March 10, 2021

Why Do Interest Rates Matter?

With the passage of another multi-trillion dollar spending bill, making the total federal government spending in the last year in the order of $5 trillion, the question for economists is how will this affect interest rates and why does it matter?

Many people think that when the government spends twice the money that it takes in, it simply prints the money in the basement of the Federal Reserve building. Literally, that is true, but the government, on the books, must borrow the money that it does not have from somewhere. The government borrows by issuing various kinds of debt, such as bonds. People only buy those bonds if they receive a sufficient interest rate. If there is too much borrowing by the government, there may not be enough buyers. The people who do buy government debt will demand a higher return on their investment, if there are fewer buyers and more debt to be purchased. That is what causes rising interest rates.

Why does it matter when interest rates go up? Virtually all businesses in this country, and most consumers, live from day to day by borrowing money themselves. When the interest rates for federal bonds go up, all interest rates go up. When borrowing becomes more expensive, business spends less money, there is less hiring, fewer pay raises and the consumer suffers.

There are other effects to rising interest rates. The stock market falls, savings of hardworking Americans disappear, and fear sets in.

The economy can take a certain amount of increasing interest rates. The question is, how much, how fast and how dramatic are the interest rate increases? Those who like to spend money that they do not have brag that the deficit spending is actually good for the economy. This is based upon the notion of “pump priming,” a concept promoted many years ago by John Maynard Keynes. Keynes believed that during hard times, the government should spend more money than it takes in, with the hope of shocking the economy back to life. As Richard Nixon famously said: “Now we are Keynesians.” It is good in theory, but the problem is that we easily find excuses to prime the pump, but we forge to refill the well in between times.

Good management of the economy should not be a Republican or Democratic cause célèbre but, in reality, it is. Democrats will say that Republicans are being cheapskates who just want to keep money for the rich, while the Republicans will say that the Democrats profligate spenders who care not a whit about the economy in a year or two years from now. In a sense, they are both correct.

President Obama signed an Executive Order establishing the bipartisan National Commission on Fiscal Responsibility and Reform headed by former White House Chief of Staff Erskine Bowles and former Republican Senate Whip Alan Simpson. Whoever heard of that Commission today? When it reported on February 6, 2009, after four meetings, its results were promptly ignored by everyone. The authorization of the Counsel was not renewed and it was permanently shut down.

The problem with the Commission is that it attempted to address debts, deficits and growth with some long-term solutions. American politicians just could not stand for that.

The United States has gone through terrible economic dislocation before COVID-19. Whether it was the GI's returning from World War II, the stresses and strains of the Korean and Vietnam Wars, the dislocation caused by the savings and loan crisis, the .com bubble crash, or the Great Recession of George Bush, the solution has always been a reinvestment in the economy. In addition, there was a loosening of the money supply so that lending could renew and the Treasury would maintain a watchful eye so as not to permit the deficit to get out of control.

We seem to have lost what we have learned previously. While the money supply today is adequate for lending, we will be engaging on a spending and borrowing spree without the slightest comprehension of how all this debt will be financed or paid for. The time will come when our primary lenders, the Chinese in particular, demand a higher return on their investment in America. That will drive up rates and demolish growth. The folks who are today anticipating their $1,400 stimulus payments will pay it back more quickly than they realize in inflation and wage stagnation. As for those who say that we will make up for the deficit by future growth and soaking the rich with tax increases, the math just does not work out. While there are plenty of rich people in this country, the amount of money that can be raised by closing tax loopholes and growing the economy is unlikely to equal, in any reasonable period of time, the $3+ trillion in debt that we are creating over a very short period of time.

Giving away lots of money without any clue as to how to refill the coffers, while planning to spend more on infrastructure repair, is nothing short of vote buying. Donald Trump did it to bury the stock market, and Joe Biden will do it to assure a favorable Congress in the next election.

While the political parties debate the wisdom of spending ourselves into oblivion, with a hope and a prayer that we will not go bankrupt, legitimate economists have largely been ignored. When I studied economics, it was almost a science, full of mathematics and devoid of easy assumptions. Today, economics has fallen prey to political scientists. There is no "science" about politics and there is much less science about economics. To some extent, economists have always been a tool of their political bosses, but today we do not even pretend that advance planning has a role in our spending and tax policies.

We could only hope that with the passage of time and the abatement of COVID-19, some common sense and responsible behavior will return to the halls of Congress. However, I am not investing in that hope.

Clifford A. Rieders, Esquire
Rieders, Travis, Humphrey,
Waters & Dohrmann
161 West Third Street
Williamsport, PA 17701
(570) 323-8711 (telephone)
(570) 323-4192 (facsimile)

Cliff Rieders is a Board-Certified Trial Advocate in Williamsport, is Past President of the Pennsylvania Trial Lawyers Association and a past member of the Pennsylvania Patient Safety Authority. None of the opinions expressed necessarily represent the views of these organizations.

CAR/srb