Rates Of Interest
By William L. Silber
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## By William L. Silber

Interest rates have been on a roller-coaster ride since January. Yields climbed by about five percentage points through the end of March and have plummeted by more than that since then. While the precise picture is somewhat different, depending upon which rate you keep track of, the gyrations during the last few months have been unprecedented. By explaining what has happened we can help avoid past policy errors. In fact, unless the Federal Reserve maintains its objectives, the turbulence we have thus far endured will have been for naught.

We can identify the rise in interest rates through March with a confrontation between accelerating inflationary psychology and the October 1979 decision by the Federal Reserve Board to maintain sustained control over bank reserves and the money supply. The decline in rates since then stems from the arrival of recession and a continued Federal Reserve attempt at controlling bank reserves and the money supply.

In each case, the swing in interest rates was triggered by economic activity, either inflation or recession, but the rate fluctuations were magnified by the new Federal Reserve doctrine.

The Fed's behavior under the direction of Paul A. Volcker, the chairman, has been admirable. By focusing on bank reserves and the money supply, the central bank has finally let natural economic forces push interest rates up and down. And it is precisely these swings in interest rates that will help moderate fluctuations in the economy: Sharply rising interest rates break the back of runaway inflation while plummeting costs of funds moderate the recessionary contractions. The financial world might be complicated by such interest-rate gyrations, but the benefits will accrue in the form of shallower and shorter recessions and less-extensive inflations.

Unfortunately, we could be on the brink of a serious error unless corrective measures are taken. The money supply has been on a steep down trend since the beginning of April. While some of this drop comes from technical factors and might be reversed, there is an unmistakable weakness in the money stock. This is not what the doctor ordered; nor is it even what the Fed would like to see. Bank reserves should be pumped up faster so that money supply will grow at an appropriately *moderate* pace, rather than declining. The consequence of faster money-supply growth might be a further collapse in short-term interest rates in the immediate future.

Moderate growth in the money supply and the sharper decline in interest rates will help cushion the recession that is already upon us. Lower borrowing costs mean that planned cutbacks in spending can be restored.

Will sharply declining interest rates signal an end to the anti-inflationary posture that we so desperately need to sustain? This will not be the case as long as the Federal Reserve sticks to its guns and keeps control over bank reserves and the money supply. The sooner than expected upturn in economic activity will push up interest rates earlier than in previous cycles. In the past, this is when the Federal Reserve caved in to political pressures to keep interest rates from increasing. In the process of holding down interest costs during the expansion in economic activity, the Fed let bank reserves and money supply grow too quickly. And it is precisely at such junctures that the long-run inflation battle is lost. But political pressure to mitigate the upturn in interest rates can be successfuly resisted if rates have been allowed to fall freely during the contraction phase.

Allowing interest rates to gyrate more wildly is one consequence of the Federal Reserve's new focus on bank reserves and money supply. Another outcome is that interest rates should be permitted to shift direction more quickly than in earlier cycles of economic activity. The benefits will be smaller bouts of recession and inflation. And the latter can be controlled over the long run by maintaining moderate growth in the money supply in the face of both expanding and contracting economic activity.

We are in a contraction and it's time to keep at least part of the bargain — to maintain moderate growth in the money supply. If the Fed accomplishes this part, the second half — restraint during expansion — will be easier to achieve.

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