LaGrange Daily News

Interest rates — “the great game”

Sydney M. Williams

April 13, 2016

“If I owe you a pound, I have a problem; but if I owe you a million, you have a problem.”

— John Maynard Keynes (1883-1946)

I am not an economist, but it is clear that the path we are on leads to an unhappy place. It is determined by wishes and hopes, not reality and facts.

I write about debt, and I write about interest rates that are set by government, not determined in the marketplace. Price fixing, whether by consortiums, monopolies or government — and whether for goods, services, wages or money — is generally not wise.

Hidden behind Islamic terrorists, the interminable presidential nominating process, corruption and the hypocrisy of political correctness looms a debt crisis that has been abetted by artificially low interest rates. Approximately $8 trillion has been added to our national debt since the financial crisis and the “great recession” ended almost seven years ago.

To put what has happened in perspective: In 2000, U.S. Federal debt was $5.7 trillion. The 10-year government bond yielded 6.6 percent. That debt and those rates supported a GDP of $10.3 trillion.

At the end of 2015, U.S. federal debt was $18.2 trillion; the 10-year yielded 2.1 percent, while GDP was $17.9 trillion. In other words, while GDP expanded at a compounded annual rate of 3.8 percent, federal debt grew at 8 percent, more than double that of economic growth.

Despite debt tripling in those 15 years, federal interest expenses remained about the same — thanks to a compliant, and not so independent, Federal Reserve. Shortly after his inauguration, President Obama caustically noted, “I found this national debt doubled, wrapped in a big bow, waiting for me as I stepped into the Oval Office.”

Mr. Obama has returned the favor with interest — pardoning the pun. Since 2009, GDP growth has slowed further, while federal debt has persisted, increasing at double the rate of economic growth.

The situation is untenable. If deficits are not reduced and interest rates not allowed to rise during recoveries, what happens when the next recession hits?

The problem is not limited to the federal government. State and local municipalities — with tax receipts down, demands on resources up and interest rates low — have increased debt.

Making things worse are structural problems within states. Infrastructure is crumbling. Entitlements are ballooning, with the gap between benefits promised and assets on hand nearing a trillion dollars, according to Pew Research.

The Cato Institute puts the federal government's unfunded liabilities related to Social Security, Medicare and Medicaid at $70 trillion.

Corporate debt exceeds $29 trillion, with leverage at a 12-year high. Because of myriad government hindrances, corporate debt has not been used for investment, but for stock buybacks, dividends and mergers.

Consumer debt, at $12.12 trillion, is approaching the levels of 2008, despite mortgage debt being more than a trillion dollars below where it was at that time. Since the federal government took over student loan programs in 2009, student debt has increased from $700 billion to $1.2 trillion, with 43 percent of debt holders currently in arrears or in default.

What will happen to local governments, businesses and individuals when interest rates rise, as is inevitable?

The federal government has set the trap. Low interest rates are the bait that attract borrowers. Investors, savers and taxpayers are the prey.

Granted, the Federal Reserve has less ability to dictate long rates than short rates, but numerous quantitative easing (QE) programs have successfully kept long rates artificially depressed. Once rates normalize, which they will, the victims will be those that borrowed short to lend long — banks — as well as investors who bought long-dated bonds; the latter stand to lose capital.

Congress and the administration have dallied. They have focused on what they deem more pressing issues — ensuring those claiming to be transgenders have access to bathrooms of their choosing; setting aside a million or so acres for wind farms, lest tens of thousands die of heat prostration; providing "safe places" for students whose delicate sensibilities find certain words and phrases offensive; and helping the armed forces remove the dreaded designation "man" from all job titles.

They should have hastened to reform our tax and regulatory systems. Both parties need to address rising transfer payments and declining infrastructure investments. It is fiscal reform that is needed, not catering to ephemeral concerns.

It is the economy that requires support — something central bankers cannot do in isolation. High tax rates and indecipherable regulations, combined with low interest rates, have consequences.

One has been the plethora of corporate inversions; another, the hiding of money in tax-havened accounts and a third, the widening wealth gap — the last a function of low interest rates and rising asset prices. Restraints have been placed on job-creating businesses, while they have been removed from government.

The Fed, according to the New York Times, is in a "patient mood." With the pace of economic growth "modest," and the global economy weak, they "worry about raising rates too soon." They are in a box.

The domestic economic recovery, which began only a few months after Mr. Obama took office, is about to enter its eighth year, long in the tooth for post-war recoveries. Mr. Obama does not want to see a recession begin on his watch, so he is likely to encourage the Fed to take no chances by normalizing rates. Leave that for the next president.

Mr. Obama takes pride in the number of jobs added over the past seven years — about 11 million — but makes no mention that was from recession lows, and that given demographics, our economy should — in the normal course of events — add about a million jobs annually.

While workforce participation rose last month from 63.5 percent to 64 percent, it still remains mired at levels not seen since the 1970s. Wage growth has begun to show modest signs of improvement, but median household income remains below where it was in 2008.

The question for the Fed: When recession next hits, how far do you lower rates when they are already at zero?

The "great game" refers to the rivalry and wars that played out in north-central Asia during the 19th century between the British and Russian empires for supremacy in that god-forsaken region. It was the source for many of Rudyard Kipling's stories and provided opportunities for George MacDonald Fraser's unforgettable character, "Flashman."

The game being played today, not just by the Federal Reserve, but by central bankers around the world — passing on, delicately but deliberately, buckets filled with waste — is as foolhardy and dangerous as that played on the northern frontiers of India and Afghanistan 150 years ago.

I don't want to imply that deficit spending is always a bad thing. During recessions, government must step in to help right a foundering ship.

And I certainly don't want to belittle the great good done by Henry Paulson, Ben Bernanke and Tim Geithner in late 2008 and early 2009. Without their aggressive responses, the credit collapse could well have turned into something far worse.

But times have changed. It seems to this observer that the goal today of every central banker — and political leader — is to get to the end of his or her scrum without disaster, not to fix what needs mending, then pass on to the next a situation more fragile than that inherited.