Government spending can't solve Canada's demographic problems

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We all know that Canada had a postwar baby boom whose consequences continue to affect us even today.

In the 1970s and 1980s, boomers were entering the labour force. As a result, unemployment rates were stubbornly high, driven mainly by youth unemployment. That was inevitable. Also inevitable was the increasing political pressure to bring these rates down. Seldom have Canadians seen as much political unity around a single policy objective.

In an attempt to create new jobs, the government threw money at the economy by running deficits. What resulted was the addition of inflation to the inevitable unemployment, thus creating "stagflation." The annual cost of living rose by 5 per cent or more in most years of the 1970s and 1980s, reaching double digits in the early 1980s. However, the overall unemployment rate did not fall. In fact, it rose consistently through the 1970s and exceeded 9 per cent from 1982 to 1986 inclusive, peaking at 12 per cent in 1983. This policy was doomed to failure by the demographic reality into which it was forced.

Who was hurt? Borrowers, many facing double-digit interest rates on their mortgages and loans. Bond rates exceeded 15 per cent in seven of those turbulent 20 years, although after paying income taxes and subtracting inflation, savers often netted negative rates in the majority of their fixed-income investments.

Fast forward to 2015. We are now on the other side of the demographic mountain. The baby boomers are just starting to retire. With this exit of workers from the labour force, it is extremely difficult to achieve high rates of gross domestic product growth. This negative pressure on the economy is just beginning and one can expect it to remain at least for the next 15 years.

But, again, we see mounting political pressure to solve what is basically a demographic (and thus mostly intractable) problem. Again, the political attempt at a solution has been to throw money at the economy in the form of quantitative easing, first in the United States and now in Europe. Will Canada be next?

This has not created inflation because most of the boomers are no longer borrowers and spenders. They are now increasingly holders of assets and are trying to create cash flow for their retirement and consumption needs. What has resulted are rising asset prices and some of the lowest nominal rates of return that we have ever seen in Canada and the world. Some European bonds are now paying negative rates of return. And the price of longer-term bonds indicates that the market sees no expectation of a rise in these rates.

So, who is being hurt? Savers, including institutional savers such as pension funds and insurance companies. Bonds are the most appropriate investment for pension funds and it has become extremely difficult for individuals and institutions to earn anything close to acceptable rates of return to fund current and future retirements. Low interest rates also increase pension-fund liabilities by increasing discounted future benefit promises

While this is the first layer of "victims," we may all be victims of quantitative easing and low interest rates, ultimately. Why?

If Canada's retirees cannot make a reasonable return on their assets, then there will be several inevitable consequences. They will pay less income tax (so others may have to pay more). They will have less income to spend in our communities on goods and services, thereby slowing growth and job creation. Poverty will rise. More of them will be dependent on old-age security (OAS) and the guaranteed income supplement (GIS).

While one in three Canadians now receive at least a partial GIS, this proportion will inevitably rise. And unlike the Canada Pension Plan or Quebec Pension Plan, neither OAS nor GIS have any contributions from earnings of active workers. They are paid for in total by tax dollars that have to come from today's taxpayers. That means we are passing a real burden to our children and their children. And this will only get worse as life expectancy increases and the number of workers in defined-benefit pension plans shrinks.

Moreover, inflated asset prices (equities, housing and the like) have especially benefited the wealthy, thus contributing to rising inequality that, according to the Organization for Economic Co-operation and Development and others, further impedes economic growth.

So while some may argue that quantitative easing and low interest rates are the right approach to current economic problems, we need to understand the context and the full force of the consequences – especially in the face of the unique demographic situation in which we now live.

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