Demographic Trends: The Case Against Negative Interest Rates

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Japan has a 2.2% unemployment rate, yet, for 30 years, they have not had any significant economic growth, due to their demographic structure. Today, the developed world has Japan's 1990s demographic features, with falling fertility rates, rising dependency ratios (retirees/working aged), and, ultimately, declining populations. Under these conditions, aggregate GDP growth will be harder and harder to achieve.

QE's "Wealth Effect"

All the central banks of developed economies have adopted the Fed's (Bernanke's) Quantitative Easing (QE) policies. These rely chiefly on the "wealth effect" to spur economic growth. Economists have long recognized that the transmission mechanism of the "wealth effect" is quite weak. The wealthier segments of society hold the bulk of financial assets, and they are the major beneficiaries of QE's "wealth effect." Because the wealthy have a very low marginal propensity to consume, QE's transmission to the general economy is quite weak. A side effect of QE is a widening wealth gap between the upper 10% and the rest of the society. This has now become a political issue that has the potential to significantly change the free-market capitalist system.

Much of today's policy dilemma stems from the universal belief among politicians, business-people, academics, etc. that economic policies must be aimed at achieving aggregate economic growth, i.e., the real aggregate GDP must have positive growth. If it doesn't, then we have the "R" word, and drastic measures, like QE, or massive budget deficits, become the policies of choice.

Future Economic Growth

But, as the developed world's demographics become more and more like Japan's, potential economic growth will disappear; it may even become negative. Imagine the damage as policies like QE and deficits attempt to squeeze blood from a stone! It could be that those policies end up causing the ridiculous notion of negative interest rates, as they already have in the EU, with huge negative implications for financial institutions including life insurers, pension funds, and banks.

What we have today is slowing world growth, and with each passing week/month, the data continues to weaken. This is occurring with unemployment rates at or near historic lows. For example, U.S. unemployment is 3.5%, not seen since 1969; China's is a record low 3.6%; the EU is 6.2% (low for them); and, as mentioned earlier, Japan is at a low of 2.2%. Today's slowing growth certainly is partly attributable to the trade issues, but let's recognize that the current economic expansion has been the weakest in the post-WWII era, most likely related to the demographics of the developed economies.

The Data

Here are some of the latest data showing continued economic weakness:

- China's real Q3 GDP growth sank to 6% Y/Y (official figures), down from 6.2% in Q2, and the slowest since their record keeping began (1992).

- Industrial Production and Retail Sales in China are also in a downtrend. As of September, exports are down -3.2% Y/Y as are imports (-8.5%). Worse, exports to China from major trading economies like Japan and So. Korea are down double digits.

- Germany (4th largest economy) and the UK (5th largest) look like they have slipped into recession.

- Q3 S&P 500 earnings are now estimated at -4.7% Y/Y (Factset); yes, even despite the glee that markets get when companies "beat" analysts' softball estimates (it's a game Wall Street plays every quarter). As of this writing, with 89 reporting companies, Y/Y earnings growth has been –2.9%.

- The Cass Freight Index fell-3.4% Y/Y (Sept.), the 10th straight month of contraction. Here is what was in the Cass report: "We see a growing risk that GDP will go negative by year's end."

- U.S. Retail Sales fell -0.25% M/M (Sept.). They are still positive +4.1% Y/Y. But, remember, it is the margin and the trend that count. Auto sales were down -0.9% (-$1 billion).

- IMF's global growth forecast for 2019 is now +3.0%, down from +3.6% six months ago, and the slowest growth forecast since 2009. In a related IMF study, the authors concluded that 40% of global business debt is at risk of default in a recession scenario; that includes the U.S, China and Europe.
- Housing Starts fell -9.4% M/M (Sept.). The culprit was multi-family starts (-28.2% M/M). These are down -5.1% Y/Y. Single-family starts were barely up (+0.3% M/M). Building permits, always a leading indicator for this industry, fell -2.8% M/M. Existing Home Sales in September also contracted -2.2% M/M.
- U.S. Industrial Production (IP) (Sept.) was soft (-0.4% M/M). IP is -0.2% lower Y/Y; not a good sign. Capacity utilization continues to fall, down -0.6% M/M to 77.5%.
- Finally, the trade-war truce continues to be elusive despite Wall Street's cheerleading. It appears that the "hostilities" are still on with a "cease-fire," perhaps, in the making. But even if a "Phase 1" deal is signed, this is simply the avoidance of additional pain, not a significant reversal of what is currently in place and what has negatively impacted the world's economies.

Is This Time Different?

The question is, "Is this time different?" Put another way, are the low unemployment rates in the developed economies low because they are lagging economic indicators that will soon start to rise, or are they low because demographics have changed the paradigm (i.e., not enough working aged population)? If the former, then traditional policy approaches (easy money and deficits) might be appropriate. But, if demographics have changed the playing field, then the traditional policy responses may end up doing irreparable harm in that low/negative interest rates and huge budget deficits simply add more to an already top-heavy debt burden.

The European Central Bank (ECB) has adopted QE once again now buying €20 billion/month. The Fed is now providing $60 billion/month in balance sheet expansion. This looks and acts very much like QE despite Fed Chair Powell's protestations. While the Fed is hesitant to admit it, policy looks very much like it has shifted from "neutral" toward "ease." The Bank of Japan (BOJ) continues to support negative interest rates there, targeting 0% for their 10-year bond, and indicating a further move toward even lower rates.

Clearly, the world's central bankers still believe that today's economies react similar to those typical of the post-WWII era. But, it is possible and even likely that today's demographics allow slow growth and/or recession without significant negative impacts on employment. If this is the case, negative interest rates are likely a colossal blunder!

About the Contributor

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