

Are Low Interest Rates Good for Consumers?

There seems to be little debate about the desirability of the Federal Reserve's policy of keeping the federal funds rate near zero. This is a bit surprising because the short-term interest rate is not just banks' marginal cost of borrowing in the reserve market but also the rate of return for households that save. And although banks' cost of funds has dropped dramatically with the federal funds rate target, households' cost of funds has remained high, especially if we look at their cost of borrowing relative to their rate of return on saving.

Savings accounts held at thrifts and banks (a component of the M2 aggregate) have grown rapidly with the recent sharp rise in the personal saving rate. But this is only one aspect of a higher saving rate. The other and more dramatic consequence is the paying down of accumulated debt.

The chart shows the average rate that bank customers would pay for three types of loans relative to the amount they would earn on a weighted average of funds held in M2 (which is essentially cash on hand or in easily accessible bank accounts). The rate with the highest spread is on credit card debt. This spread is higher today than at any time in the past decade—even when the federal funds rate was as high as 6.5 percent in 2000:Q4. The other rates are an unsecured (two-year) personal loan rate and the rate charged in used car loans, which is lowest because it is secured by the used car.

Households' cost of borrowing has remained high (see chart) even as the average rate of return on funds held in M2 has fallen to around 1/3 percent. Therefore, because interest rates on savings are so low, households have "saved" by paying down credit card and mortgage debt. Over the past year households have reduced credit card debt by 3.5 percent. It is true that credit card debt was reduced slightly at the ends of some previous recessions, but that was not the case in 2001 and the current reduction is the largest since the Fed began

collecting such data (in the early 1950s). Households have also reduced mortgage debt by almost 2 percent, the first time since the series began that we have seen an actual year-over-year decline in mortgage debt.

As the Fed has followed unconventional monetary policies over the past year—near-zero federal funds rate target and the outright purchase of more than \$1,300 billion of government and federal agency securities—the reserve deposits of banks at the Fed have skyrocketed from about \$8.7 billion on August 27, 2008, to \$1,069 billion on December 30, 2009. Yet this large increase in reserves has yet to have much impact in the market for consumer loans. The economy is currently in the worst recession since World War II. Conventional macroeconomic wisdom suggests that low interest rates will aid in the recovery by restoring health to the banking system and promoting lending to both businesses and households. So, if low interest rates are indeed good for consumers, then the benefits must come from the effect these policies have on future output growth.

—William T. Gavin

**Consumer Loan Spreads
(Borrowing Rate minus M2-Own Rate)**

