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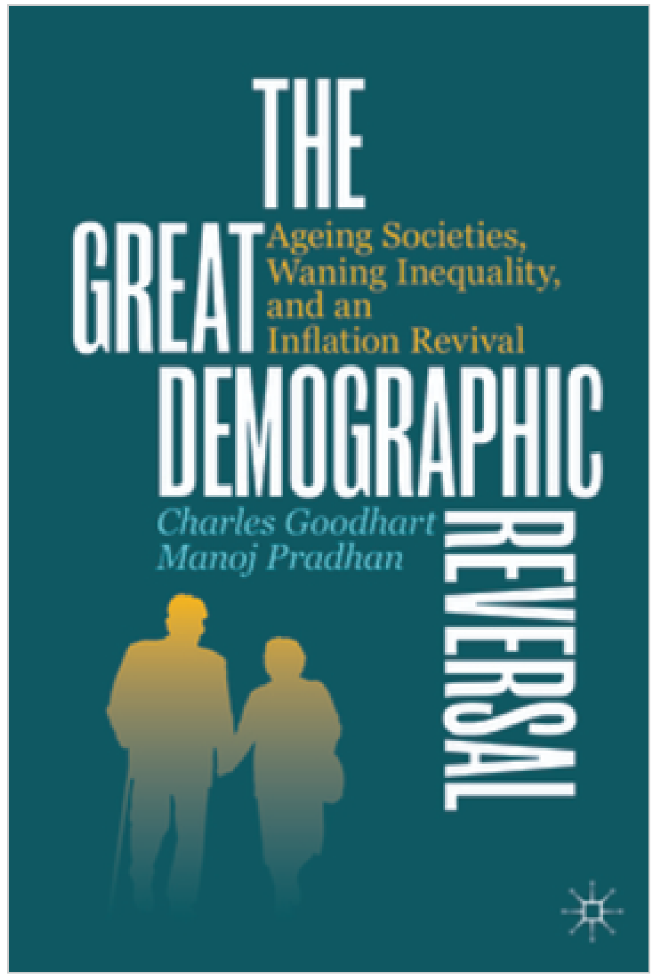
# The world at an economic inflection point

*The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival.* By Charles Goodhart and Manoj Pradhan. Palgrave Macmillan, 2020, 280 pp., $29.99 hardcover.

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The last few decades have largely been a time of remarkable economic growth for the world. This long-term picture can be difficult to see while we remain hyper-focused on recovering from the economic shock wrought by the COVID-19 pandemic. However, as we move further into the second year of the pandemic—and as economic forecasts in advanced economies grow increasingly optimistic in light of vaccine rollouts—it may be helpful to take a step back and seek to understand these long-term economic trends. In *The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival*, authors Charles Goodhart and Manoj Pradhan take a global, long-term view of past and future macroeconomic developments. They point to rising labor supply and strong globalization pressures as the key factors responsible for the global economic growth we have seen over the last three decades. The authors single out China as the biggest economic story over this period, describing it as the foremost champion of globalization. Looking forward, however, they propose that a future reversal of labor supply and globalization trends will likewise reverse the global economic trends of record-breaking growth, low inflation, low interest rates, and rising inequality. While the bulk of the book was written in 2019, before the pandemic hit, the authors believe that the impact of the pandemic will accelerate these developments.

The book's central argument is that inflation will rise because of demographic shifts. Declining fertility rates and rising life expectancy will increase the proportion of the elderly in the populations of advanced economies. This shift will cause a slowdown in labor force growth, an absolute decline in the labor force of many countries,

worsening dependency ratios, increasing medical and pension costs, and rising real wages driven up by labor scarcity. Together, these changes will exert a strong inflationary pressure that future surges in labor productivity or aggressive policymaking will be unlikely to counter. Goodhart and Pradhan also forecast that, in the absence of a substantial increase in labor productivity, output growth will slow as a direct result of labor force declines. Although the effects of demographics on interest rates are harder to project because of many competing forces, the authors suggest that short-term rates will likely be held below the increase in inflation by central banks, whereas long-term rates will likely rise above that level, leading to a steeper yield curve. On a more benign note, the authors believe that income and wealth inequality within countries will fall as a side effect of increasing real wages.

