Did Lowering Interest Rates Actually Help the Economy?

by Professor Larry Allen

Access to credit at reasonable interest rates is something households and businesses count on to act on their own initiative. The bargain basement interest rates of today should straighten the road to full economic recovery, but an unhurried and prosaic economic rebound leaves observers wondering whether interest rates are a big enough rudder to steer the economic ship. A post-mortem on the recent recession lays bare how a string of interest rate hikes in 1999 and 2000 was the undoing of a dynamic and highflying economy. If a hard-nosed policy of lofty interest rates can so surely put a raring economy into screeching reverse, then an obvious corollary implies that a dose of interest rate cuts should abbreviate recession and stoke the furnace of recovery. This reasoning, however, is not impregnable and infallible. The proper analogy may be the difference between pulling on a rope and pushing on a rope, and low interest rates is pushing on a rope.

The current recovery is far enough along to show that low interest rates inoculated and resurrected the housing industry against a general contagion of economic doldrums. U.S. housing starts at a seasonally adjusted annual rate skidded 10.3% between December 1999 and December 2000. In 2001 the Federal Reserve somersaulted to a low interest rate policy. U.S housing starts rallied 2.3% between December 2000 and December 2001, 16.0% between December 2001 and December 2002, and 13.3% between December 2002 and December 2003. Each economic sector goes enmeshed in countless other sectors, and strength in one sector breeds and imparts strength in a matrix of interwoven sectors. The lapse into recession would have run wider, deeper and longer without the timely infusion of fresh strength from housing. The economy is always growing on the back of a few leading sectors. Interest rate cuts awakened newer advancing sectors to neutralize the effects of sectors losing steam.

Bargain interest rates can rescue the interest rate sensitive sectors unless decision-making in these sectors is usurped by the weight of gloomy expectations. Before households and businesses finance large projects, they scan the economic sky for hints of inclement weather. The full-stimulus of interest rate cuts only hits interest sensitive sectors after expectations are no longer pinned down by a narrow pessimism induced by recession. Expansion in interest rate sensitive sectors will radiate and ripple through the remainder of the economy, kindling broad economic expansion. The upshot is that interest rate cuts do not ignite a sudden and large burst of economic activity. The effects build and ferment slowly and may take nearly a year to visibly push the economy forward to a threshold of even toned growth. It is no surprise therefore if a parade of interest rate cuts issue in a slow dawn of economic recovery.

Low interest rates hold a large place in another sphere of economic strategy. Low U.S. interest rates invite foreign investors to sell dollar financial assets and sell the proceeds for another currency. Foreign investors selling dollars undercut the value of the dollar in foreign exchange markets. A dollar bereft of measurable value in foreign exchange markets does not stretch as far buying foreign goods. On the other hand, units of foreign currencies equate to more U.S. goods. The end result is that Hondas become costlier in the United States and Harley-Davidsons cheaper in Tokyo. A weaker dollar tips the balance in favor of U.S. goods over foreign goods. A U.S. dollar equated to 131.06 yen in March 2002. By March 2004, the dollar sank to 108.52 yen.

A weak dollar in foreign exchange markets unmasks the hazards of pegging interest rates at low levels. A weak dollar boosts the costs of imported raw materials, which can sap economic

growth, and arouse inflationary pressures. Hence it is no surprise that spiking gasoline prices walk hand in hand with a tumbling dollar.

If low interest rates fail to stir a slack economy, maybe policy makers should keep cutting interest rates until the desired effect is observed. This strategy raises a pretty question. Interest rates already stand at 40-year lows, and short-term interest rates cannot sink far lower. It is easy to show that low interest rates have enlivened some sectors. It is harder to say what comes next if short-term interest rates flirt with zero, and the economy still gasps and stumbles with sub-optimal growth. Japan has held its central bank discount rate at one-tenth of a percent since August 2001, and Japan's economy still churns in the marshes of pale growth and deflation.

If short-term interest rates skid to zero without setting off a convincing and lasting economic turn about, the government must reach for deficit spending as the only tonic for restoring healthy growth. Japan substantially widened it budget deficits over the decade of the 1990s.

For now the United States economy remains on a trajectory of economic recovery. The federal government unleashed a tax cut that snatched much of the glory for kicking-off economic recover, perhaps reflecting a tendency to give elected officials credit for curing economic woes. Even so, feverish and stampeding speculation in the stock market left some misgivings about the usefulness of low interest rates. The speculative frenzy underwrote the chanciest purchases of capital goods, bequeathing an economy overgrown with capital goods. A messy redundancy of capital goods undermines the resale values of used capital goods. Chastened and unnerved businesses balk at buying and financing capital goods that might have to be sold at a large loss should liquidation become necessary. Rather than financing new capital goods, businesses are apt to wait for bargains to bubble up in the market for used capital goods. In such an environment low interest rates invite little investment spending on new capital goods, and excite negligible forward momentum. In 2003, nonresidential fixed investment peaked in the third quarter at a mere 1.25% annualized growth, whereas real GDP annual growth peaked in the same quarter at a strident 8.2%, suggesting real GDP owed small growth to investment spending outside of housing.

Observers whose eyes go glued to the sagging labor market are likeliest to suspect rheumatic joints in the linkage between low interest rates and revitalized economic activity. It is always true that the unemployment rate is one of the last indicators to signal marked improvement. Like the interest rate, the U. S. unemployment rate has had a long-term downward drift despite its recent uptick. It is too soon to say that this drift is breaking out to an upward drift.

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