

# Why Are Interest Rates So Low?

## A Framework for Modeling Current Global Financial Developments

by Michael A. Walker

This paper is the latest version of my attempt to convey to others the sense of a model and my understanding about current financial markets that I have been developing and using for my own financial planning and my advice to others since 2009. It is an amalgam of some simple observations and statistical regularities with some comments about the economic theory toolbox that is in widespread use but which is not functional in current circumstances. One of my economist mentors and a founding member of the Fraser Institute's Editorial Advisory Board, Harry Johnson, used to say that most things about economics are simple; the problem is to recognize simplicity when you see it.

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At the core of this paper are a few simple observations. The first is that while the virtues of saving and the evils of indebtedness are widely understood and universally supported, the fact is that every saver who wants to earn a return needs a debtor as an accomplice. Because of the anonymity of financial institutions, the connection is not appreciated and indeed most people taking a loan or a mortgage think they are getting it from the bank or credit union. Of course, they are getting it from a saver/depositor who needs the borrower as much as the borrower needs the saver.

The second observation is that our theories or models for describing whole economies rely on the extrapolation to the national level what we observe in the behavior of individuals. So, the standard theory about interest rates and saving is based on how an economy would behave if it were the simple aggregation or summation of all households on the assumption they all behave like a typical household. As long

as the typical household is representative, that is not a problem. However, there is strong reason to believe that in the current economy of the world, typicality, if I can call it that, has broken down; as a consequence, the inferences made using the standard model are incorrect.

The third observation, though not so obvious, is that the only time the representative household model will work for understanding interest rates and most likely for other economic magnitudes is when there is constant population growth. Constant population growth ensures that there will always be a "typical" relationship between borrowers and savers. That typical relationship is that there is always a greater volume of incipient borrowing than incipient saving. So interest rates perform the function of "rationing" the number/volume of borrowers/borrowing to pair up with the smaller number/volume of savers/saving or encouraging more savers/saving to occur. The paper explores the impli-

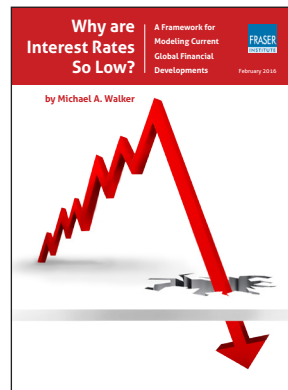
cations for interest rates when, as at present, population growth is not constant and when, as a consequence, a relative shortage of borrowers emerges as saver cohorts dominate the population.

The conclusions are that:

- 1) Interest rates in the 29 economies that make up 90 percent of the world's GDP are low because—and to the extent that—these economies are experiencing a dearth of borrowers and hence a relatively high saver-to-borrower ratio;
- 2) The dearth of borrowers has removed the power of monetary policy to increase the inflation rate in many countries because the potency of monetary policy as currently operated is derived from loan growth in the banking system;
- 3) The Japanese deflation experience has been badly misdiagnosed because the standard model used in the diagnosis does not work in Japanese demographic circumstances;

- 4) The world's largest economies are rapidly approaching Japan-like demographics—and the deflationary implications of that situation;

This paper explores various implications of these main points and performs several statistical tests that support the paper's findings.



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*Demographically derived Saver/Borrower Ratios for the US and Japan 1920 - 2010*

