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May 2022

The Great Demographic Reversal

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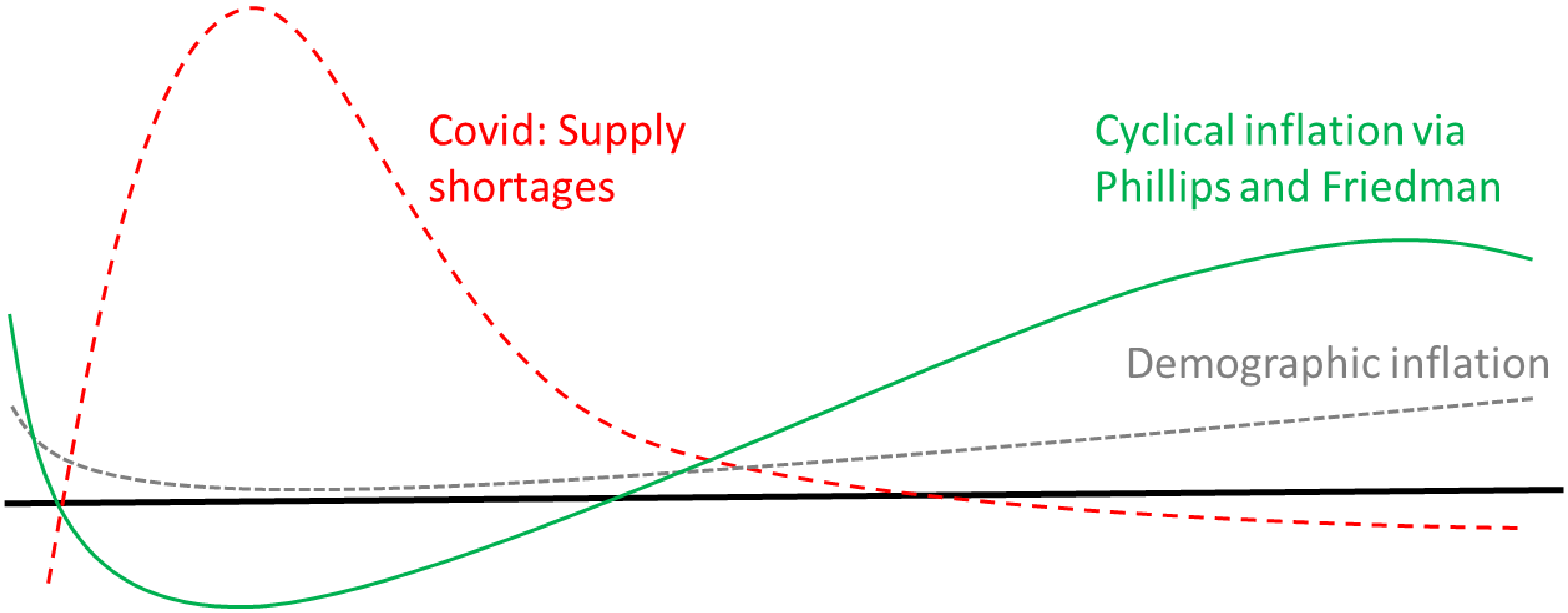
3 Inflation Cycles

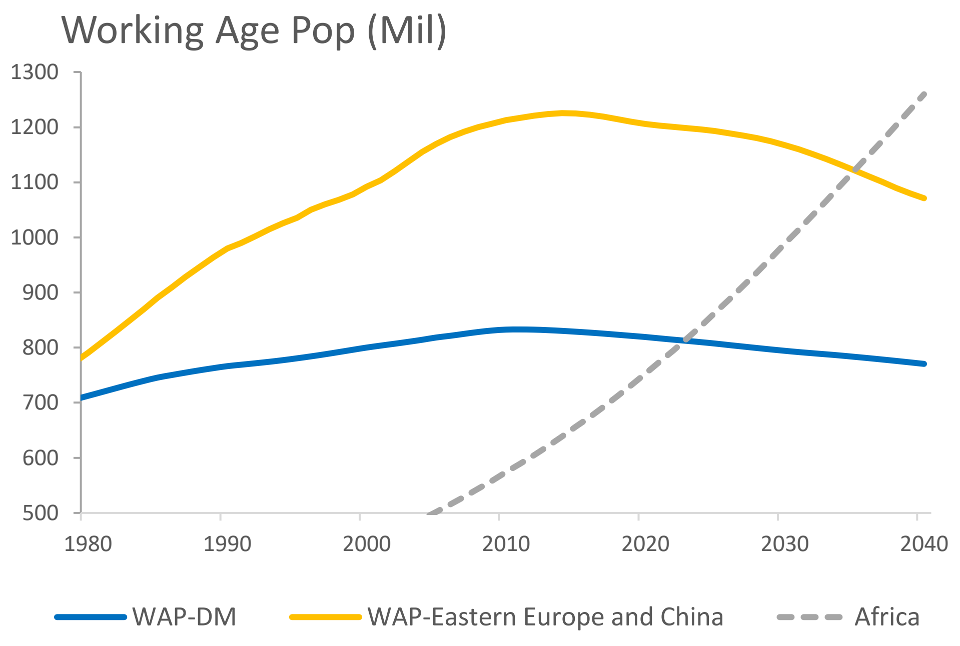


Source: Talking Heads Macro

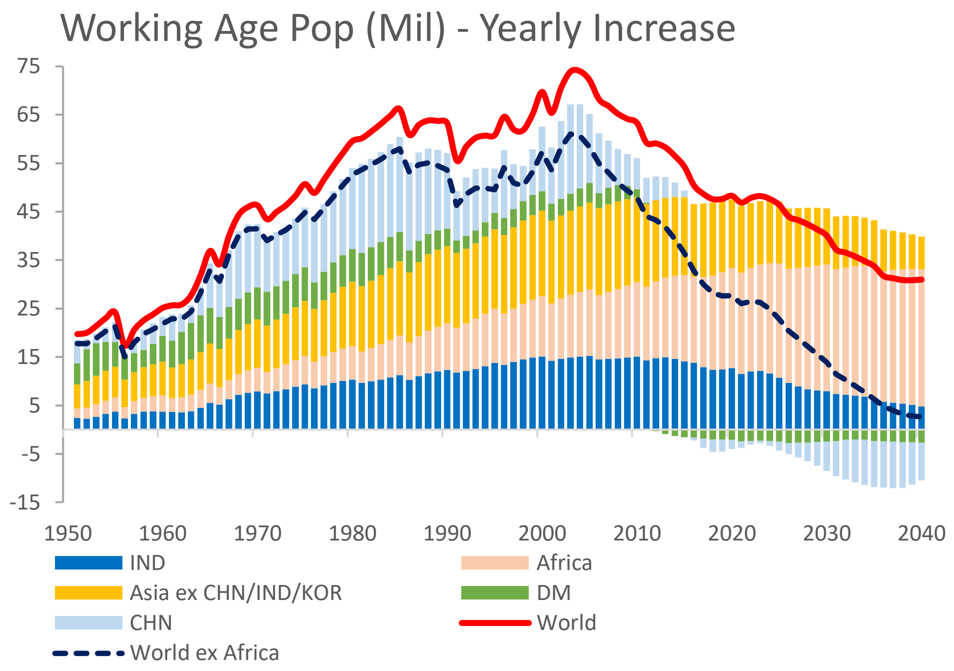
The Demographic ‘Sweet Spot’

