

COMMENT

# Ghost Town

By JOHN RUTLEDGE

**W**HY are real interest rates so high, and what will it take bringing them down? Real rates have never been this high for so long. Economists are frantically rummaging around in their meager tool kits looking for a way to make their old explanations fit this new phenomenon.

I see today's high real interest rates as the consequence of a structural change that households and businesses in the economy are going through to accommodate the sharp, and largely unanticipated, disinflation of the past two years. The tools of cyclical analysis — macroeconomics — are of little help in understanding and forecasting structural change.

One of my favorite old movies, "Guns Over Beaver Fork," is a perfect illustration of the kind of structural change now facing many investors in the United States. Beaver Fork had been chosen as the town where the railroads from the East and the West were to meet. With only 100 miles of track still to be laid, the folks in Beaver Fork were set to enjoy the bonanza that comes with being a railroad town. The air was filled with the sounds of building the additional stores, hotels, saloons and dance halls for a growing town.

The story then followed a familiar line. Erich von Stroheim, who played the town banker, was out to get control by buying up all the property, forcing widows to sell their farms, foreclosing mortgages, and doing all the other things for which bankers are known. Richard Widmark, the honest sheriff, meant to stop him.

But the ending was a surprise. There were no blazing gun battles. Instead, the final scene showed Widmark and von Stroheim sitting together in an abandoned saloon. The streets were empty. At the last minute, the railroads changed plans. They decided to meet, instead, in Twin Creeks, 80 miles to the south.

What this story highlights is the economic significance of expectations. For the past decade, people have been conditioned to high and rising inflation and climbing oil prices. This means that they have shifted their business practices, product lines,

financial strategies, and portfolios of tangible and financial assets toward those that would succeed in a high-inflation, expensive-energy world.

It has been a shock to many that, in the past year, inflation has collapsed, wages have slowed, commodity prices have sunk below ground level, and spot oil prices have fallen from more than \$40 a barrel to the low \$30's. As I travel the country talking with C.E.O.s and investment directors of large and small companies, and talking with groups of investors, I see the same look in everyone's eyes. Like the sheriff and the banker, they are all wondering where the railroad went.

The abrupt disinflation of the past two years has caused an important loss of real current wealth. People have come to realize, like the residents of Beaver Fork, that the investments, products and skills they have developed over the past decade are not the ones which they need for the future. The shock of this sudden wealth loss has led to a kind of paralysis of decision making in both businesses and households. It is these delayed decisions on how to restructure for the future, together with the effects of disinflation on internal cash flow, that are the principal sources of today's high real interest rates.

**S**TILL, it is not possible for interest rates to remain high indefinitely during a period of low inflation. Real interest rates measure the profit that people are losing by owning commodities and tangible assets, rather than interest-bearing securities. As inflation falls, people begin to take advantage of this spread — swapping real assets for securities — and interest rates must fall.

The problem today, however, is that the abruptness of the disinflation has produced a sort of logjam of people who are now unwilling or unable to adjust to low-inflation portfolios. The result is a long, drawn-out decline in interest rates rather than a quick one.

This logjam will be broken over the next year or two, as one by one, individuals are either convinced or forced to take steps to restructure their businesses and investments toward those appropriate to low inflation. While the dominant pressure in the markets will be for falling interest rates, the decline could be very gradual. In the meantime, the pressures for people to change will be enormous. ■

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