FINANCIAL REPRESSION - WHAT LOW INTEREST RATES ARE DOING TO SAVERS

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"Financial repression" is any method by which governments use to channel funds to themselves that in a deregulated market would otherwise go elsewhere.

The best way I can describe what is happening with financial repression is to describe it by example. Imagine a widow whose husband and she saved prudently all their lives to be able to live comfortably in retirement. The widow receives social security of $2000 per month. Additionally, based on their prudence in saving, she now has a nest egg of $400,000 in bank certificates of deposit. She has been expecting and used to receiving an approximate 5% return on her deposits (historical long-term return on bonds is 5%). Based on a 5% return, she has been used to receiving $20,000 per year or $1,666 per month on average. With this extra money, she has been able to go out to eat occasionally, buy gifts for her children and grandchildren on their birthdays and at Christmas, maintain her house, get her hair done every couple of weeks etc. Now with deposit rates at 1%, she is receiving only $4000 per year or $333 per month, not the $1,666 per month she was expecting. Her choice is to now spend the principal of her savings or to cut back drastically on her expected lifestyle. Most elderly people I know are scared to death they will run out of money; and therefore, will not spend from the principal. Therefore, they cut back dramatically, which means she will not be able to buy the gifts for her kids and grandkids and maintain her house and do all the other things I described above.

Why is this happening? The Federal Reserve, as a result of the financial crash, has tried to stimulate the economy with unprecedented low interest rates. The idea is that this will stimulate borrowing for homes and cars and will lower debt levels of consumers and finally will inflate values of stocks and houses and lower quality bonds as investors are forced to take more risks to get any return or yield. Although this has some logic, it minimizes the effect of what low interest rates do to savers, like the widow described above. The widow's spending does not go up, it goes down. When the crash first occurred, the Fed's action made sense, but now it seems to be "pushing on a string".

In addition, when the government keeps rates much lower than inflation, as mentioned above, it hurts savers, but it helps borrowers. Since the government is the biggest borrower with $16 trillion of debt, low interest rates lower the effective cost of the debt which allows it to borrow more. If interest rates are 3% too low right now, that saves the government nearly $500 billion per year in interest. This is basically a tax on savers to that transfers savers expected return to the government. Also, effectively printing money to buy an unlimited amount of government bonds and keeping rates near zero could lead to inflation or even hyper-inflation down the road, which also effectively steals from savers but also effectively lowers the value of the government debt as dollars become worth much less.

With the Federal Reserve announcing that interest rates will stay nearly at zero until at least 2015, I believe they have gone too far, which will lead to unintended consequences down the road of another bubble or hyper-inflation.

Although I can't change what is happening to savers, at least you now know if you have been a saver that you are a victim of "financial repression".

Remember every investor's situation is unique; and it is important to review your specific situation with a financial professional.

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