A Triple Demographic Shock

Globalisation…



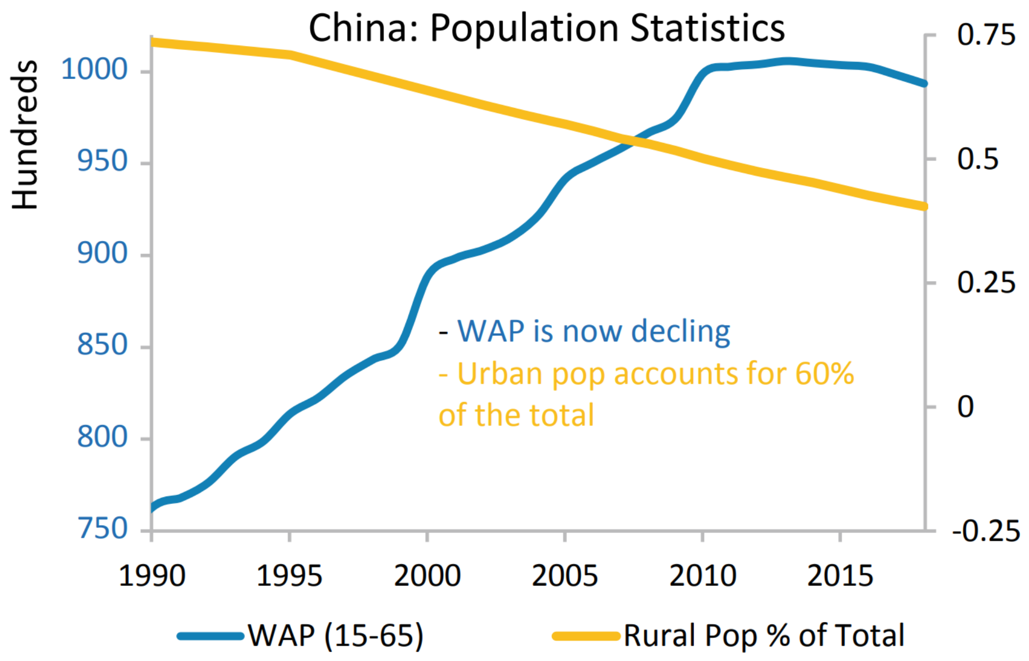
…and demography



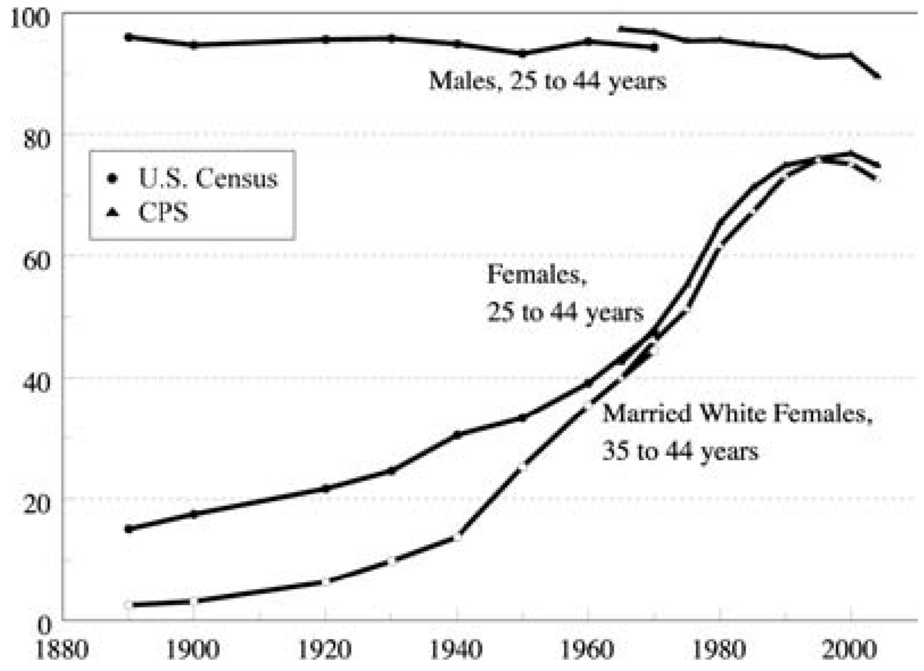
Source: Talking Heads Macro

A Triple Demographic Shock

China’s internal migration



Female labour force participation



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Demography and Inflation: Stolper-Samuelson

