ECONOMIC BRIEF NO. 6

Interest Rates and Two Birds in the Bush

This is the sixth in a series of briefs exploring fundamental concepts in economics and community and economic development.

The old saying a bird in hand is worth two in the bush captures the essence of an important economic concept. An economist would say: A dollar in hand is worth more than a dollar tomorrow.

Both sayings are about risk. There is a risk that one cannot capture both birds from the bush. There is even some risk that both will be scared away, and a person will have nothing. Similarly, the promise of a dollar tomorrow might not be kept.

Even if we forget about the inherent risk that future prospects or promises may not materialize, there is also a cost in waiting. If one is broke and does not have a dollar, he or she will go to bed hungry tonight unable to buy supper. Tomorrow when one has two dollars, one may feast; but in the meantime he or she suffers hunger pains.

Given the choice of a dollar today or a dollar tomorrow, most people will take the dollar today and satisfy their wants without waiting. To get one to defer gratification, it is usually necessary to offer a bribe. In its purest sense, that is what the interest rate is—a bribe for deferring consumption.

The size of the bribe (that is, interest rate) necessary to get a particular individual to defer consumption depends on the person's psyche and situation. It may take a fairly high interest rate to get an individual to save (or loan) a dollar if it means going to bed without supper that night. If it means only that the individual must forego seeing a movie, a smaller interest rate may suffice.

The pure interest rate is a payment for waiting—a bribe to defer consumption.

The fundamental component of the interest rate, therefore, is a payment for waiting—a bribe to defer consumption. Usually this is called the pure interest rate or the discount rate.

We have already mentioned the risks that are inevitably associated with waiting. If there is a high degree of certainty that promised repayment will be forthcoming, the risk is low and the interest rate need not be much more than what is required to get individuals to defer consumption. But if the risks are high, the interest rate must be high to induce persons to run those risks. The interest on U.S. government bonds is relatively low; there is almost no risk that repayment will not be forthcoming. But interest rates on junk bonds are high because the risk of default is high.

Finally, there is the risk of inflation. If the inflation rate is 5 percent and the interest rate paid on savings deposits is only 4 percent, savers are losing buying power. One hundred dollars put in the bank today will grow to $104 in one year, but it will take $105 to buy what the original one hundred dollars buys now. So the interest rate must more than offset inflation, or those who have dollars will stop saving or loaning out money.

In general, then, an interest rate is (1) a payment for deferring gratification, (2) a risk premium that is an inducement to risk nonrepayment, and (3) compensation for expected inflation.