In advanced economies, effective labor supply has more than doubled in the past three decades. Goodhart and Pradhan cite the rise of China, the post-Cold War reintegration of Eastern Europe into global economic structures, increasing participation rates among women, and the influx of baby boomers into the labor force as the primary forces responsible for the large positive labor supply shock. This shock, the largest ever, has significantly reduced the bargaining power of labor, decreased union membership, and suppressed wage growth among workers within the bottom 90 percent of the income distribution. The observed wage stagnation for all but the top income earners has been the primary culprit for inequality, and while inequality across countries has decreased, inequality within countries has skyrocketed. According to the authors, stagnant wages, coupled with a decrease in prices for manufactured goods, have been a powerful deflationary force. Even prepandemic expansionary monetary and fiscal policies that have led to a persistent rise in public sector debt have not generated much inflation, and in recent years, many central banks have struggled to hit their 2-percent inflation targets.

What will the demographic reversal described in the book look like? Japan is often used as a case study illustrating the employment implications of population aging, and the authors spend some time examining its experience. Japan, which has the oldest population in the world, with 28 percent of its people being 65 and over, is the first country to face a shrinking labor supply because of demographics. The authors give several reasons why the labor force shrinkage in Japan did not lead to inflation. First, as Japan's working-age population began to decline in the mid-1990s, other regional economies were overflowing with cheap and efficient labor. Many Japanese jobs, particularly those in the manufacturing sector, were moved to China and other countries. Second, cultural norms in Japan account for a uniquely flat Phillips curve, an economic model that shows an inverse relationship between unemployment and inflation. The Japanese highly value job security, frowning on job terminations except under rare and extreme circumstances. At the height of the financial crisis of 2007–08, Japan's unemployment rate topped out at 5.5 percent, mainly because the country's preferred approach to confronting the crisis was through lowering hours and wages rather than through mass layoffs. Lastly, Japan has seen a large rise in labor force participation among those ages 55 and over. This is due to both an increased life expectancy and cuts in pension benefits aimed at reducing the government's fiscal burden.

Goodhart and Pradhan argue that little of Japan's experience will be applicable to the West as it ages. Perhaps most significantly, the authors say that the demographic goalpost has shifted, and it may take two or three countries like China to support the aging global economy. India and emerging economies in Africa and elsewhere will not be able to support the aging West, although they will keep growing and may have the populations to do so. India, which has suffered from internal collisions among political parties and between individual states and the federal government, will be limited by its lack of administrative capital. Overall, India ranks poorly on measures such as ease of doing business and contract enforcement, and this reputation creates difficulties in attracting foreign capital and investment. The country simply lacks the needed infrastructure and administrative

cohesiveness that have been a key component of China’s success. The population of Africa can rival that of India, but it is spread over a much larger geographic area and across more than 50 independent countries. Further, Goodhart and Pradhan note that the labor force participation rates of older people have already been slowly rising in advanced economies. Different countries have different combinations of pension benefits and participation rates, and this variation suggests that some countries will have more fiscal flexibility than others. However, raising retirement ages and cutting pension and welfare programs are deeply unpopular policies that can be difficult to pass legislatively.

Whether the authors’ projections come to fruition or not, I agree that the effects of the “great demographic reversal” will be ubiquitous. Government monetary and fiscal policies, healthcare and pension systems, and finance will need to adapt in the wake of demographic change. Given the lack of a readily available means to absorb the costs of an aging population and a shrinking workforce, I find the authors’ argument about a future increase in inflation particularly persuasive. Still, demographic change is only one of many forces that steer major economic indicators such as inflation and interest rates, and its effect on macroeconomics is not easily quantifiable. Future technological and productivity developments are perhaps the biggest missing piece of the puzzle. As proposed by the authors, large advancements in productivity could help mitigate the economic effects of demographic change, just as slow technological advancement could exacerbate them. I appreciate the global scope of this book and its emphasis on the complexity and interconnectedness of the global economy. This is the kind of long-term thinking that economists, policymakers, and others may find beneficial.