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WHY SAVINGS ARE SUFFERING: FED QE3 POLICY COSTS SENIORS

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INTRODUCTION

With U.S. and global growth slowing, Federal Reserve chairman Ben Bernanke is pumping more money into the banking system in an attempt to rescue the economy.

This has lowered interest rates, reducing the return from savings. Seniors are particularly hard-hit, because 10 percent of their income comes from interest on savings.

If interest rates were 2 percent rather than 1 percent, the average senior would have an additional $3,200 in income. If rates were 4 percent, the senior would have an additional $9,500. If rates were 6 percent, the senior would earn $15,800 more per year.

Naturally, other parts of seniors' portfolios are positively affected by low interest rates, so the amounts above are not a net gain. For instance, low rates causes the value of equity investments and housing to rise, so seniors' portfolios become more valuable.

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THE ANALYSIS

Chairman Bernanke has led the Federal Open Market Committee to QE3, a decision to buy more bonds, in the hope that a further diminution of already record-low interest rates will have a tonic effect on spending. But it is unlikely that such an action will have any palpable effect on the economy after QE1, QE2, and Operation Twist.

Quantitative easing could work in theory if interest rates were high and in coordination with fiscal policy. But neither of these conditions is true now.

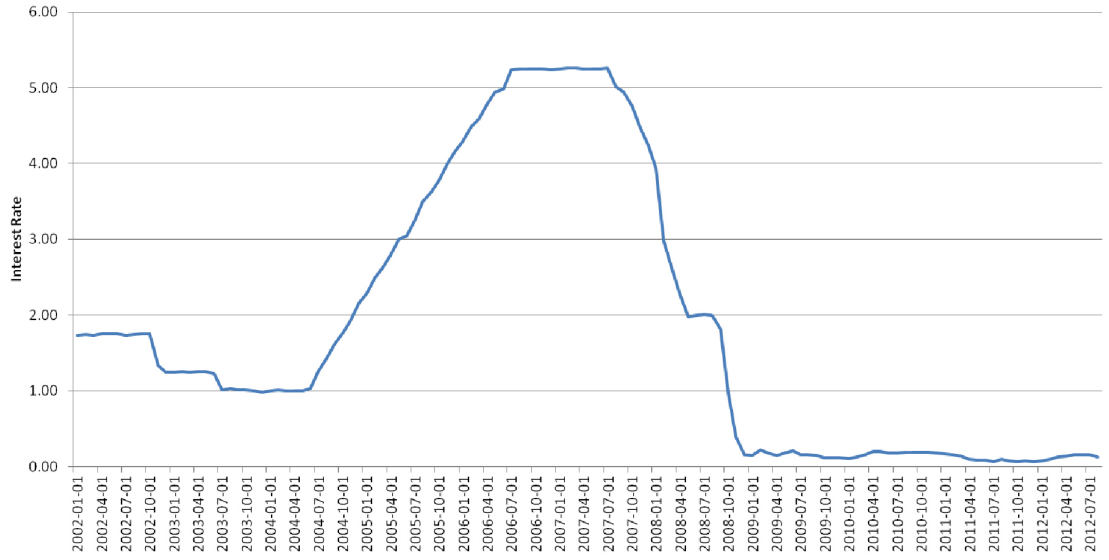
Interest rates have been on a rollercoaster over the last decade. In 2002, the federal funds rate held steady at around 1.75 percent. After decreasing to about 1.0 percent in mid–2004, the federal funds rate climbed to a plateau of about 5.25 percent between the summers of 2006 and 2007. However, from the end of 2007 to the beginning of 2009, the rate declined to 0.2 percent and below, and has hovered there ever since.[1] This is illustrated in Figure 1.

Further, Congress has taken no tangible steps to postpone tax hikes and budget reductions under sequestration due on January 1, 2013. The Congressional Budget Office has estimated that these tax hikes, combined with spending cuts, will cause real GDP to shrink 0.5 percent in 2013.[2] Congress may yet take steps to postpone dramatic budget actions before 2013, but there is no discussion of addressing the underlying causes of budgetary imbalance, much less making fiscal policy in coordination with QE3.

Low interest rates under recent quantitative easing have led to little additional borrowing and investment by households because households have difficulty qualifying for loans, regardless of interest rates. Part of these difficulties are due to new capital requirements, some of which were put in under the Dodd-Frank law. This defeats one of the primary purposes of QE.

