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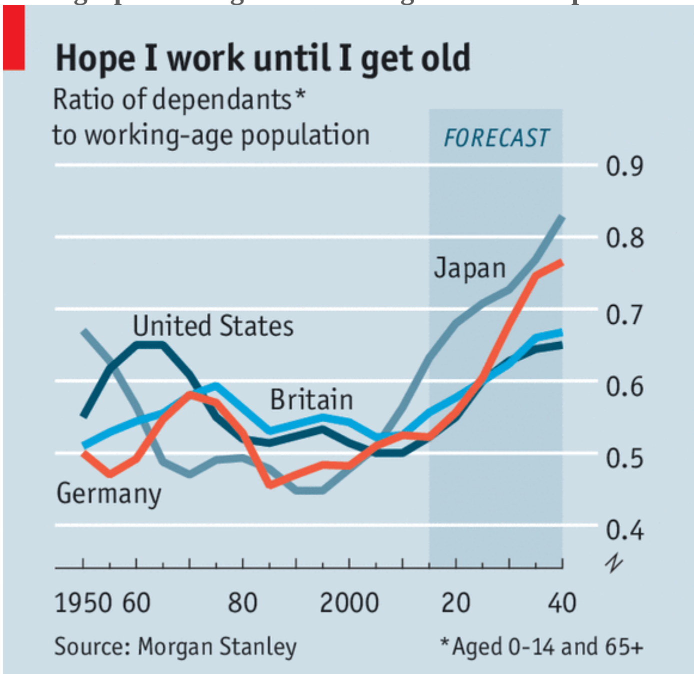
Greys' elegy

Demographic change will have big economic impacts



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THE population of the developed world is ageing. Everyone knows that it is happening but no one is sure what it will mean. A new paper from Morgan Stanley, part-written by Charles Goodhart, a former member of the Bank of England's rate-setting committee, along with Manoj Pradhan and Pratyancha Pardeshi, suggests there may be dramatic economic impacts.

In particular, the paper suggests that the greying population may reverse three long-term trends: a decline in real (inflation-adjusted) interest rates, a squeeze on real wages and widening inequality. That is because those trends were driven by previous demographic shifts; first, the entry of the baby boomers into the workforce after 1970 and second, the more than doubling of the globally integrated workforce as China and eastern Europe joined the capitalist system.

This rise in the labour force produced downward pressure on real wages. It also led to slower improvements in productivity, particularly in Europe. As Mr Goodhart writes, "As labour cheapens, managers spend less effort and invest less capital in order to raise productivity."

The falling cost of labour also produced downward pressure on the prices of manufactured goods, especially as companies relocated to Asia and eastern Europe. This created deflationary pressures, allowing central banks to ease monetary policy. China's relatively closed financial system and lack of a social safety net created a savings glut that added to the downward pressure on real interest rates. In turn, lower real rates pushed up asset prices which, along with the pressure on wages, added to inequality since financial assets tend to be owned by the better-off.

But population growth in the rich world, which was 1% a year in the 1950s, has fallen to 0.5% and should drop to zero by 2040. Some countries will see declining populations before then. Crucially, the share of the population formed by those of working age is already starting to fall. Indeed, Mr Goodhart reckons that the ageing population will create additional demand for labour, as illnesses such as dementia will require more care workers. This will start to push real wages higher, raising labour's share of national income and reducing inequality.

Real interest rates balance the desired level of savings with the desired level of investment. The elderly save less and spend more of their income than the middle-aged, as a natural part of the life cycle. But even the middle-aged will not save enough, Mr Goodhart says, either because they underestimate the amount they will need for a comfortable retirement or because they expect to depend on the state.

If that analysis shows that savings are bound to fall, what about investment? In a slow-growing economy, there will be fewer profitable investment opportunities. But Mr Goodhart argues that investment will not fall as fast as savings and thus real rates will rise.

What is his rationale? Most investment by households is in the form of housing. The old are usually reluctant to move out of the homes they bought when middle-aged, even though their children have moved out. This will make it more difficult for families to find the space they need; that means residential investment will not fall significantly. As for investment by firms, rising wages will encourage companies to substitute capital for labour. Corporate investment could rise.

The thesis is vulnerable to other changes in the economy. The labour force could be boosted by greater participation by women and the elderly, or by immigration—although Mr Goodhart does not think these factors will be sufficient to compensate for the effect of ageing. The less educated, for example, find it harder to stay in the workforce beyond 65.

This last point also raises the question of whether inequality will fall as he predicts. Demography has not been the only factor behind widening inequality: many economists point to "skill-biased" technological change as a driving force. Low-skilled workers who can be replaced by computers or robots will be more vulnerable in a world of rising real wages; the computer-literate will still command premium salaries.

The people who would most like Mr Goodhart to be right are probably mainstream politicians. The sluggish performance of real wages in advanced economies, along with the signs of rising inequality, have caused them to lose votes to parties on their left and right. If these trends go into reverse, voters might be a bit more content. But the change might not occur fast enough to save some political careers.