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The Age-Old Problem Of Low Interest Rates

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Earlier this year, Michael Walker of the Fraser Institute in Vancouver, Canada released a paper that deserves the attention of everyone interested in the subjects of central banking, inflation and interest rates. In it, he makes a claim that could fundamentally change our understanding of monetary economics: An aging population (think of Japan, Germany and most of the EU) inevitably creates a "borrowers market" where interest rates fall to encourage more borrowing and to discourage saving. When examining monetary policy, demographics matter.

In his paper, Walker applied his model to 29 countries that produce 90% of the world's GDP and created a saver/borrower ratio, "which is the total fraction of the population between the age of 50 and 74 divided by the fraction of the population aged 0-49. Low values of the ratio indicate the country has a 'savers market' while higher values indicate a 'borrowers market.'"

Generally speaking, the higher the saver/borrower ratio, the lower the interest rate.

In a paper published in the latest issue of the Cato Journal, I asserted that the world's major central banks have lost control of both interest rates and inflation. The views I offered in that paper were heavily influenced by my numerous discussions with Walker as he was writing his paper. Essentially, Walker is challenging everything that has been taught about monetary theory, central banking, interest rates and the causes of inflation for most of the past century.
Why central banks have failed to achieve higher inflation rates

This will be upsetting to many people, but they should at least carefully read and reflect on the arguments and evidence presented as they seek a better understanding of why central banks have failed to achieve the higher inflation rates they have set as targets. It might serve as food for thought for the Federal Reserve.

The U.S. central bank announced last December that they were embarking on a program to raise interest rates over the course of this year. The result has been across-the-board lower market interest rates. If the central bank wants higher interest rates, why are they powerless to achieve that objective?

The Walker paper presents a framework—and empirical evidence—that explains what has been going on in financial markets in terms of global demographic trends that are totally independent of any actions taken by monetary authorities. Because Japan was the first major country to experience rapidly aging (and ultimately declining) population, it was the first country caught in a low-interest-rate, low-inflation, low-growth trap. The Bank of Japan has monetized an enormous amount of government debt through their version of quantitative easing, with no effect at all. In fact, in my Cato paper I assert that QE has been perverse—actually contractionary rather than expansionary to economic activity.

If the analysis and evidence of the Walker paper are correct, the "negative interest rates" now imposed by the Bank of Japan and European central banks will not only have no stimulative effect, such policies will also exacerbate the economic problems they seek to address. The evidence is mounting that actions by monetary authorities to stimulate real economic activity by "easy money" and eroding the purchasing power of their currencies are doomed to failure.

The "pursuit of profits" in the private sector is virtuous

None of this says governments are powerless to promote higher standards of living; it does say that further delays in fundamental structural, tax and regulatory reforms—while waiting for monetary policy to get the job done—is time wasted. Real interest rates can rise again—when risk-adjusted, real rates of return on new investment opportunities available to entrepreneurs start to rise again.

The Walker analysis implies that the supply of earning assets (stocks and bonds) offered by private sector investors to savers must increase dramatically in the face of adverse demographic trends in which potential savers/lenders are swamping potential borrowers. For that to happen, improved productivity (and potential profitability) trends must be strong enough to overwhelm the unavoidable adverse demographics of aging populations. Government policies can help bring that about if they remove much of the sand-in-the-gears caused by anti-growth regulatory, tax, labor law and environmental policies that have been put in place in recent decades.

The things that must be done are very difficult and will require exceptional political skill and leadership. Selling to the public the idea that the "pursuit of profits" in the private sector is actually virtuous and should be encouraged will not be easy. However, the alternative "easy way out" of undermining the purchasing power of money has not worked and will not work.