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Financial Repression From The Obama Administration: How Savers May Be Forced To Buy Federal Debt

By William Tucker

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As still another showdown over the national debt looms, some experts are concerned that the Obama Administration is poised to begin forcing Americans to stock their retirement accounts with low-return government bonds.

Richard Cordray, director of the Consumer Financial Protection Board, told *Bloomberg News* that his new regulatory agency was mulling a move to control the $20 trillion that Americans have invested for retirement. He specifically mentioned 401(k) plans and IRAs.

"That's one of the things we've been exploring," Cordray told *Bloomberg* reporter Carter Dougherty in January. Cordray's seemingly stray comment was largely ignored by mainstream and financial media, but won the attention of fund managers and economists.

Cordray suggested that "mismanagement" of individual retirement accounts by the nation's major financial institutions could leave investors exposed, just as those who bought subprime mortgages were left in the lurch during the 2008 housing crisis.

Cordray's agency is already moving toward regulating 401(k)s and IRAs. In April the CFPB issued a report questioning the "senior designations" that are awarded to individual financial advisors who manage retirement accounts. "In recent years, federal and state regulators, financial industry representatives and consumer groups have been reporting that some financial advisers with senior designations are targeting older consumers and selling them inappropriate and sometimes fraudulent financial products," warned the report.

Although four financial companies – Fidelity Investments, JPMorgan Chase & Co., Charles Schwab Corp. and the T. Rowe Price Group – handle the largest portion of individual IRAs and companies manage their employees' 401(k)s, a small portion of financial individual retirement accounts are handled by independent financial advisers.

The April report claimed that the CFPB had jurisdiction under the 2010 Wall Street and Consumer Protection (Dodd-Frank) Act, which directed it to "make recommendations to Congress and the Securities and Exchange Commission (SEC) on best practices."

"CFPB will be clearly overstepping its bounds if it makes a blatant political move to present itself as a protector of senior citizens," says Mark Calabria, director of financial regulation studies at the Cato Institute. "Congress chose to leave oversight for retirement products at the SEC and Department of Labor. With the creation of the CFPB, Dodd-Frank is attempting to do for the rest of consumer finance what the federal government has done to the mortgage market — to completely politicize it and subject it to twisted incentives that ultimately cost both consumers and the taxpayer."

Michelle Muth Person, an officer in the CFPB communications office, declined to be comment on plans to regulate retirement accounts but said that CFPB has "no immediate plans" for intervening in the management of individual accounts.

Despite the reassurance, economists and industry officials are still worried. "The runaway, unaccountable regulators at the Consumer Finance Protection Bureau would like to 'protect' the IRAs of U.S. citizens by making them into a $20 trillion ATM for the government," says economist George Gilder.

Critics fear that the CFPB would claim regulatory authority over IRAs and self-employed person pensions (SEPPs) on the grounds that seniors aren't capable of handling their accounts and are being defrauded by the firms that manage them.

Then it would argue that corporate stocks and bonds are too risky and funds should be instead in the one safe instrument that is the equivalent of cash –- Treasury bonds, backed by the full faith and credit of the United States. Of course, the returns paid by the federal government are far lower. Treasuries pay low interest rates and when combined with inflation, usually provide a negative real rate of return over time.

For now, almost every dollar in America's individual retirement accounts is invested in the private sector — which earns higher returns than government debt. "I wouldn't put it past the government to go after some of that money, almost all which is invested in corporate stocks and bonds or real estate," says Curtis De Young, founder and CEO of American Pension Services, a leading financial advisory company.

"The government is already starting to nibble around the edges, imposing big penalties if you make a small mistake on your paperwork. I'm sure they'd eventually like to tax these accounts as well, not that they are not already being taxed down the road," says De Young. "But our capital markets couldn't function without private savings and right now most Americans have those invested in individual retirement accounts."

While individuals may lose, the feds would gain. Suddenly Washington would have a captive buyer for new debt on top of the existing $17 trillion in government debt. That the actions of the CFPB and other new regulatory authorities created by the Dodd-Frank Act could end up squeezing Americans into holding more low-interest government debt would be nothing new.