Just because QE3 is unlikely to have a major macroeconomic effect, it does not mean that there will not be redistributive effects. Winners include those who want to borrow, as do those who hold equities and

Figure I: Effective Federal Funds Rate, Monthly Average, January 2002-present



Source: Federal Reserve Bank of St. Louis, FRED Economic Data: Effective Federal Funds Rate (DFF), http://research.stlouisfed.org/fred2/series/DFF/downloaddata?cid=118.

commodities—which rise in price in nominal terms. Losers include those who lend and save, because they receive less in interest payments from their assets. Energy users lose, because oil becomes more expensive.

With a continuation of loose monetary policy, Bernanke is further weakening the dollar. A weak dollar policy is no route to economic recovery. If it were, then all that countries would have to do to grow would be to print more money. Rather, a weak dollar policy raises prices of commodities, such as gold and oil, and hurts savings.

The effect of low interest rates falls disproportionately on those who save and who live off of savings. Frugality is punished. Spending—especially on credit—is rewarded. The elderly who have worked hard all their lives to save money for retirement find that their nest eggs do not produce as much income as anticipated. As inflation rises, as it has always done after monetary growth, real savings shrink together with the value of the currency.

Data from the Bureau of Labor Statistics show that people 65 and older receive over 50 percent of their income from Social Security and other retirement accounts, and another 6 percent from "interest, dividends, rental income, other property income." In comparison, people ages 35–44, in their prime working years, receive less than 3 percent of their income from such interest-rate dependent sources.[3]

Princeton professors Brunnermeier and Sannikov argue that the objectives of price stability, financial stability, and fiscal government debt are interlinked because the central bank can become "cornered" by fiscal authorities, who will lobby for government debt to be monetized in order to avoid upsetting voters by cutting back spending, and financial institutions.[4] This can force the bank into an undesirable choice of allowing government debt to default or bending to the calls for fiscal dominance (solving government debt build up by monetizing it) which creates inflation.

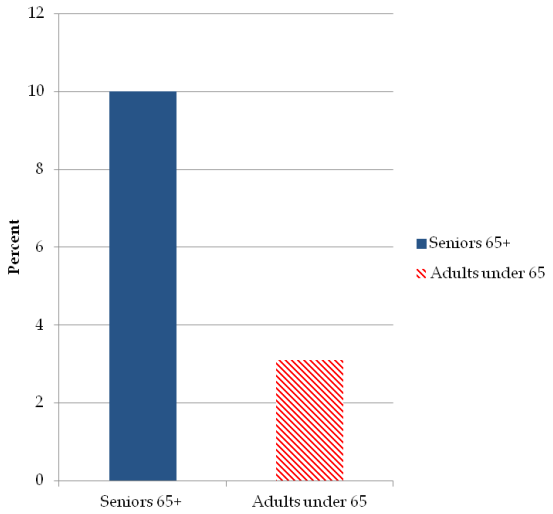
American households, in any income range and in any age range, hold some financial assets. The holdings of financial assets are not limited to simple bank accounts. Some households in every income category

Table I: Distribution of Types of Income by Age Group, 2011

Item	All consumer units	Under 25 years	25-34 years	35-44 years	45-54 years	55-64 years	65-74 years	75 years and older
Income after taxes	$61,673	$27,495	$56,851	$75,537	$75,234	$72,115	$51,161	$31,779
Wages and salaries (percent)	80.8	86.6	94.3	93.3	93.1	76.8	38.4	16.7
Self-employment income (percent)	5.3	2.8	3.4	4.5	4.0	9.8	6.2	2.0
Social Security, private and government retirement (percent)	12.4	1.1	0.6	1.4	3.5	12.9	50.5	72.4
Interest, dividends, rental income, other property income (percent)	2.1	0.5	0.5	0.8	1.3	2.8	5.5	8.0
Unemployment and workers' compensation, veterans' benefits (percent)	0.9	1.1	1.2	0.8	1.0	1.0	0.6	0.4
Public assistance, supplemental security income, food stamps (percent)	0.8	2.2	1.0	0.8	0.8	0.8	0.6	0.9
Regular contributions for support (percent)	0.6	3.7	0.8	0.5	0.4	0.3	0.6	0.4
Other income (percent)	0.4	2.2	0.5	0.3	0.3	0.2	0.3	0.3

Source: U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey, September 2012, http://bls.gov/cex/2011/Standard/age.pdfhttp://bls.gov/cex/2010/Standard/quintile.pdf, and Manhattan Institute calculations.

