How Would Negative Interest Rates Impact Retirement Security?

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The answer is a little complicated; it depends on where you are in the life-cycle.

The press keeps asking how zero or negative interest rates would affect retirement security. Here's my answer, and I'm sticking with it until someone corrects me.

The answer depends on a person's stage in life.

Those starting out their careers would be affected in two ways. The bad news is that they would have to contribute more to their 401(k) plan to accumulate a pile big enough to generate the income required to hit their target replacement rate. The good news is that they would be able to borrow more cheaply, which means that it would cost them much less to acquire a house – the other major way people accumulate assets at retirement. By paying off their mortgage, homeowners increase their home equity, creating a resource they could – but alas don't – tap to supplement their retirement income. So, my sense is that the impact is mixed for the young.

Now consider those in mid-career, say age 50, who have been accumulating assets in their 401(k) and therefore hold a mix of stocks and bonds. If interest rates decline then bond prices rise. Similarly, to the extent that equity prices reflect the present discounted value of future earnings, a lower discount rate should increase equity prices. So the good news is that the value of assets in their 401(k) accounts would rise. The bad news is that, going forward, they would have to increase their 401(k) contributions to achieve their target replacement rate.

Finally, we have people just approaching retirement, who have made their savings decisions on the basis of higher returns. In a zero interest-rate environment, they would suddenly find that their assets are not going to provide the level of income they had expected. It seems to me that they would be in an unambiguously bad spot. They would have three options. The first is to work longer than they had planned and get a higher benefit from Social Security. The second is to cut down on how much they had planned to spend in retirement. And the third is to recognize that their house is also a retirement asset, and that they can tap their home equity by taking out a reverse mortgage (which like other loans will be cheaper than before), selling their house and buying a cheaper one, or taking advantage of property tax deferral programs.

This somewhat long-winded answer indicates the story is complicated. It really doesn't yield itself to sound bites. And that's before considering the macro picture. If the world would have fallen apart had the Fed not dramatically lowered rates, then everyone is better off than they would have been slogging through a prolonged deep recession. At the same time, if the concern is the nation's fiscal health – as the President's tweet about this subject suggested – it can be managed much more effectively by matching revenues with outlays than by targeting a zero interest rate.