Readers have a lot of interest in interest rates

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Why am I getting so little for my savings? How much do we owe China?

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There's a lot of interest in rates this week. James is peeved that he's making so little on his savings: shouldn't rates be higher to encourage savings? Richard, meanwhile, is wondering what happens to the value of his bonds if rates go up.

I don't understand why banks are paying so little interest on CDs and savings accounts. You'd think in these tough times they'd want more people to save money in their banks and offer them better rates as incentive to do it. The rates they are offering today are pathetic.
— James M., Miami, Fla.

The "they" you're talking about in this case is the Federal Reserve, which pretty much gets to set short-term interest rates wherever it wants.

And while the folks down at the Fed are happy we're all saving more these days (which we all are), they don't set interest rates to please savers. In normal times, their job is to 1) keep inflation under control and 2) keep the economy growing at a healthy rate — not too fast, not too slow.

Alas, these are not normal times down at the Fed. The lenders who are taking your deposits are still trying to whittle down a mountain of bad loans they made to people who couldn't pay them back. In normal times, bankers who screw up have to take their losses and move on. But since the scope of the screw-up was so widespread, and the banks that screwed up were so huge, the government decided they were "too big to fail." History will have to determine whether that was the right call.

To keep them from failing, the Fed has made money extremely cheap for banks to borrow, which they can then lend out — for mortgages, credit cards, car loans, etc. — at higher rates. Sometimes much higher.

The difference is profit for the banks, which they're using to fill that big hole of losses they created by making dumb loans and investments.

Unfortunately, until the government comes up with a rational set of regulations to keep the banks from making these dumb loans and investments, there's no reason to believe it can't happen all over again.

If interest rates rise what effect will that have on bond prices?
— Richard O., Fairport Harbor, Ohio

They will go down. Bond prices and interest rates go in opposite directions. Here's why:

Bonds come with a fixed rate (sometimes called the "coupon" because you used have to clip little coupons from the paper bond and send them in to get your interest payment). But the "yield" changes according to how much the issuer has to pay at auction to get investors and savers to part with their money.

If you buy a bond today that pays 4.5 percent (the rate on the latest 30-year Treasury sold at auction August 17), you'll get $45 a year for every $1,000 worth of face value of the bond, paid in quarterly installments. If you hold onto the bond until it matures, you'll get $45 a year for 30 years and then get all your money back in August, 2039.

But maybe you need the money before then. If so, you can sell the bond to someone else (that's why there's a "bond market"). Let's say you sell it three years from now, when the bonds sold at the latest auction are paying 6 percent. Anyone else with $1,000 to invest could buy a fresh bond and get $60 a year, every year, until the bond matures. Why would they buy your bond for $1,000 — when it only pays $45 a year?

They won't. What happens is the price of your bond falls to a level that keeps the "yield" the same as a new bond. Your bond now sells for $750 because your $45 fixed payment represents a 6 percent return on the money from whoever buys your bond. (The math: 6 percent of $750 is $45.)

The reverse is also true: if bond prices go down, interest rates go up (and vice versa). There are all kinds of reasons why bond prices go up or

down, based on whether investors think they are a good place to keep their money (we'll leave that for another column).

What amount of interest are we paying on the money we borrow from China?
— J.C., Address withheld

It depends when they borrowed it.

For example, a fresh 10-year Treasury note bought at auction in May 2006 came with a coupon of 5 and 1/8 percent. The latest 10-year, sold last month, paid 3 and 5/8 percent.

We couldn't find data that tracks exactly how much money flows from the U.S. Treasury every month to cover the interest owed on the bonds, bills and notes held by the Chinese government. If any readers can point us to this, we'll publish in a follow-up.

The best we could come up with is a (very) rough estimate. There are a number of reasons why this is so rough.

First, the data we have for foreign holdings of U.S. Treasury debt is, itself, an estimate. According to the Treasury, the Chinese government held $776.4 billion in Treasuries in June down from $801.5 billion in May. That amount can change for two reasons: either the Chinese have bought or sold Treasury debt, or the value of their holdings has risen or fallen. Or both.

Then you have to know the mix of holdings. Interest on long-term bonds will cost Uncle Sam more than short-tem T-bills, which pay a lot less. T-bills mature in a year or less; notes mature in two to 10 years; bonds mature in 30 years.

You also have to know when the bonds were purchased; if you bought a bond issued when interest rates were high, you're going to collect more interest than bonds issued more recently when rates have fallen.

The difference in those rates is substantial. As of June 30, 2009, (the latest data available on Chinese-held U.S. debt) the average rate on short-term bills was only 0.458 percent (about a third of a percent). Treasury notes were paying an average of 3.239 percent. And longer-term bonds were paying 6.748 percent, on average.

The average paid on all marketable Treasury securities — the ones sold on the open market — was 2.694 percent at the end of June. So let's assume that the Chinese are holding a mix of Treasuries that mirrors that total debt outstanding.

In that case, you come up $20.9 billion ($776.4 billion x 2.694 percent) a year in interest payments to China for interest on their holdings of the national debt.

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