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Bad news for savers

The government holds down interest rates for its own benefit

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Do not expect to get a higher real rate of interest on your savings — ever. Traditionally, people could expect to receive 2 or 3 percent more than the rate of inflation on their savings or money market accounts. For instance, if inflation was 2 percent, many people received 5 percent interest per year on their government-insured savings accounts. The Internal Revenue Service would then tax the entire amount of interest received (even the portion due only to inflation, which is obviously not income, but who expects the IRS to be ethical?). So, even after inflation and taxes, most received a small, 1.5 to 2 percent real positive rate of return on their savings.

Contrast the current situation with what people traditionally expected. Now, if you are lucky, you may be receiving a half percent or so interest rate, about equal to the rate of inflation, yet the IRS still taxes you on this meager amount even though you have had no real interest income. So, at the end of the year, you are worse off — a negative return — because you did the responsible thing, and that was to save for your retirement or for various emergencies that come along with life.

The following is a simplified but accurate description of how we got into the mess and why the situation will not get better. Back in 2009 during the Great Recession, the government greatly increased spending, all of which was borrowed. At the same time, the Federal Reserve decided it needed to strengthen the balance sheets of the big banks. Without going through all of the mechanics, to accomplish those two operations, — large banks bought bonds from the U.S. Treasury (at restricted auctions) and then sold many of these U.S. government bonds to the Fed at a small profit. Using this mechanism, the U.S. Treasury was able to sell more than a trillion of dollars of debt at very low interest rates.

The Fed earns interest on the U.S. government bonds that it holds, but at the end of the year it remits its interest earnings — after deducting a couple of billion dollars to pay for its own operations — back to the Treasury. Currently, it is remitting back more than $100 billion a year, making the government's cost of debt service very low. Again, it is important to understand that Fed and the Treasury are running an unsustainable scheme — whereby the Fed creates an artificial demand for government debt, driving down the interest rates, and then remits most of the interest earned back to the Treasury. If a private party engaged in such activities, it would be called "money laundering," and the participants might well go to jail.

The reason this monetary game has not resulted in inflation up to now is that even though the Fed is buying the bonds from the banks with money created out of thin air, the banks are increasingly subject to greater regulatory restraints on what they can do with the money. The big banks have "bank accounts" with the Fed. The Fed started paying a small amount of interest on these accounts to the banks. So the big banks, in essence, get free money from the government on which the government pays them interest. If the banks lend the money to private parties who are willing to pay a higher interest rate, the banks risk fines, or worse, if the loans happen to go bad. As a result, the banks increasingly restrict their lending to big companies and the politically favored where the risks are perceived to be lower — rather than to small business and entrepreneurial enterprises that create most of real jobs.

Because of all of the new financial regulatory restrictions that make it more difficult to borrow, the demand for loans is artificially depressed. At the same time, the population pyramid is changing. Young people typically are borrowers — for education, homes and autos. As people get older, they tend to increase their savings rates to prepare for old age and borrow less. As a result of the decline in birth rates and an aging population, there are fewer borrowers and more savers. As the real return on savings declines, many save more, as the Japanese have been doing for the last few decades, to make up for the lower rate of return on the savings.

The Fed has no costless way to wind down its massive holdings of U.S. government debt and its holdings of government-backed mortgages that it bought from Fannie Mae and Freddie Mac. Who would buy all of this stuff if the Fed decided to sell, and at what price? If the Fed interest rate subsidy to the Treasury stops — the cost of debt service will soar, either crowding out other spending or forcing massive tax increases or inflation.

Rapid economic growth is the only real solution to the government debt problem and negative interest rates for savers. Such growth will require large cuts in regulatory costs, a far less damaging tax system, and major real cuts in government spending. Which politician is going to deliver that?

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