Project Syndicate

# Why Are US Interest Rates High and Rising?

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CAMBRIDGE – Long-term interest rates in the United States are rising, and are likely to continue heading up. Over the past 20 months, the yield on ten-year Treasury bonds has more than doubled, from 1.38% to 2.94%. Why is this happening?
About half of the 1.56-percentage-point rise is attributable to an increase in the real interest rate, as measured by the inflation-indexed ten-year Treasury bonds, whose expected real yield has risen from zero in July 2016 to 0.82% now. The other half of the rise in the interest rate reflects the increase in the expected rate of inflation from 1.38% to 2.12%.

High and rising interest rates have important effects on the economy, especially on the prices of stocks and of homes. Because extremely low interest rates during the past decade caused equity prices to rise to unprecedentedly high levels, the shift to higher interest rates will slow and depress share prices. The level of real interest rates is particularly important for share prices, because higher inflation raises nominal profits in a way that offsets the inflation component of higher interest rates.

The interest rate charged on home mortgages reflects the long-term yield on Treasury bonds, with the rate for 30-year mortgages rising a full percentage point during the past 20 months. House prices reflect nominal interest rates as well as real interest rates. Higher nominal interest rates limit the number of qualified homebuyers by increasing the monthly interest payments for any size of mortgage.

The US Federal Reserve’s monetary policy has an important effect on long-term interest rates. Although the Fed traditionally controlled only the short-term federal funds rate, investors’ response to a change in that rate depended on their expectation of how long the rate change would last. If an increase in the short-term rate were expected to persist or to be an indicator of further increases in the future, the long-term rate would also rise. During the period of monetary easing that followed the 2008 financial crisis, the Fed cut the federal funds rate to just

0.15% and declared that it would remain low for a long period of time. Not surprisingly, that caused the long-term rate to fall from 3% at the beginning of 2014 to 1.5% in mid-2016.

The Fed has now started to raise the short-term rate and has said that it will continue to do that gradually for the next few years, aiming at a rate of nearly 3% in 2020 and beyond. That doubling of the federal funds rate will pull up the long-term bond rate.
During the past decade, the Fed also intervened in the long-term market as part of its "unconventional monetary policy" aimed at stimulating the economy. The Fed bought Treasury bonds and mortgage-backed securities, increasing its balance sheet from $900 billion in 2008 to about $4.5 trillion now. Those bond purchases bid up the price of bonds and caused their yields to decline. The Fed is now in the process of shrinking its balance sheet, forcing the market to buy more bonds and therefore raising interest rates.

Changes in expected inflation have a direct effect on long-term interest rates. Growing confidence in economic expansion and falling unemployment has raised investors' expectation of future inflation, pulling up the nominal interest rate on ten-year bonds. Inflation has still remained very low, with the consumer price index up only 2.1% over the past 12 months. But with an unemployment rate of just 4.1% and a weakening dollar, investors' expected rate of inflation is increasing. The expected inflation rate over the next ten years implied by the inflation-indexed bonds rose 0.3 percentage points in the 14 months after July 2016, but then increased 0.8 percentage points in the next five months. Future evidence of increasing inflation will be reflected in higher long-term interest rates.

The widening budget deficit and rising national debt will also push up long-term interest rates. The federal budget deficit is projected to increase from about 3.5% of GDP in recent years to 5% in 2018 and for the rest of the decade. The debt-to-GDP ratio has doubled in the last ten years, to 75%, and is projected to rise to nearly 100% during the coming decade. My own forecast assumes an even greater rise in the debt level, owing to continued increases in government spending and extensions of recent reductions in personal income tax.

As a result, the government's net sale of bonds will rise from about $700 billion a year in 2017 to more than $1 trillion in 2019 and about $1.5 trillion in 2027. The cumulative increase in the debt during the decade will therefore be about $10 trillion. Getting the market to absorb those bonds will require higher real interest rates.

All of this could make new savers happy, as returns on savings – which have been subject to severe financial repression for most of the last decade – begin to rise. But higher interest rates could leave homeowners and shareholders vulnerable to losses.

## MARTIN FELDSTEIN

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Martin Feldstein, Professor of Economics at Harvard University and President Emeritus of the National Bureau of Economic Research, chaired President Ronald Reagan's Council of Economic Advisers from 1982 to 1984. In 2006, he was appointed to President Bush's Foreign Intelligence Advisory Board, and, in 2009, was appointed to President Obama's Economic Recovery Advisory Board. Currently, he is on the board of directors of the Council on Foreign Relations, the Trilateral Commission, and the Group of 30, a non-profit, international body that seeks greater understanding of global economic issues.

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