Dependents (Young, Old) Consume
But Don't Produce

Dependents
Inflationary

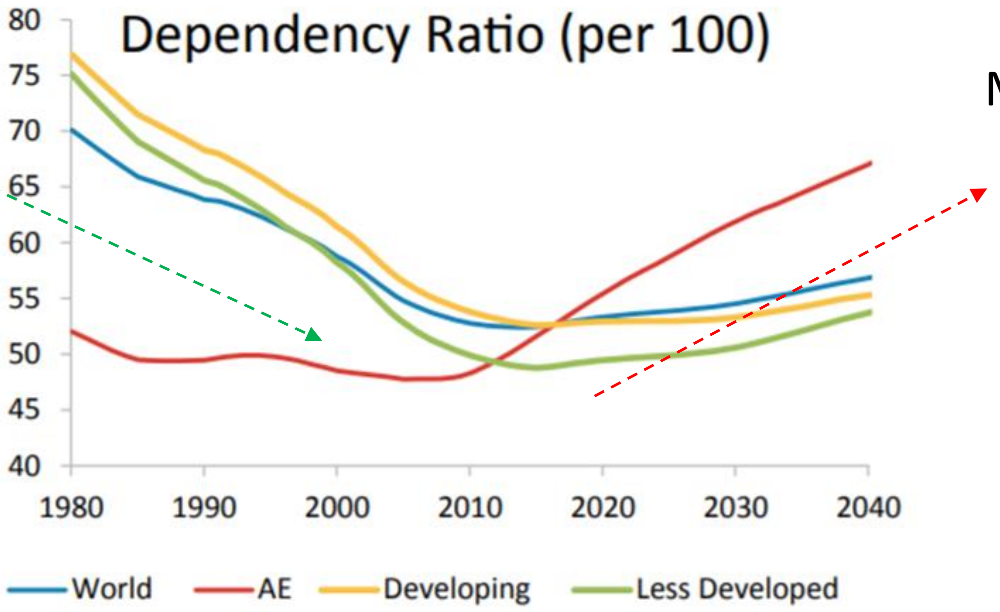
Workers Consume + Produce + Save
Wages < Production, Consume < Wages

Workers
Deflationary

More Workers
Than Dependents

=

Inflation Falls



More Dependents
Than Workers

=

Inflation Rises

Source: Talking Heads Macro

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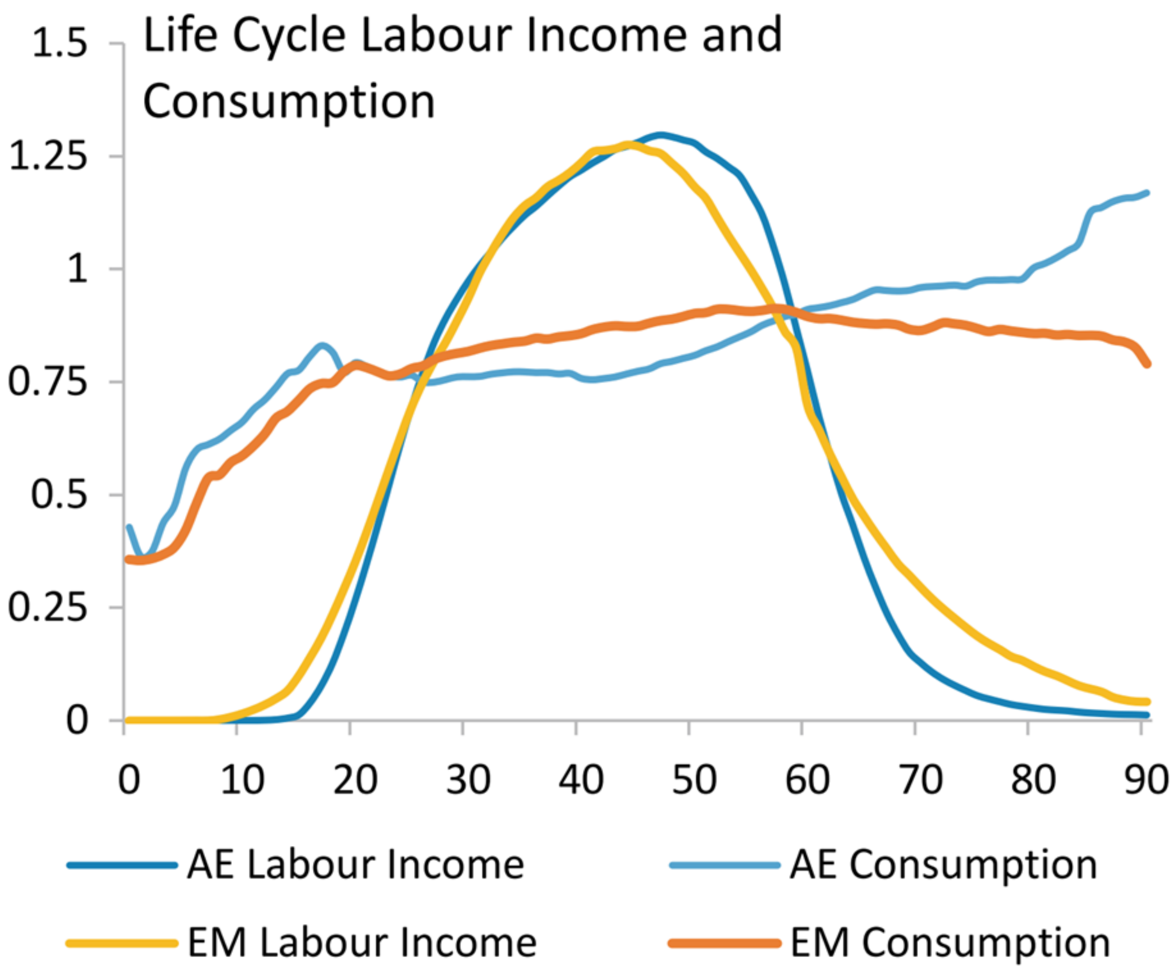
Private Dissavings Related to Ageing



Source: Talking Heads Macro

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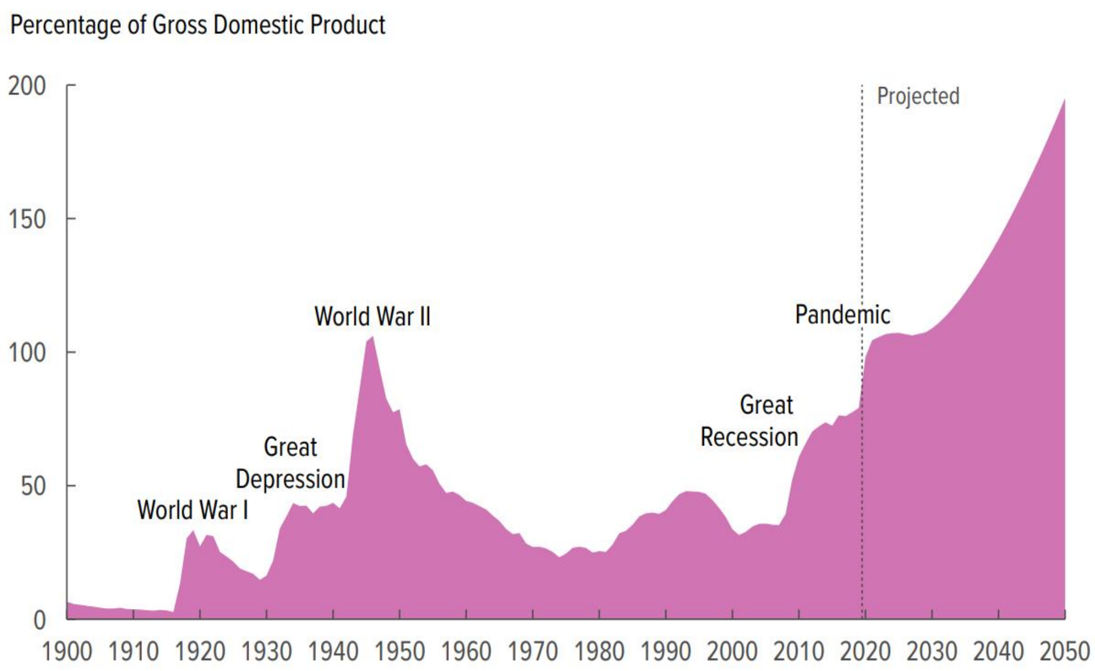
Demography, Debt and Inflation: Political Economy

