The great demographic reversal and what it means for the economy

The rise of China to the status of economic superpower has been the dominant narrative of the last three decades. China's rise as the main feature of globalisation, in conjunction with a beneficial sweet spot in demography, drove output up and inflation down in the advanced economies. But these trends are now reversing. China's economic success depended on many factors, a strong historical social and cultural background, political single-mindedness, a flexible and competent labour force, fed by internal migration, capital controls, developing satisfactory infrastructure and absorption of Western technological know-how. But China's greatest contribution to global growth is now past. Its working age population is now shrinking, while the ranks of the old expands.

This great demographic reversal will lead to a return of inflation, higher nominal interest rates, lessening inequality and higher productivity, but worsening fiscal problems, as medical, care and pension expenditures all increase in our ageing societies. Below are key points in our new book. They are the executive summaries of some of its chapters.

Output growth will decline

The surge in the labour force working in the world's trading system in previous decades is now reversing. The ratio of the retired-old to workers will worsen, as longevity out-distances retirement age, particularly in those countries which earlier grew fastest. Overall output growth depends on a combination of the growth rate of the working population and their productivity. With the former declining, unless offset by a major rise in the participation rates of the elderly, growth has to be based on higher productivity per worker. While there are some reasons for hoping that we may improve on recent disappointments on this latter front, we are reasonably confident that overall output growth will now generally decline.

Dependency, dementia and the coming crisis of caring

Extra longevity is not such a boon if it is accompanied by enhanced morbidity. Ageing leads to a greater incidence of neuro-degenerative diseases, e.g. Alzheimer's and Parkinson's. Unlike their success with cancer and cardio-vascular ills, medicine has been largely unsuccessful in dealing with dementia; research, diagnosis and treatment are all under-funded and unsatisfactory. The costs of such diseases are bound to grow rapidly, partly by diverting a growing proportion of the available workforce into care for the dependent old. Even then, the availability of properly trained carers will probably be insufficient, leading to a greater burden for the affected old and their families. Combine this with the rising age of having children and the result is a markedly changing life-cycle pattern, one that we argue will reduce the household savings ratio.

The resurgence of inflation

The great demographic reversal and the retreat from globalisation will bring back stronger inflationary pressures – this is our highest conviction view. Worsening dependency ratios naturally raise inflation. The lesser availability of labour at home and abroad will serve to restore the (previously diminished) bargaining power of labour. It will also end up raising the equilibrium natural rate of unemployment. Households will save less, and invest more in housing, than some mainstream models suggest. The non-financial corporate sector may have to invest more to hold down unit labour costs, though we are agnostic about the various causes for recent low investment rates. But we doubt that politicians, facing rising health and pension costs, will be prepared or able to raise taxes enough to equilibrate the economy via fiscal policy.

The determination of (real) interest rates during the great reversal

The rising inflation that we foresee in the future will raise nominal interest rates, but not necessarily real interest rates. There are multiple factors influencing the equilibrium real interest rate, r*. We doubt whether the prospective slowdown in world growth will depress r*. While slower growth will tend to reduce both ex ante saving and ex ante investment in the private sector, we tend to believe that savings will fall by more. If so, the public sector should ideally move back towards primary surplus to balance the economy. But rising health and pension costs, and the political unpopularity of tax increases, will hinder that. Political pressures may force central banks to hold short-term rates below the level consistent with inflation targets, thus keeping short real rates low, while market pressures lead to stronger increases in long rates, both nominal and real. The yield curve will become much more upwards sloping.

Inequality and the rise of populism

After two centuries of growing global inequality, faster growth in Asia compared to the West has seen this trend start to recede. Inequality *within* countries, however, has generally risen, though perhaps more in perception than in fact. The allocation of responsibility for this, between technology, growing monopoly power, and the surge in labour supply due to globalisation and demography, is complex and uncertain. One might have expected such rising within-country inequality to benefit left-leaning political parties, (and it did in Latin America). But in North America and Europe it has led to rising support for right-wing, populist parties. We attribute this largely to the public's distaste for large-scale immigration. Immigration is an issue that sharply divides the views of mainstream economists, who mainly welcome it, and the public at large, who want it to be restricted.

A switch from debt to equity finance?

The best way to reduce excessive debt leverage, and perhaps to rescue capitalism, is to remove the fiscal advantages of debt over equity finance. There should be a greater equity element in both housing and student financing, and the public sector should start issuing nominal income bonds. But the main change should occur in corporate finance. Here there are two proposals on the table, an allowance for corporate equity and destination-based cash flow taxation. A general problem, however, is that the remuneration and incentive structure for corporate managers encourages them to maximise the return on equity (RoE), which is most easily achieved by increasing leverage. We suggest a reformulation of limited liability for those equity holders with the power to influence corporate strategy, in order to mitigate this concern.

Future policy problems: old age and taxes, and the monetary-fiscal clash

Demographic trends will place increasing pressures on public policies, fiscal and monetary. An ageing society will require greater medical and pension expenditure, just as a declining workforce is slowing output growth, and hence taxable capacity. We consider four ways for enhancing taxable capacity: 1) reforming the basis of corporation tax; 2) land value taxation; 3. a carbon tax; 4) destination-based cash flow tax.

But we doubt whether politicians will be able to raise taxes enough to equilibrate the economy. Hence inflation will rise. That will lead central banks to raise nominal interest rates in pursuit of their inflation targets. In turn, that will put them at loggerheads with ministers of finance and prime ministers/presidents, especially those of a populist inclination. In any such conflict between politicians and central bankers, we would back the former to win – that conflict has already begun.

Swimming against the (main)stream

From 1750 until 1950 inflationary expectations, and nominal and real interest rates, remained roughly constant, in the UK at least, while inflation was a function of occasional wars and the vagaries of harvest. After the 1950s there was a strong upwards trend in inflation, inflationary expectations and nominal interest rates (1950 – 1980), followed by an extraordinary downwards trend in inflation, inflationary expectations and both nominal and real interest rates (1980 – 2020). The earlier trend can be ascribed to a doomed, but well intentioned, attempt to keep unemployment below its rising natural rate, with the monetary regime allowing that to happen. We ascribe the subsequent downwards trend to underlying demography and globalisation factors. Given the expansionary intent of monetary policies, it is hard to claim that such disinflation was a monetary phenomenon. But in that case the forthcoming reversal of the previous demographic and globalisation trends should lead to a revival of inflation and nominal (but not necessarily real) interest rates. But this view is at odds with most current mainstream analysis, even of those who do focus on demography, who generally continue to foresee secular stagnation, 'lower for longer'. We outline why they differ from the mainstream. Our view of the future is not encouraging, but it is coherent and plausible.

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Notes:

- *This blog post is based on executive summaries of the chapters in the authors' book The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival, co-written with Manoj Pradhan.*
- *The post expresses the views of its author(s), not the position of LSE Business Review or the London School of Economics.*
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