Figure 2: Share of Income from Interest by Age Group, 2011



Source: U.S. Census Bureau, Current Population Survey, 2012 Annual Social and Economic Supplement.

hold a portfolio of different financial assets, and some of these portfolios are likely diversified. The pattern of savings is relatively invariant to age and macroeconomic conditions.

Federal Reserve Board data show that the pattern of holdings of financial assets by households did not change substantially between economic good times (2007) and weak times (2010–11). However, the net worth of families (households) suffered substantially between 2007 and 2010 except for those headed by individuals above age 75.

Over 90 percent of families in all age groups own some types of financial assets, including checking accounts, CDs, retirement accounts, stocks, bonds, pooled investment funds, and cash value life insurance plans.

Other than checking accounts, the largest category of financial assets is in savings accounts, as would be expected from their tax-preferred status. Almost 60 percent of families with heads of household between 45 and 65 own retirement accounts. For Americans over 65, the percentage diminishes, presumably because they draw down these accounts during retirement. The largest values are in bonds, pooled investment funds, and retirement accounts.

The net worth of families declined between 2007 and 2010 with the recession. Even though families continued to hold financial assets, these were worth less. The percentage of families that saved declined between 2007 and 2010, except for those 75 and above.

Table 1 shows that as Americans get older an increasing share of their income comes from retirement income. Americans 75 and older receive 72 percent of income from Social Security and retirement accounts. The burden of low interest rates and a weakening currency falls primarily on them.

According to data from the Census Bureau, seniors age 65 and over made an average of $3,154 from interest in 2011, and an average of $31,557 in total income. Thus on average, 10 percent of their income came from interest. In contrast, people ages 15–65 earned an average of $1,293 annually from interest, and $41,528 in total income.[5] Only 3.1 percent of

Table 2: Potential Interest Income for Seniors at Selected Interest Rates, 2011						
Interest Rate (percent)	1	2	3	4	5	6
Interest income (dollars)	3,154	6,308	9,462	12,616	15,770	18,924

Source: U.S. Census Bureau, Current Population Survey, 2012 Annual Social and Economic Supplement, and Manhattan Institute Calculations assuming 2011 earnings were based on an average interest rate of 1.0 percent.

income came from interest for people under 65 years of age. This is illustrated in Figure 2.

With the average interest earnings for households headed by people 65 and over at $3,154 in 2011, a higher interest rate would have raised the income of seniors by thousands of dollars. The current interest rate is now assumed to be about 1 percent. Table 2 shows increases in earnings from a range of higher interest rates. At an interest of 2 percent, an average senior would have earned $6,300 annually, a difference of $3,200. At 4 percent, she would have earned $13,000, an additional $9,500. At 6 percent, the highest rate in our range, she would have earned $19,000 annually, $15,800 more than she is earning now.

It should be noted that weakening the currency with low interest rates is often correlated with higher equity and home prices, as these prices rise in nominal terms. Many seniors also hold equities and homes in their portfolios. Although they lose by not receiving as much interest, this is partly offset by increases in other asset values.

CONCLUSION

With fiscal stimulus off the table in a divided Congress, the uncertainty of tax hikes next year, and burdensome regulations discouraging investment, the economy faces substantial uncertainty. Many, including presidents of the regional Federal Reserve banks are worried that more liquidity will accelerate future inflation.

It's clear that political difficulties in America are stifling economic growth. So, people turn to the central bank, hoping that printing money will paper over the problems long enough for another set of politicians to exert more responsible leadership.

But central banks are unable to help in the face of persistently flawed economic policies. Loose monetary policy obscures the underlying problem and hurts savers and retirees.

ENDNOTES

[1] Federal Reserve Bank of St. Louis, FRED Economics Data: Effective Federal Funds Rate (DFF), http://research.stlouisfed.org/fred2/series/DFF/downloaddata?cid=118.

[2] Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, August 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update_to_Outlook.pdf.

[3] U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey, September 2011, http://bls.gov/cex/2010/Standard/quintile.pdf, and Manhattan Institute calculations.

[4] Brunnermeier, Markus K. and Yuliy Sannikov, *Redistributive Monetary Policy*, Princeton University, August 2012, http://scholar.princeton.edu/markus/files/03f%20Redistributive%20Monetary%20Policy.pdf.

[5] U.S. Census Bureau, Current Population Survey, 2012 Annual Social and Economic Supplement.