

Interest rates and income distribution effects

By Svein Gjedrem, Governor of Norges Bank, Dagbladet, 25 October 2000.

Norges Bank has raised interest rates four times during the past six months, by a total of 11/2 percentage points. Banks' deposit and lending rates have increased correspondingly. Many have been concerned about the different ways in which interest rate changes affect the distribution of income and wealth.

Those with large loans must use a larger proportion of their income to pay interest on debt when the interest rate rises. Statistics show that the more people earn, the higher their loans. Viewed in relation to income, the increased expenses for serving loans are about the same for all income groups. However, people with high incomes have proportionately more savings.

Young people often have large mortgages and student loans. These loans are repaid during their working life. Most people save for their old age. One immediate effect of an increase in interest rates will be a reduction in the disposable income of households in the start-up phase, while pensioners have more at their disposal for consumption and for saving.

Rising and falling rates

Over time, interest rates rise and fall. For example, Norges Bank's interest rate fell from 12 per cent in 1992 to 3 1/2 per cent in 1997. A typical mortgage rate was as high as 14-15 per cent at the beginning of the 1990s and was down to 5 per cent at the lowest in 1997. At present it is about 8 1/2 per cent. The groups that lose in the short-term when interest rates are raised will benefit when interest rates are lowered.

Borrowers can now hedge against interest rate fluctuations. Fixed-rate loans are now offered widely, at least for a period of up to 3-5 years. By choosing a fixed-rate loan, borrowers ensure that they have more predictable expenses for servicing their loans.

Distributional shift

The more long-term distributional effects of interest rates are completely different. If interest rates are kept too low, domestic price inflation will eventually pick up. This erodes the value of deposits and loans. At the same time, artificially low interest rates will lead to a rise in house and property prices, in stock exchange prices and in other asset prices. This implies a shift in favour of those who are already well positioned. Many young people will find that the price of entering the housing market is higher. Periods of high price inflation are frequently followed by economic recessions. At worst, developments may lead to a situation comparable to a bubble that bursts.

The winners and losers as a result of such instability are arbitrary. Some will come out ahead; many who take their profits in boom periods may also be able to hedge or withdraw from exposed positions in time. Others - who do not spend as much time and energy on these activities, or who are unlucky - are the losers. An economic downturn and unemployment will primarily affect those segments of the labour force with least education and least capacity to adapt. Then we will really have negative distributional effects. Norway has experience of this phenomenon from the 1970s, and from the bubble economy of the 1980s. Many other industrial countries have had similar experiences over the past 20 years.

Dangerous

In general, it is dangerous to underestimate how rapidly loan markets, housing and property markets and price and wage inflation can take off when the price of loans is set too low - and how pronounced the downturn can be if interest rates are set too high. We do not aim to steer credit and house and property prices with interest rates. But if the interest rate is set in such a way that it contributes to low price inflation - and hence to exchange rate stability - the basis for such market fluctuations will be weakened. This is also the best contribution monetary policy can make to sound developments in the distribution of income and wealth.