INVESTOR'S BUSINESS DAILY®

# Fed's 'Unconventional' Monetary Policies Amount To A War On Saving

James A. Dorn

February 23, 2018

The Federal Reserve's unconventional monetary policies, which were launched in 2008 and designed to keep interest rates low for a long time, have devastated the savings of conservative investors. Yields on traditional savings accounts and money market funds have been inching up since the Fed began raising its policy rate in late 2015, but real (inflation-adjusted) rates are still negative, especially when taxes on interest income are factored in.

For seven long years (Dec. 16, 2008–Dec. 16, 2015), the Fed held its policy rate, the so-called federal funds rate, within a target range of zero to 0.25%. Savers lost billions of dollars in interest income and pension funds took on more risk to meet their long-run commitments. Those investments are now at risk as interest rates rise and asset prices fall.

One popular money market fund, T. Rowe Price's "Government Money Fund" (formerly the "Prime Reserve Fund") had an average annual total return of 0.13% over the last 5 years and 0.30% over the last 10 years. Those ultralow nominal rates are in contrast to the Fund's 4.82% yield since its inception in January 1976. Nominal rates increase when inflation is high, as it was in the late 1970s and early 1980s. What matters to savers are real, after-tax rates. With expected inflation of about 2%, a nominal interest rate of less than 2% turns into a real rate of zero.

Bank of America currently pays 0.03% on its standard saving account, 0.04% on its gold account, and 0.07% on its 1-year certificate of deposit, all of which translate into negative real rates. So you might as well spend your money now on consumption goods — or try to get a much higher yield by going into risky assets like stocks. And that is what investors have done for more than nine years.

Stocks have done extremely well: Last year the Dow surged 25%, but that surge is ending as investors realize rising fiscal deficits and Fed tightening will push interest rates higher and asset prices lower. Investors also recognize that there has been a disconnect between the real economy and the stock market.

When the market goes up by 25% in one year, as it did in 2017, but the economy grows by about 2.5%, it is reasonable to conclude that asset prices are overvalued and financial markets must adjust to that reality. In the past, the Fed has supported stock markets, but eventually policymakers will have to "take the punch bowl away" and let market forces determine market prices.

Myopic policymakers have a bias toward consumption and against saving. They view saving as antisocial and rely on crude Keynesian models that posit saving as an undesirable leakage from aggregate demand. In doing so, they ignore the social benefits that stem from forgoing current consumption: Savers gain from a positive return on their investments, but so do workers who are now more productive and consumers who have a wider range of choices in a growing economy.

The U.S. household saving rate reached a 12-year low last December as consumers spent more of their disposable income and saved only 2.4%. Underlying the war on saving is the idea that, at very low interest rates, people have a strong incentive to consume now rather than save for the future. Federal Reserve policymakers have had the goal of keeping rates low and using forward guidance to reinforce that goal.

Meanwhile, the Fed's large-scale asset purchases, also known as quantitative easing, were designed to increase asset prices and reduce yields.

However, those policies have penalized savers and increased risk taking, while having only a modest effect on real economic growth. The war on saving has been misplaced and policymakers must recognize that saving is beneficial. The only sure path toward future prosperity is to let free markets determine interest rates and the allocation of credit.

Economics is supposed to teach policymakers to look at the long-run effects of policy alternatives. Enacting policies that penalize saving always prove costly. Saving is a virtue, not a vice. It is the glue of civil society. It put millions of Americans on the path toward higher living standards and fostered a long-run perspective and an ethos of responsibility. In contrast, the Fed's myopic low-interest policy has fostered speculation, debt, and greater inequality of income and wealth.

*James A. Dorn is vice president for monetary studies and a senior fellow at the Cato Institute in Washington, DC.*