Where are the interest rates heading?

In recent years, interest rates have soared. A steady stream of news reports have documented how these high rates hurt the economy. Ruth Simon, writing for the Wall Street Journal, notes that the interest rates for small business loans have doubled in the last two years.

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These high borrowing costs have discouraged small businesses from taking out loans to buy new equipment that could have increased the firms' output. Higher interest rates have discouraged enough people from buying cars that new car sales have declined, a decline mostly driven by the sharp drop in EV sales. High mortgage rates have dampened people's desire to buy new houses. The high rates have also made homeowners unwilling to sell their existing houses to buy new ones. These homeowners want to remain in their current houses to keep their existing low mortgage rates and to avoid having to finance new homes at much higher interest rates.

Interest rates exerted such a large impact on the economy because they changed so quickly. Small businesses that made plans a few years ago probably expected that they could continue to borrow money at the rates that existed at the time. Some of these plans have become unprofitable now that the higher interest rates cause their loan repayment costs to skyrocket.

While the rapid change in interest rates may have hurt the economy, the level of the interest rate is not too concerning. Interest rates are not at historically high levels. The accompanying graph shows the 30-year fixed-rate mortgage from April 2, 1971, to Nov. 9, 2023. The far-right portion of the graph shows the sharp rise in interest rates that are currently making the news. The mortgage rate increased from 2.78 percent in Nov. 5, 2020 to 7.5 percent three years later. However, to only consider this time period would be misleading.

Submitted graph

The graph shows the 30-year fixed-rate mortgage from April 2, 1971, to Nov. 9, 2023. The far-right portion of the graph shows the sharp rise in interest rates that are currently making the news.

This month's 7.5 percent interest rate is not shockingly high by historical standards. It is slightly below the 7.74 percent average interest rate (calculated from the data from the graph). It is also substantially below the 18 percent rates from 1981.

The graph can help us form expectations about where the interest rates are heading. It is unrealistic to think we will see 2.78 percent mortgage rates again. Those rates from three years ago were abnormally low because the Federal Reserve drastically increased the money supply. Banks could only loan out this extra money by drastically decreasing their interest rates. The Fed's policy was a unique response to the pandemic and probably won't be repeated. Still, the 7.74 percent average may not provide useful guidance for where future interest rates will end up. This average was pulled upward by the extraordinarily high mortgage rates of the 1970s and 1980s. These interest rates were so high because inflation was shockingly high and the Federal Reserve reduced the money supply to combat inflation. With less money available, the banks could get away with charging high interest rates without fearing that other banks, with a huge stash of cash, would steal their business by offering lower rates. The other banks did not have this stash of cash. These events are also unlikely to be repeated in the near future.

That leaves us with the last twenty years as the best indicator of where future interest rates will end up. During most of this period, the inflation rate was very low. If we can get inflation back down to these low levels, then the 30-year mortgage rate probably won't get any higher and will probably go lower.

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