Commentary: A price to pay for long-term low interest rates

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The Federal Reserve has held interest rates at near zero for so long that many have forgotten that near-zero rates are not normal. And when we finally do return to normal, there's going to be a very large bill to pay.

To help hold interest rates so low for so long, the Fed has increased bank reserve balances by 20,000 percent over the past decade, flooding financial institutions with enough reserves that borrowing money, literally, costs almost nothing. The Fed's target interest rate, the federal funds rate, which averaged 5.7 percent from 1955 through 2008, has averaged just 0.1 percent since 2008, which has lowered interest rates across the board for eight years.

While low interest rates are a boon for home buyers and college students, they don't come without danger. If the Fed isn't careful, the increase in bank reserves that spawned those low rates will eventually also spawn massive inflation.

For years, the Fed has signaled that it intends to start rolling back bank reserves, thereby allowing interest rates to rise. But apart from a paltry three-tenths of one-percent increase in December of 2015, the Fed hasn't raised interest rates since 2006.

The debate among Fed watchers has centered on the trade-off between inflation and recession. If the Fed raises interest rates too late it risks significant inflation, but if it raises rates too early it risks recession.

As bad as those options are, the debate misses a crucial point. While the Fed has been holding interest rates at near zero, the U.S. government, has gone on an unprecedented borrowing binge.

In 2006, the federal government owed $8.5 trillion. Today it owes $19.5 trillion. As interest rates rise and fall, so too does the interest rate the federal government pays on its debt. That rate currently stands at 2.2 percent. But in 2006, before the Fed's intervention, the federal government paid 5 percent on its debt. That almost three percentage point difference in interest rates doesn't seem like much, but on a $19.5 trillion debt, it is astronomical.

If the Fed were to allow interest rates to return to prerecession levels, the federal government would owe an additional one-half trillion dollars annually in interest payments. There are only three ways to come up with that much every year. Washington could raise taxes by about 16 percent across the board. The federal government could borrow more, effectively doubling its current budget deficits, and accelerating the growth of its already massive federal debt. Or it could cut spending by 14 percent across the board.

Voters won't stand for higher taxes. And given that the last time Washington cut spending by more than 3 percent was 1955, there isn't much hope for budget cuts either. That leaves only increased deficits.

This is what Fed watchers should be talking about. The Federal Reserve has painted itself into a corner. If the Fed tries to return interest rates anywhere close to their prerecession levels, it will cause deficits to balloon permanently, which will accelerate the growth of the now $19.5 trillion debt.

Complicating matters, the federal debt is not long-term debt. Almost 60 percent of the federal debt will mature within four years. An additional 30 percent will mature within the subsequent six years. That means that, as interest rates rise, the federal government will only have a couple of years' grace before it has to start refinancing large chunks of its low-interest debt at higher rates.

Sometime, possibly within months but certainly within a few years, the Federal Reserve will have to choose between the people and the government. When inflation starts rising, the Fed can either raise interest rates, which will dramatically increase federal deficits, or it can let inflation rage, which will decimate people's savings.

The third way, a 14 percent across-the-board cut in spending, is the only way to stave off the devastating effects of decades of fiscal irresponsibility. The most likely outcome, unfortunately, is that Washington and the Fed will continue to do what they've been doing for decades - waiting and hoping that the day of reckoning holds off until someone else is in office.

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