US Pandemic Debt is a Drop in the Ocean



Critical assumption: Pension, health benefits whittled down to some extent, not excessively

How to finance debt?

Productivity, Growth?

Taxation

Aggressive rate hikes

Inflation

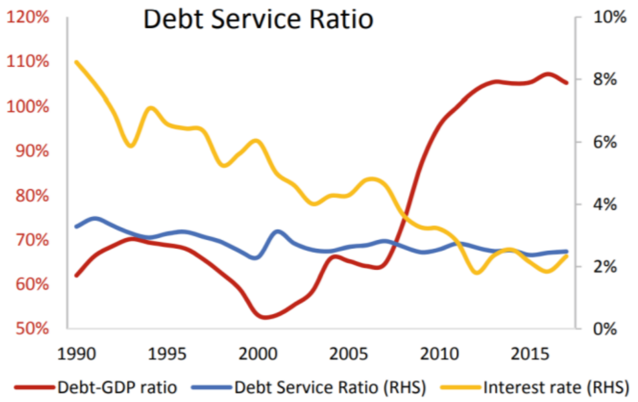
Balance Sheet expansion: Turn bonds into variable coupon consols

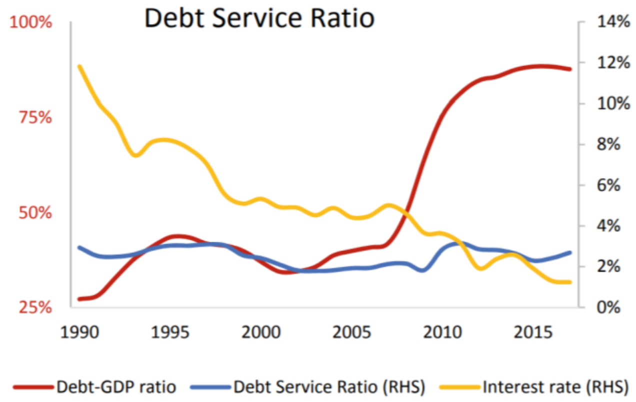
Source: Talking Heads Macro

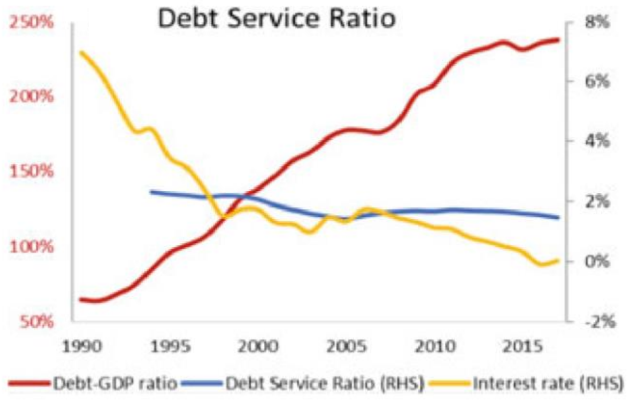
The Pushback:
(i) Why Didn’t It Happen on Japan?
(ii) Inequality Will Depress *r**
(iii) Timing

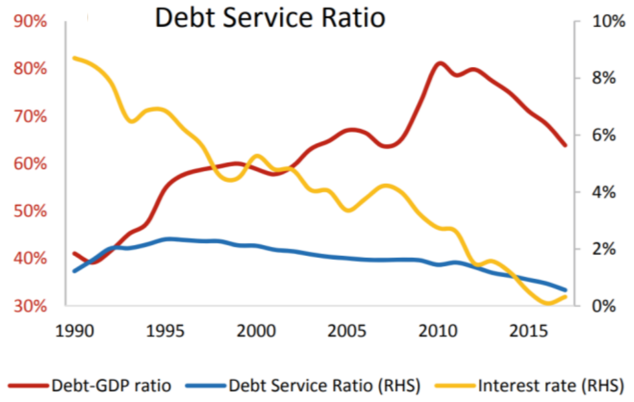
1. Why Didn’t It Happen in Japan?

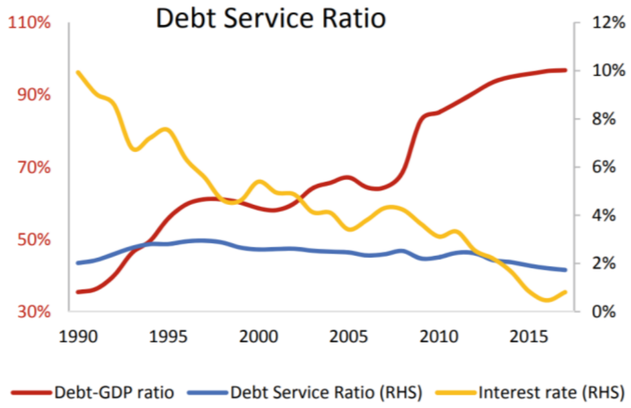
Japan was not unique, nor resistant to global disinflation and the trend of falling interest rates

