Every economist I know, including me, has been premature in predicting an increase in interest rates. I still don’t think it’s question about if, but more when and how much.

Interest rates on agricultural loans have gone up, but it’s been more because spreads have increased due to the need for additional loan loss reserves and increased risk premiums than because of an increase in the underlying cost of funds. Obviously, the federal reserve has been increasing the money supply and holding down the discount and fed funds rates to stimulate the economy; but, I don’t think those factors are enough to explain the rates that drive the overall market and those are the rates on U.S. treasuries.

So why are treasury rates so low and what do we need to watch as indicators of when they might increase? The first is that while the economy may have bottomed there isn’t much indication of a strong recovery. The result is that the private sector isn’t competing with the federal government for debt capital. The housing market is still in the doldrums and will be until we work off the existing inventory as well as what is still to come as result of non-performing loans. New housing starts are currently running at an annual rate of about 600,000 and they need to be over 1 million before housing will make much of a contribution to stronger economic growth. In addition, the commercial real estate market is lagging the residential market. Industrial capacity utilization is in the 70-75 percent range, well below the 80-85 percent associated with strong economic growth. The unemployment rate is still 9.5 percent and that not only creates an income drag on consumer spending, it also has a very negative impact on consumer optimism. Consumer spending has picked up slightly, but it isn’t likely to drive the economy as much as it has the past 20 years. The wealth effect resulting from increasing home equity and stock market gains isn’t there and the use of consumer credit to finance consumption has fallen significantly. The growth in consumer spending for the next several years is likely to be in direct proportion to increases in income, i.e., consumers aren’t going to be as likely to bet on the come. Coupled with the growing federal debt burden and the potential for tax increases, I don’t see real GDP growing much above 3 percent for any extended period over the next several years. What all this means is that until we find a new economic engine, there isn’t likely to be much pressure for a crowding out effect.

The second factor holding interest rates down has been the willingness of foreign investors to continue purchasing U.S. debt. They
currently hold about 40 percent of the outstanding balance. Much of this has been the result of the flight to safety, low inflation, and the lack of better alternatives in foreign debt markets. In the short run, the problems in the EU have benefited us. How long this plays out I don’t know. Spain should be watched closely.

Third, unlike individuals, businesses and state governments, the size of federal debt by itself isn’t the immediate problem because it is never paid off anyway, it’s just refinanced. The big issues are the rate of growth in the debt and the rate of growth in the debt service requirement, which is the interest on the debt. If they grow faster than the rate of growth in GDP, it will eventually lead to inflation, higher taxes, and/or higher interest rates. Remember, one of the primary causes of inflation is too much money chasing too few goods. Currently, interest on the federal debt consumes 6 percent of the federal budget. It is projected to grow to 11 percent by 2015; but, that assumes current interest rates and projected rate of growth in the federal debt.

Fourth, watch the value of the dollar. We don’t just import goods and services, we also import money. In fact, the amount of money we import dwarfs the amount spent on imported goods and services. A stronger dollar makes all imports cheaper. If the value of the dollar drops relative to the currencies of those countries who buy U.S. treasuries, it will take higher interest rates, i.e., the cost of money, to attract those funds.

We’ve become used to cheap money. I would still be doing everything I could to lock in interest rates even if it’s at a 1 - 1.5 percent premium. Think of it as insurance. Trying to guess the timing of when interest rates are going to increase is gambling and thinking rates might go much lower is very unlikely. Don’t be like one of those who passed on the opportunity to price $6-7 corn betting it would go to $10.