

But in the public sector, interest rate policy perhaps has been just as remote from economic rationality as in the Soviet Union. In many fields of investment there is no use of interest rates at all. In the water resource areas the interest rates have been about 3 percent, leading to the usual results: excessive scale of development, excessive capital intensity, in other words, waste of the Nation's capital.

So long as Federal investment was no more than a few billion dollars a year, the waste that resulted from a 3-percent interest policy was a luxury that we could afford. But the magnitudes of the tasks before us have increased, and we expect more from economic policy than we used to do. As we attempt to bring economic rationality into the public sector generally, interest rate policy must be thoroughly reexamined. My testimony today will attempt to contribute to the discussion which will lead to the foundation of a sound and comprehensive interest rate policy for Federal investment programs.

I. THE ROLE OF THE INTEREST RATE IN A MARKET ECONOMY

Interest rates serve four essential functions in the market economy:

(1) *The price for liquidity.*—The interest rates in the short-term money market are paid for the use of money for a brief period, usually less than a year. The variations of short-term interest rates are mainly determined by the interplay of swings in the financial needs of business and the Federal Government and the policy of the Federal Reserve System. These interest rates are not pertinent to the planning of long-lived public investments.

(2) *The price and cost of long-term capital.*—Long-term interest rates are the price for borrowing long-term capital. As such, they serve to allocate that share of the Nation's savings which becomes available for long-term investment. They funnel savings into those uses in which they promise to yield a return greater than the interest rate. They also serve to keep capital out of uses which do not hold the promise of yielding the market rate of interest.

(3) *Interest rate as a means of valuation of income and consumption at different points in time.*—Households can choose to consume their lifetime income in various time profiles by saving or borrowing. Typically, households borrow in their early years while acquiring a home and raising children, pass through a savings phase preparatory to retirement, and draw down their savings thereafter. The prices confronting households in these choices are the interest rate at which they can borrow, such as the interest rate on home mortgages, on installment credit or personal loans, and the rates at which they can lend, such as the interest rates on savings accounts, Government bonds and the return on common stocks.

(4) *Interest rates as a way of compensating for the return for taking risks.*—Interest rates differ according to the riskiness of the loan or investment. The highly diverse structure of actual interest rates found in the economy is partly due to differences in risk as viewed by investors.

II. IMPERFECTIONS IN CAPITAL MARKETS

In a perfectly competitive, and perfectly functioning market economy, there would be only one interest rate for all risk-free loans of any given maturity. This interest rate would be faced by both the