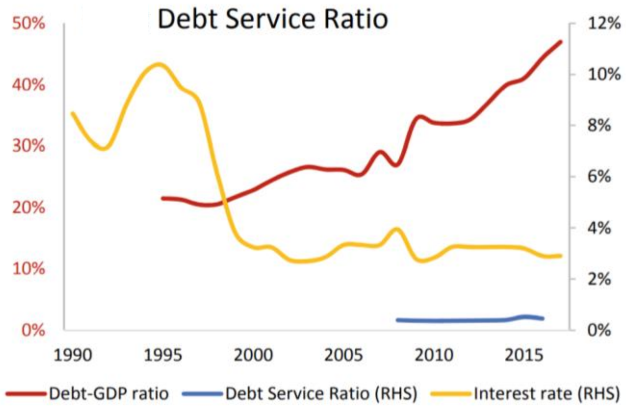










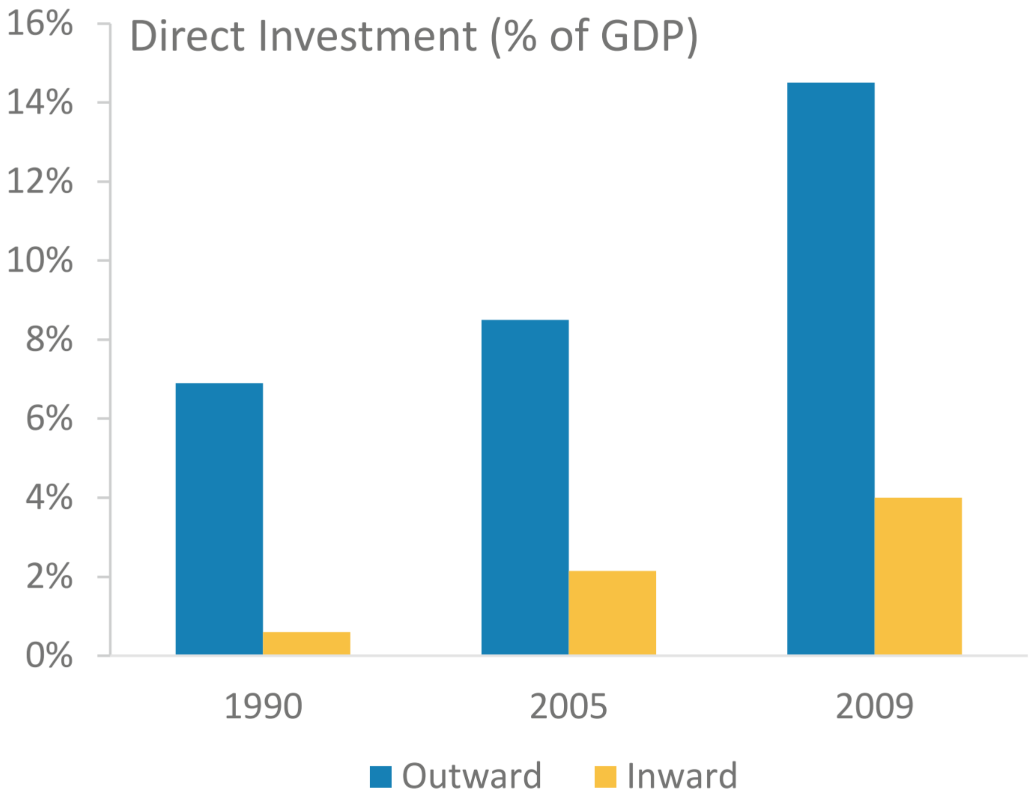


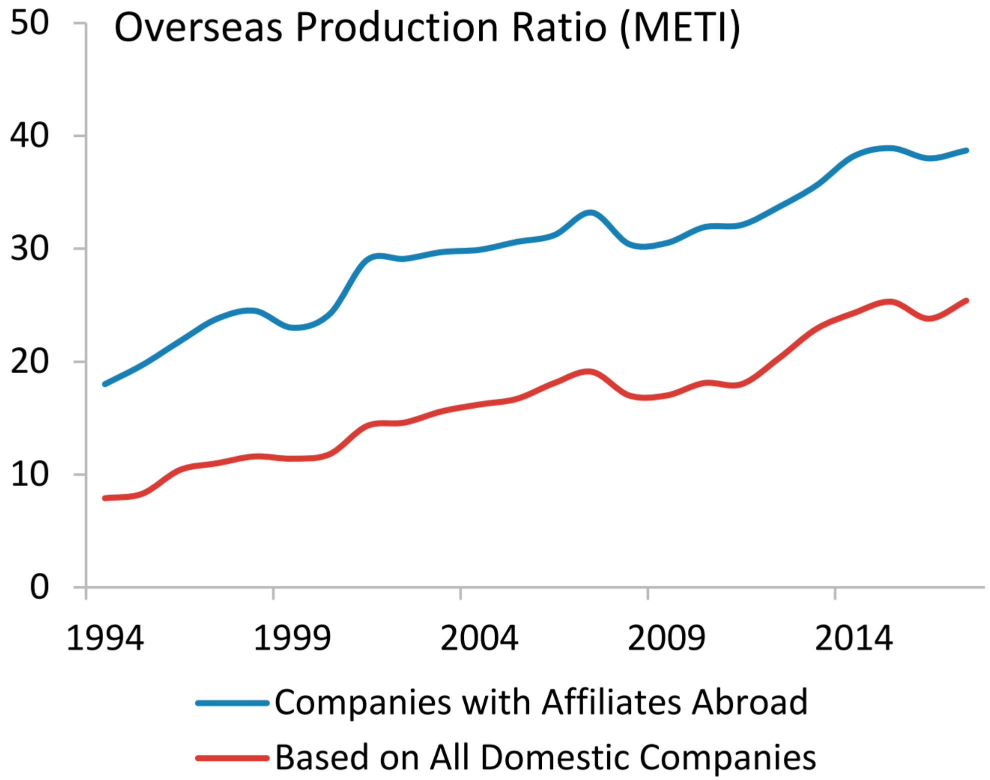
Source: Talking Heads Macro

Japan's Outbound FDI was an 'Escape Valve'

Without the global element, Japan demography forced to explain growth, inflation, rates

Corporates understood the global labour supply shock and used Outbound-FDI as a 'Escape Valve'

