# Turn Up the Economic Heat

Reprinted from *The Globe and Mail*, December 10, 2001. p. A17

**By David K. Foot**

As Paul Martin presents his budget today, he faces a challenge. The Governor of the Bank of Canada has attempted to get the economy going again by choosing to lower interest rates, but it hasn't worked. From the federal government's perspective, a low-interest policy has the additional advantage of reducing interest payments on the debt (resulting in decreased expenditures and avoiding a return to deficits).

Nonetheless, despite recent encouraging sales in automobiles and residential housing -- two interest-sensitive sectors -- past interest rate cuts have been ineffective in achieving their stated goal of getting the economy moving. The same has been true in the United States, which officially declared last week that a recession began in March.

Many reasons have been suggested for the current ineffectiveness. Most focus on the fact that everything has changed since Sept. 11. Consumers have become skittish. They have gone into a shell. Perhaps they are cocooning again, reluctant to come out and spend. Other explanations mention the evaporation of the wealth effect on spending as stock markets tanked; or on the reluctance of investors to borrow and build for the future in these uncertain times. Perhaps it is still too early to see the impacts of interest-rate cuts on consumer and investor behaviour.

But perhaps there is a much more subtle and fundamental reason -- demographics. We are all aware that we live in an aging population, but the linkage of demographics to interest rates and the economy appears to have escaped our policymakers' attention.

As individuals, our response to interest rates depends on where we are in our lives. Generally, we borrow when we are young adults -- first for our education in our late teens and early 20s; then for autos and furniture as we leave home to establish our own households in our later 20s; then for mortgages, appliances and furniture for our first homes, usually in our early 30s.

In these times, interest rates really matter to our spending decisions. We may still borrow at high rates, as the boomers did in the 1970s and 1980s, not because we want to, but because we are at that stage when we have to. Any reduction in rates is greatly appreciated and can lead to a major impact on spending decisions.

As we move through our 30s and 40s, we do what every borrower does -- pay back our loans. This means we gradually build our assets as we own more and more of our houses, autos, furniture and so on. We also try to begin to build our nest eggs for retirement, either through an employee pension plan or through our own RRSPs, and by purchasing mutual funds and stocks. At these ages, we are still raising our children -- which doesn't leave much income for saving.

This is what the boomers were doing over the 1990s. They were raising their Echo children, paying down their debts, building up their material assets and worrying about their pensions. Their households were consuming most of the family income. Retirement seemed like a forgotten dream and "Freedom 55" looked like a public-relations exercise rather than a remote reality.

In this part of our lives, interest rates are important for how fast we pay down the mortgage, credit card and other debts. Lower interest charges can provide more family income to spend on basics, such as food and clothing, or on discretionary items like holidays and toys. The decline in interest charges over the 1990s, caused in large part by lower demand for money as fewer boomers were in their prime

borrowing ages, were a boon to the boomers. They spent their interest savings on themselves and their families and the economy boomed.

However, the economies of North America are now experiencing another demographic shift in the new millennium. The first boomers, born in 1947, reached age 53 in 2000. Their children are leaving home, some are in college and university, and grandchildren are on the horizon. The boomers are entering the next phase of their lives.

This phase is often referred to as the "empty nest." Household expenditures inevitably start to decline as the children assume more and more responsibility for their needs and leave to establish their own households (or so we hope). Retirement is closer, but will we have enough money? It is in our 50s that the reality of saving for the retirement years can no longer be postponed or a comfortable retirement really will be a dream.

Now higher, not lower, interest rates are preferable because interest is no longer a cost, but rather income that we can pour back into our savings. Retirement is foremost in the mind, not spending -- except, perhaps, on the grandchildren.

By this stage, most own the essentials for a comfortable life. Lower interest will only have a minimal impact on replacement decisions. But interest is often the income that is used to fund discretionary expenditure items like holidays and leisure activities. Lower interest rates are no longer an encouragement. Instead, they become a penalty to spending in the economy.

There are more than 10 million boomers in our population of more than 30 million. The impact of the birth control pill introduced four decades ago means that they had fewer children. As a generation, they did not even replace themselves, having only seven million Echo children.

Today a majority of our population (54 per cent) are boomers or older (35 years and over); 29 per cent of the population is now 50 and older -- the highest level in Canadian history.

Back in 1961, at the height of the boom, there were 59 working-age adults over age 50 for every 100 under age 35. By 1981, this figure had fallen to 50 as the boomers entered their young working years. But by 2001, the ratio had ballooned to 78 (having bottomed out in the mid-1980s).

And we haven't seen anything yet. Over the next decade, the ratio of older (50 to 64) to younger (20 to 35) working-age adults increases to 103, even though the Echo children become young workers. The impact of the boomers more than offsets the impact of their children. This ratio continues to increase to 110 by 2021.

As the millennium unfolds, there are more older working-age adults above the age of 50 than younger adults under 35. The figures are similar for the United States, which also has a boom, bust and echo profile. It is for the same reason that recent interest rate cuts have been ineffective in stimulating the economy south of the border as well.

Interest rate cuts stimulate expenditures by borrowers and penalize the income of savers. An aging population results in a reduction in the number of borrowers and an increase in the number of savers. The massive boomer population in North America is now entering prime saving ages. Even those who are not yet there are in their 40s, beyond their prime borrowing ages.

In this new demographic world, interest rate cuts are increasingly ineffective in boosting the economy. Our senior decision-makers should not be surprised that numerous successive interest rate reductions over the past year have not stimulated spending. The demographic environment has changed forever.

---

David K. Foot is a professor of economics at the University of Toronto, and co-author of the Boom, Bust & Echo books.

 Reprinted from *The Globe and Mail*, December 10, 2001, p. A17.