Demography versus Debt

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During the decades between the 1980s and the 2000s, most of the world, both the developed (DM) and emerging market (EM) economies, absorbed the largest positive supply shock to the worldwide labour market that has ever occurred. This comprised two main elements; first a demographic trend resulting from a decline in both birth and death rates that led to a temporary surge in the ratio of those in the working age group, relative to dependents, both young and old; and second the opening up of previously closed Communist economies, especially China but also Eastern Europe, to the world trading system.

Such demographic forces played a major role in the following trends during this thirty year period:-

i) Off-shoring, and a shift of manufacturing production to N. Asia, especially to China;
ii) Stagnation, or sometimes even decline, in the real wages of median workers;
iii) A collapse in membership and power of Trade Unions in the private sector;
iv) An increase in inequality *within* countries, but a decrease in inequality *between* countries;
v) Deflationary pressures, at least initially, until China's growth drove commodity prices upwards;
vi) Trend decreases in both nominal and real interest rates.

But now these demographic trends, which have been so favourable for the 1%, but not so for the lower 90% in the income distribution, are rapidly turning around. The growth of the working population will fall, in some cases absolutely, (China, Germany (unless massive migration continues) and in almost all cases (except the sub-continent, especially India, and Africa)), relative to the growing massed ranks of the old. The ratio of dependents to workers will rise in virtually every DM and EM country.

This might seem to indicate a likely reversal of the previous trends, thus,

(i) A reversion to national production, (less free trade);
(ii) Rising real wages, and greater labour power;
(iii) Less inequality within countries;
(iv) More inflation; not only will unit labour costs rise, but taxation will have to rise sharply to pay for the medical services and pensions of the old;
(v) Higher nominal, and perhaps, real interest rates.

Mitigants to this picture of reverse trends, include the following:-

i) The age of retirement may rise and the relative generosity of support for the old may fall. Perhaps, but politically difficult. The old will hardly vote for it.
ii) Robots may take over the world, so the wages of the less educated may remain submerged for ever. Actually the predicted relative fall in working population is so great that we will need much more robotics. Largely sci-fi, but who knows?
iii) India and Africa could play the role of China and Asia as the source of ever more cheap labour, either by migration out or by inflows of capital and management in. Doubtful; migration is too socially disruptive, and the infrastructure and governance required for India/Africa to play the role of China/Asia is not yet in place.

Perhaps the strongest rejoinder (push-back) to our thesis came in response to our view that demographics would lead to a future rise in nominal and real interest rates. Part of this came from a denial that a worsening dependency ratio would lead to ex ante savings falling faster than ex ante investment; thus the old might go on saving for whatever motive; the old might have to work longer, and society would not provide such generous assistance to them, as at present, etc., etc.

But, we feel, by far the strongest argument against our view on interest rates was that macro-economic policy had led us into a debt trap. Low interest rates had been the preferred response to insufficient demand and deflation over these decades, and this has encouraged a massive expansion of debt. With the partial exception of the banking sector, that syndrome of low rates stimulating ever higher debt has become, if anything, even stronger since the Great Financial Crisis, (GFC), with debt ratios in most sectors and in most countries rising sharply since the GFC.

Such increases in debt ratios have not *yet* had a seriously adverse effect on world growth, since they have been offset by falling interest rates, leaving debt service ratios stable, even often declining. But this cannot, and will not, continue, having reached the zero lower bound (ZLB). Meanwhile, real growth must fall, o.a. slower growth of the working population, while Central Banks will oppose implicit debt default via unexpected inflation. Moreover, expansionary monetary policy is losing power and running into the sand. So nominal interest rates will tend to rise, but only glacially, relative to slowing growth rates of nominal incomes, but that will still cause the burden of the debt overhang to worsen.

As the US recovers from the GFC and tries to renormalize by raising interest rates, the adverse effect of that on the rest of the World feeds back to the US economy, and thereby slows down that rise. But at some point, labour market tightening in the recovering countries, driven on partly by demographic change, will put stronger upwards pressure on wages, unit labour costs and inflation. The Phillips curve is sleeping, not dead. What then? A mixture of defaults in the weaker countries/sectors, and inflation in the stronger countries/sectors?

Overall a rather grim outlook. What are the remedies suggested:-

(i) More supply side reform: While such reform is always desirable, this seems to us a 'deus ex machina', a miraculous get-out-of-jail free card; exactly what are such reforms that will suddenly cause aggregate productivity to soar?

(ii) Negative interest rates, not just on a small scale, but on a major scale; if the fall from 5% to 0% did not do it, try -5%. If the maintenance of interest rates at the ZLB for eight years did not cause enough damage to the financial structure of our economies, then pushing much deeper into negative territory almost certainly would.

(iii) More fiscal expansion, (financed by monetary expansion, a.k.a. 'helicopter money'). The suggestion is usually for more infrastructure investment expenditure, but it is rarely made clear exactly on what projects, nor whether the time scale makes this a useful contra-cyclical tool. Apart from such investment, do we really want yet higher public sector debt ratios after an unprecedented peacetime surge, with the higher public sector expenditures from the demographic time-bomb yet to come?

(iv) Debt reduction via wealth, or land (Henry George), taxation. As fiscal burdens rise, with a rising debt service ratio, we expect support for a rebalancing of tax onto the shoulders of the wealthy will recur. But a wealth tax has many operational problems. We are surprised that 'progressive', left-wing parties have not yet pushed harder for more taxation on land valuation; but that has its own operational and political difficulties.

(v) Our preferred proposal is to use fiscal, and other, measures to shift the financing structure in *all sectors*, not just in banks, away from debt finance towards equity finance, e.g. shared responsibility mortgages (Mian and Sufi, 2012) in housing, GDP bonds in the public sector, and fiscal parity between equity and debt in the corporate sector, (Mirrlees, et al, 2011). This would, however, require coordinated political leadership, which is rare.

There is, it would seem, no silver bullet to dissipate the debt overhang and let us all live happily thereafter. It will take time to work through the overhang. While this is still happening, it will depress both nominal and real interest rates from their longer term equilibrium. It could easily take another ten years, perhaps more, to work off.

But, once the debt overhang has gone (when?), the underlying dynamics of demographic trends will, we believe, take over, reversing the trend decline in nominal and real interest rates.

This cover note is a summary of the main arguments contained in two main Morgan Stanley Global Economics Research Notes published over the last year. Such notes are, of course, in a different genre, and with a rather different style and intended audience than the standard academic research paper. These are shown as Appendices:-

- Appendix A: Could Demographics Reverse Three Multi-Decade Trends, September 15, 2015;
- Appendix B: Escaping the Debt Morass, April 27, 2016.

There is a third such note on specifically monetary policy issues, ‘Transmission Matters – Musings on Money Multipliers and Credit Creation’, March 8, 2016, which readers may, or may not want to see also, but enough is enough for the moment.