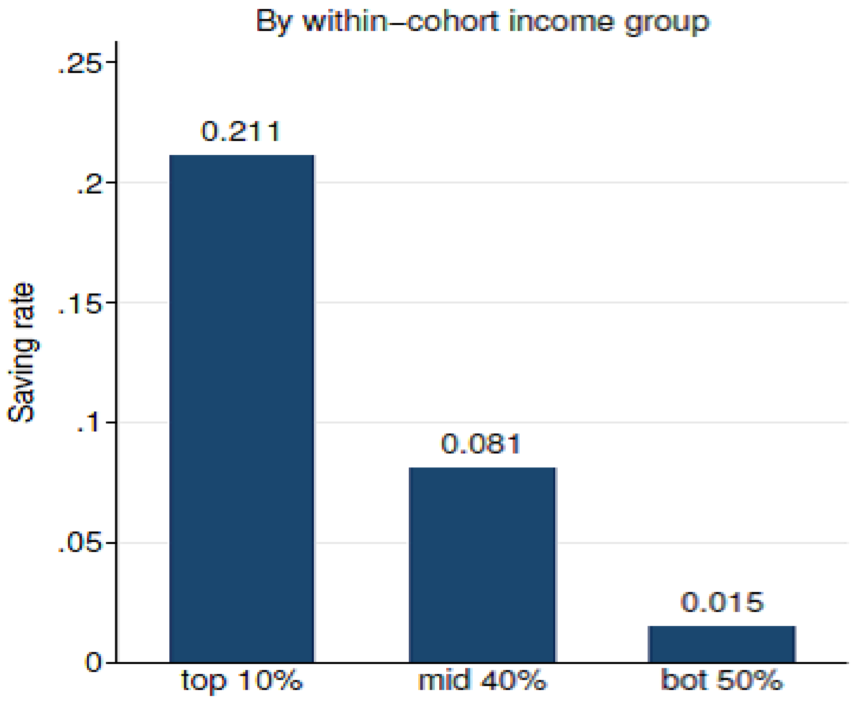


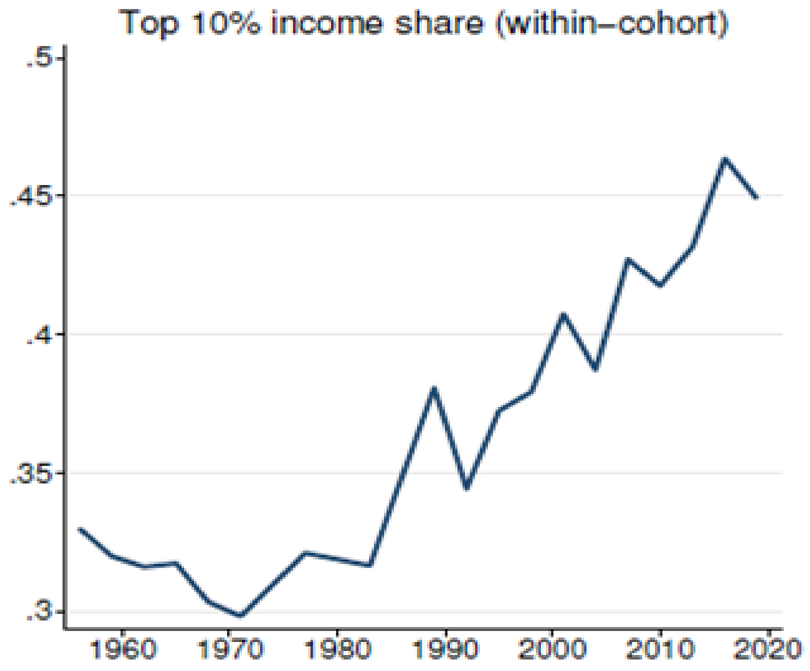


Source: Talking Heads Macro

2. Can Inequality Lower r*, Even if Ageing Raises It?

Mian, Straub, Sufi: (Savings flows of the rich > demographic dissaving) = falling *r**

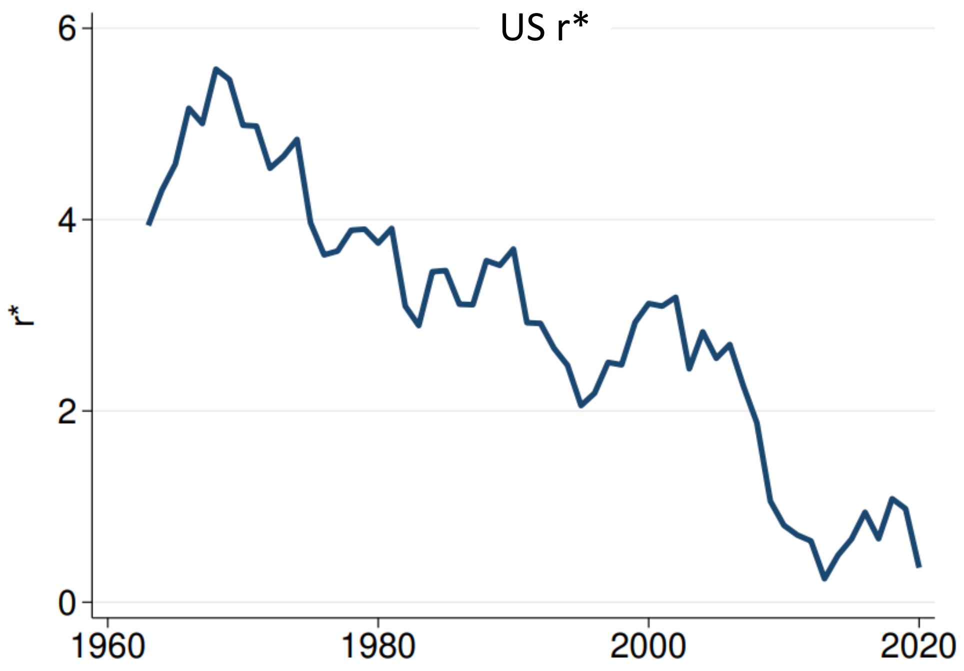




Source: Talking Heads Macro

*r** Falls With Rising US, But Falling Global Inequality?

