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The downside of low inflation

Savers see smaller returns and no increases to contribution limits on retirement accounts

By Eileen Ambrose, The Baltimore Sun

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Low inflation is a welcome economic sign for spenders, but for savers, it can be too much of a good thing.

The effect of super low inflation could be seen in recent days when the government announced changes to savings bond rates and retirement account limits that are pegged to inflation.

Savers can now expect meager returns on the inflation-protected Series I Savings Bonds, if they even still want to buy them. And employees won't be able to sock away more next year in a 401(k) or similar workplace plan, a setback if they're trying to make up for lost time or low returns.

The Bureau of Public Debt on Monday released the new rates for I Bonds being sold from November through April. The I Bond is made up of two rates: A fixed rate that's set by the Treasury for the life of the 30-year bond and an inflation rate that's adjusted every six months.

The I Bond's fixed rate — for the second time in its history — will be zero. So that means anyone buying an I Bond in the next six months will only receive the inflation rate component for as long as they hold the bond. And the inflation rate they will receive during the first six months of ownership will be an annualized rate of 0.74 percent. (If you buy a Series EE Bond within the next six months, you will receive a fixed annual rate of 0.60 percent for the life of the bond.)

Stan Richelson, co-author of "Bonds: The Unbeaten Path to Secure Investment Growth," says it's difficult to even recommend an I Bond these days given the poor interest rate and low purchase limit. You can buy up to $10,000 in I Bonds annually — $5,000 electronically and $5,000 in paper form.

Still, Richelson says, the I Bond could be a good investment under the following conditions: Inflation rises, you can hold the bonds for at least five years so you don't forfeit any interest for cashing them in early, and you're saving for a child's college education.

That's because the interest earned won't be subject to income tax if used for college, provided your adjusted gross income is under $85,100 for singles and $135,000 for joint filers.

In addition, the inflation rate determines each year how much you are allowed to set aside in tax-friendly retirement accounts at work.

The IRS announced last week that the maximum contribution to a 401(k) and similar accounts would remain at $16,500 next year because of low inflation. Maximum catch-up contributions for workers 50 and older also will stay the same at $5,500.

"In a nation of people woefully undersaving for their own retirement, it's definitely a roadblock to ramping up savings, even if the percentage of people who max out on those contributions is pretty small," says Greg McBride, senior financial analyst with Bankrate.com.

Low inflation tends to go hand-in-hand with low interest rates. And low rates on traditional bank savings accounts have been a further frustration for savers.

Steve Thalheimer, a financial planner in Silver Spring, says clients frequently ask him where they can park emergency savings to earn a higher return.

"They think there is some magical place where they can put their savings and earn 3 percent," Thalheimer says. "There is nothing."

If you want safety above all else, you will have to settle for really low returns, McBride says. "If you are willing to take a little bit of risk, you can raise that return," he says.

Investors, for instance, can supplement low returns on savings accounts with income from dividend-paying stocks, real estate investment trusts and high-quality domestic and international bonds, McBride says.

If all this make you hope for higher rates soon, be careful what you wish for.

People who lament that CDs once paid 14 percent forget inflation was 12 percent, McBride says.

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Shopping for better rates

•If banks in your backyard pay too little, look for higher rates at institutions around the country that have an online presence. Bankrate.com lists federally insured institutions that offer the highest rates on certificates of deposit, checking and savings accounts.

•Consider reward checking offered by some institutions. The accounts typically pay 2.5 percent on balances of up to $25,000. To qualify, you generally must make regular deposits and undertake a certain number of debit card transactions each month.

•Check out credit unions, which tend to offer higher rates than banks.