yields on financial assets have been at historic peaks. This has opened a gap between paper and real asset yields that, to some of the more aggressive inflation hedgers, looks like the Grand Canyon. As some households make the inevitable shift away from tangibles and back into higher-yielding paper, credit supplies will grow, and interest rates *must* fall.

We expect '82 inflation to fall to 6%. This means a continued lackluster performance for real asset yields. I'm not saying that everyone who is reading this will rush out and sell his house or buy a bond, or that everyone in the U.S. will begin to think like a currency arbitrageur. But the available evidence suggests that each percentage point drop in the inflation rate should send about $100 billion of the tangible assets that people hold back into the financial markets as increased credit supplies.

Since the inflation rate for '82 (6%) should be about four percentage points lower than the '81 figure, this suggests we'll see an increase in credit supplies of $400 billion to $500 billion for 1982, without counting on a nickel of increased savings. If the administration's tax cut stimulates private savings by a significant amount, the case for lower interest rates is stronger still. To my knowledge, no one has yet announced that the deficit will hit one-half trillion dollars for 1982. If it does not, interest rates *must* fall.

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REVIEW & OUTLOOK

Forces of Reaction

Some years ago we formulated our basic position on econometrics: that we would start to take the models seriously when computers started to beat chess champions. And since the electronic wizards still haven't solved a simple pastime like chess, we see no reason to defer to them on anything so complicated as an economy.

In fact, we blanch at the notion of anyone doing anything serious merely on the basis of numbers thrown out of a computer. For that matter, having spent the last few years watching economists predicting a recession that never arrived, followed by the onset of a recession almost no one predicted, we are not going to take economic predictions about the day after tomorrow as more than food for reflection. Yet on the basis of what someone's computer says about the federal deficit in 1984, or 1987, the President of the United States is now being urgently pressed to frame his next budget around the proposition that high taxes are good for you.

As we glance over the OMB predictions leaked to the press in behalf of this campaign, we find that the deficit is not even the most striking number. The bogeyman deficit of $162 billion in 1984 turns out to be some 4.3% of what the OMB guesses the GNP will be then. This figure, if true, is not exactly comforting. But on the other hand it is well within the range of our historical experience. The postwar high was 7% in 1975.

We are struck, rather, by the figure for outlays. Here the 1984 OMB number amounts to 22.7% of GNP. This is only a grudging reduction from the 23.1% estimated for the just-closed fiscal year, which was run under a Carter administration budget. It compares with an average of 21.2% in the 1970s and 19.5% in the 1960s. It is a far cry from the 19.3% the Reagan administration originally posted as its 1984 goal.

The much-touted predictions, then, are merely one more confirmation of the basic economic philosophy of the Jim Joneses and Pete Domenicis and now David Stockmans: that because we cannot perform our assigned task of bringing the budget under control, taxes must increase. "An adequate revenue base" thus means an ever-expanding slice of the national wealth, a game that cannot continue forever, and a game Ronald Reagan was elected to stop.

What is happening now is a rallying of the forces of reaction in Washington to prevent Mr. Reagan from fulfilling his mandate for change. In this regard, notice the telling but widespread formulation: Because of the deficit, Mr. Reagan will have either to increase taxes or reduce his defense spending plans. Conspicuously absent is any suggestion that he might need to apply some discipline to the one area of expenditure truly out of control and so far nearly exempt from the budget-trimming action—the entitlements systems in general and Social Security in particular (see below).

Naturally, the Washington reactionaries do not want to disturb vote-buying as usual, since the whole purpose of the exercise is to garner and devote more funds to that end. This same impetus gives rise to the most curious economic maxims—that deficits are not inflationary but deflationary; that the way to lick a recession is to increase taxes. Typically, these notions are bandied about by the same people who dismiss as "voodoo economics" the supply-side notion that you get more work and investment if you provide bigger rewards for work and investment.

The fear ostensibly is that deficits will force up interest rates and abort a recovery. But federal borrowing is only one determinant of interest rates. If off-budget federal credit demands can be contained, if the savings rate increases to finance borrowing, if confidence in anti-inflationary policy leads to the kind of asset reconfiguration described in John Rutledge's interesting article nearby, then interest rates need not soar. Investment would be less than it would have been if the deficit had been closed through expenditure reduction, but closing it through tax increases scarcely solves this problem.

What the President needs now is steadfastness. And much depends on his personal qualities, since his staff has become a means of the Washington establishment pressuring him rather than a means of his pressuring Washington to implement the policies for which he campaigned. If the new budget buys the tax-increase path, Congress will know the administration will bend if it refuses to cut spending, the contest will be lost and Washington will go happily back to business as usual. We will have lost the great hope of the Reagan presidency, the chance to at least try policies fundamentally different from those that have been progressively leaching the economy's vitality.