Laubach-Williams Estimate of r* falls sharply in the 2000s



The surprisingly Swift Decline in US Manufacturing Employment

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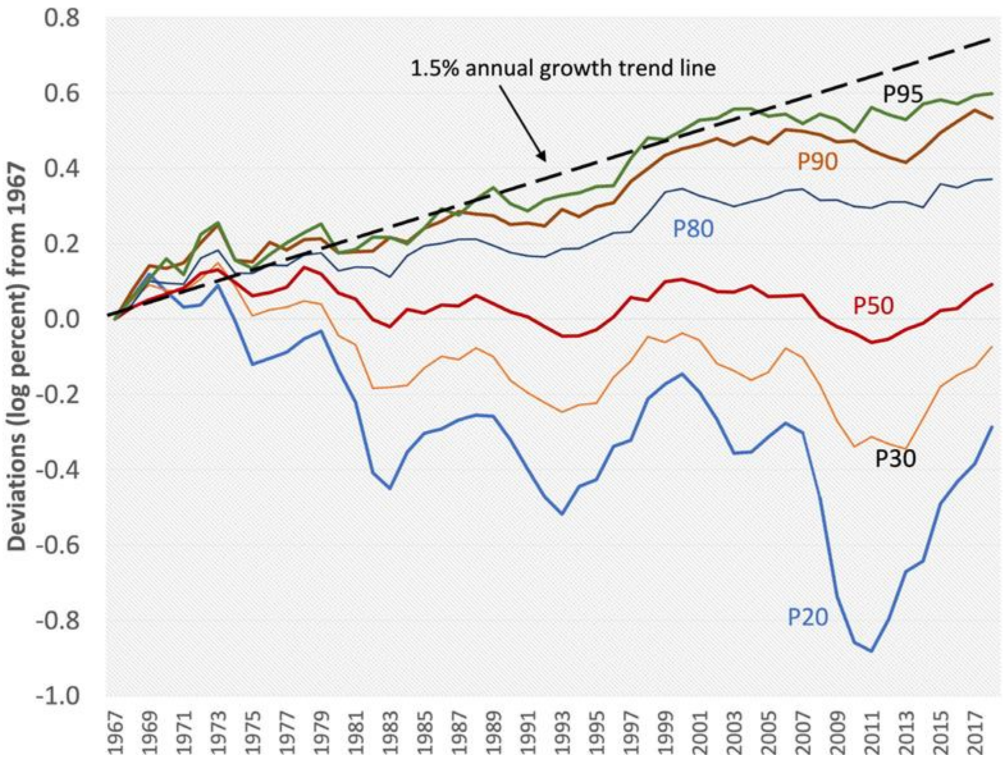
US Inequality is Globally Endogenous

Guvenen at JH: Share of top 1%, 10% has grown because of worse fortunes for the poorer 90%...



...and the lower cohorts were directly challenged by China's labour force

	USA/China	France/Poland
2000	34.6	3.9
2001	30.6	3.3
2002	27.4	3.5
2003	25.0	4.0
2004	22.9	4.2
2005	20.4	3.8
2006	18.1	3.7
2007	15.2	3.5
2008	12.2	3.0
2009	10.8	3.7
2010	9.7	3.3
2011	8.4	3.3
2012	7.5	3.4
2013	6.7	3.4
2014	6.3	3.3
2015	6.0	3.4
2016	5.9	3.4
2017	5.6	3.2
2018	5.1	2.9

Source National Sources

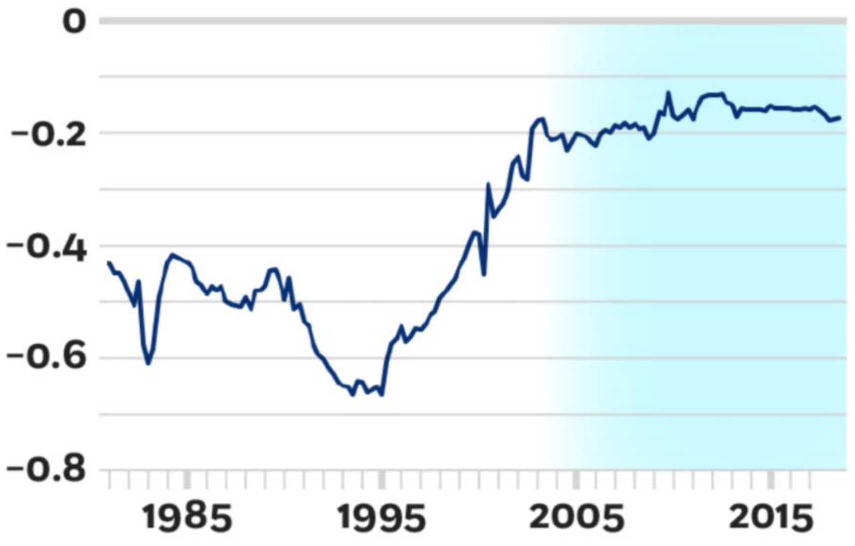
Source: Talking Heads Macro

The Current Inflation Surge

The Fed Didn't Kill the Phillips Curve, China Put it in a Coma

Phillips curve's slope

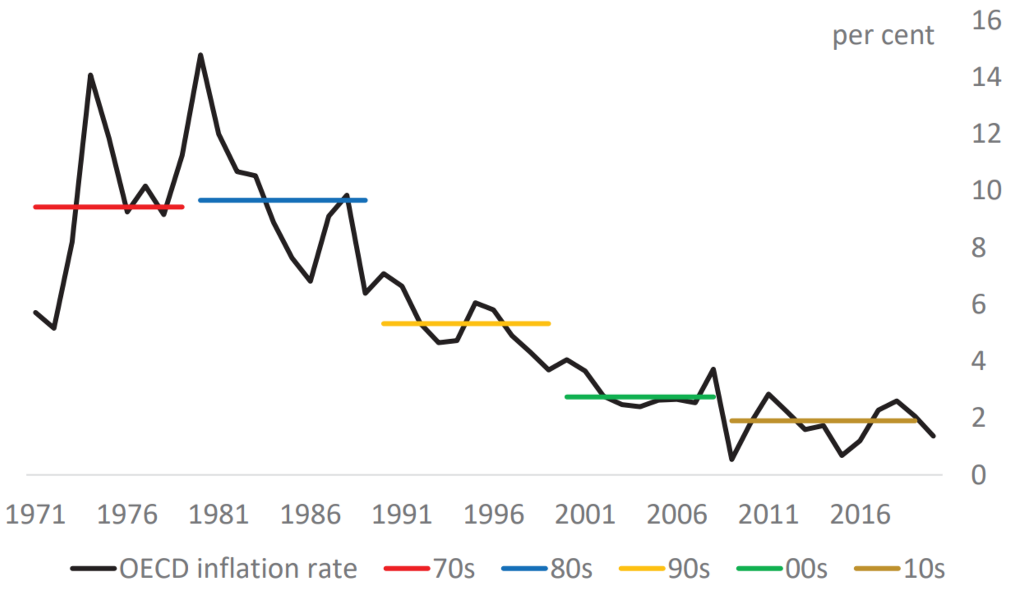
Closer to zero = weaker connection between US unemployment rate and previous 20 years of price inflation