“There’s always been a tendency for governments to favor their own securities but it’s intensified since the adoption of Dodd-Frank,” says Hester Peirce, senior research fellow at the Mercatus Institute at George Mason University and editor of “Dodd-Frank: What It Does and Why It’s Flawed.” “There’s a lot of new pressure on banks, money market funds and private pension plans to hold more government debt.”

“Treasuries are being treated as the equivalent of cash, which doesn’t apply to other financial instruments. The Commodities Futures Trading Commission, the Fed, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency are all getting in on the act. It’s not as if the regulators are saying, `Oh, now we’ve created a bigger market for Treasuries.’ But the effect is the same. Government really has a conflict of interest here that it doesn’t like to admit,” Peirce said.

The strategy is “financial repression,” according to Kenneth Rogoff and Carmen Reinhart in their “This Time It’s Different: Eight Centuries of Financial Folly,” a 2009 history of bank failures, inflation and government defaults.

“We found there are basically three ways a nation can pay down its debt when it starts to get out of hand,” said Rogoff, who is Thomas D. Cabot Professor of Public Policy at Harvard University. “First you can cut spending and raise taxes. That’s always unpopular. Then you can try inflation. But that poses the danger of getting out of hand and causing a run on your currency.

“There’s a very subtle third way, however, where the government keeps interest rates very low and takes control of the banking system so that there are limits on how much people can make on their savings,” he explains. “That reduces the competition against government bonds and makes it easier for the government to continue borrowing. Financial repression played a huge part in retiring our [federal] debts after World War II. With an effective minus-3 per cent rate of interest, a country can reduce the value of its debt by 30 percent in ten years.”

Rogoff and Reinhart found that, rather than paying off the huge national debt accumulated as a result of World War II —110 percent of GDP in 1945, by far the highest ever — the federal government exercised an almost invisible policy of financial repression by combining a steady rate of inflation with intrusive banking regulations.

Key to this plan was Regulation Q, part of the 1933 Glass-Steagall Act, that prohibited banks from paying more than 3 percent interest on savings accounts. “The rationale was that banks would ruin themselves by competing for customers too intensely by offering higher interest rates,” says Reinhart, who is Minos A. Zombanakis Professor of the International Financial System at Harvard’s Kennedy School. Yet, he said, the regulation stuck around until 1986 since it was a convenient way for the government to steer savers into its own low-interest bonds.

“The secret for a government that is piling up debt is to keep its own borrowing costs low,” says Reinhart. “A rise from just 3 percent to 6 percent on government bonds can double the government’s costs in the long run. But in order to keep interest rates low, the government has to make sure no one is offering rates any better.”

You can see this policy at work today as out-going Federal Reserve Chairman Ben Berneke’s pursued “quantitative easing,” a way to inflate away federal debts by flooding the economy with newly printed money. Critical to this strategy is a government-led effort to keep interest rates at historic lows — below 1% since 2009 and essentially at zero over the past year.

This puts savers in a vise. Available interest rates on bank savings accounts or money market funds rarely top 1% in today's market. Why not just give up and invest in low-paying but "safe" government debt?

Still it could be worse. Overseas governments are using "financial repression" to shield their own profligate spending. In China, interest rates have been effectively at zero since 2003 and Beijing doesn't allow much money to leave the country. So Chinese investors can't move their nest eggs to more profitable places. Ireland and France "encourage" pension funds to invest in government debt. Spain has capped what savers can withdraw from their accounts, slowing their ability to shop for higher returns.

With U.S. national debt cresting at more than $17 trillion — that's $53,000 for each American man, woman and child – there's little indication that the squeeze on savings and retirement funds will end soon.

Before the federal takeover of Chrysler in 2009, few investors believed that Uncle Sam would leave bondholders with only pennies on the dollar. Yet their contractual protections were swiftly swept aside while the U.S. Supreme Court failed to rescue bondholders. Warns George Gilder:

"American stock and bond holders are the owners of America and their property is the bastion of our independence and freedom. Some of the worst tyrannies of the 20th Century began by expropriating the property of individual citizens. Divested of their independence, they become mere tools of the state marching down the road to serfdom. We cannot let that happen in the United States."