Hooper et al., 2019

China Disinflated the World, and Raised Growth Too

Chart 2: Global Inflation

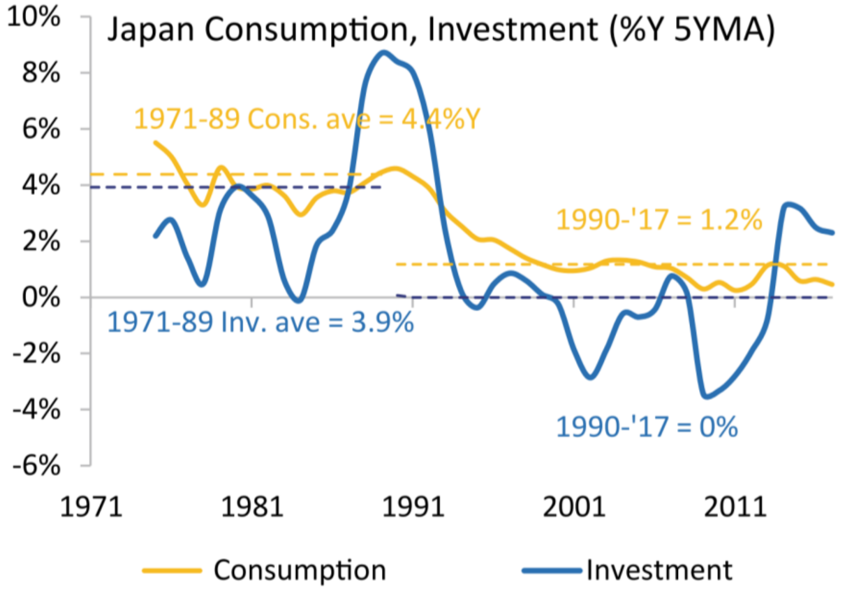


China's Global Disinflationary Impulse Has Passed

China: Japan-esque labour constraint

Services provide employment, **hi-tech** provides productivity, **SOEs** provide state control

Manufacturing, real estate losing importance

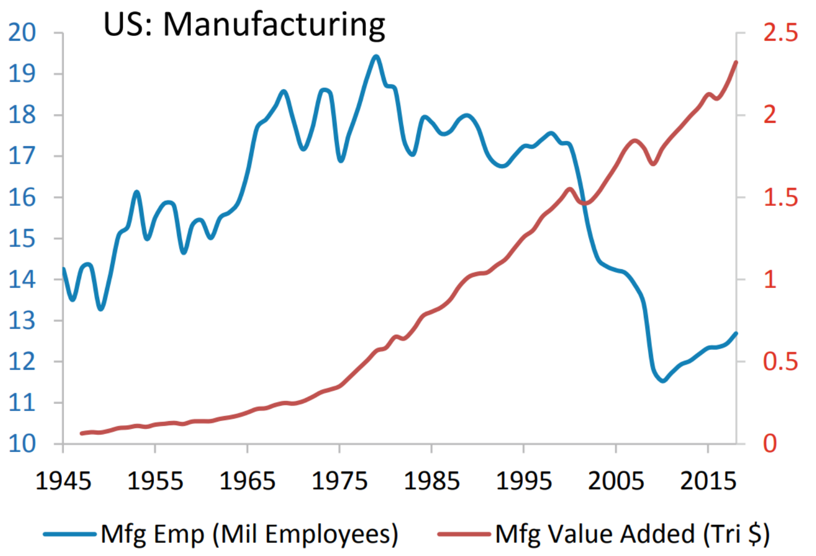


Source: China Ministry of Commerce

Geopolitical Reshoring of Mfg inflationary?

US/AE: capital/labour rises = disinflationary
US Inc.: globally sub-optimal cost of production

A **slow reversal** of Pierce and Schott's "surprisingly swift decline of US manufacturing employment"?



Source: BEA, Pierce and Schott (2016), "The Surprisingly Swift Decline of US Manufacturing Employment"

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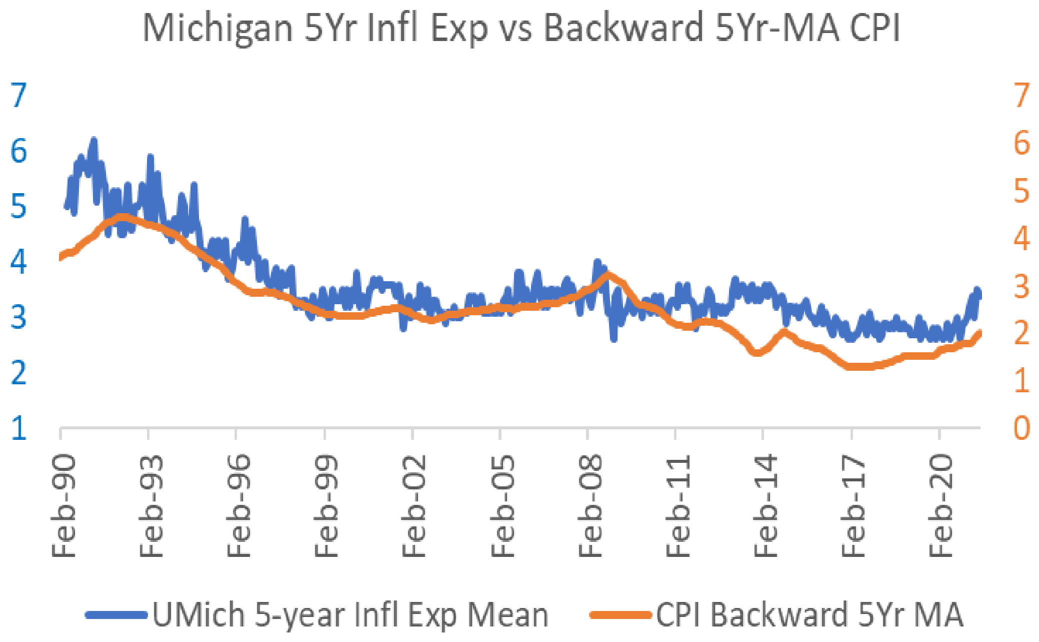
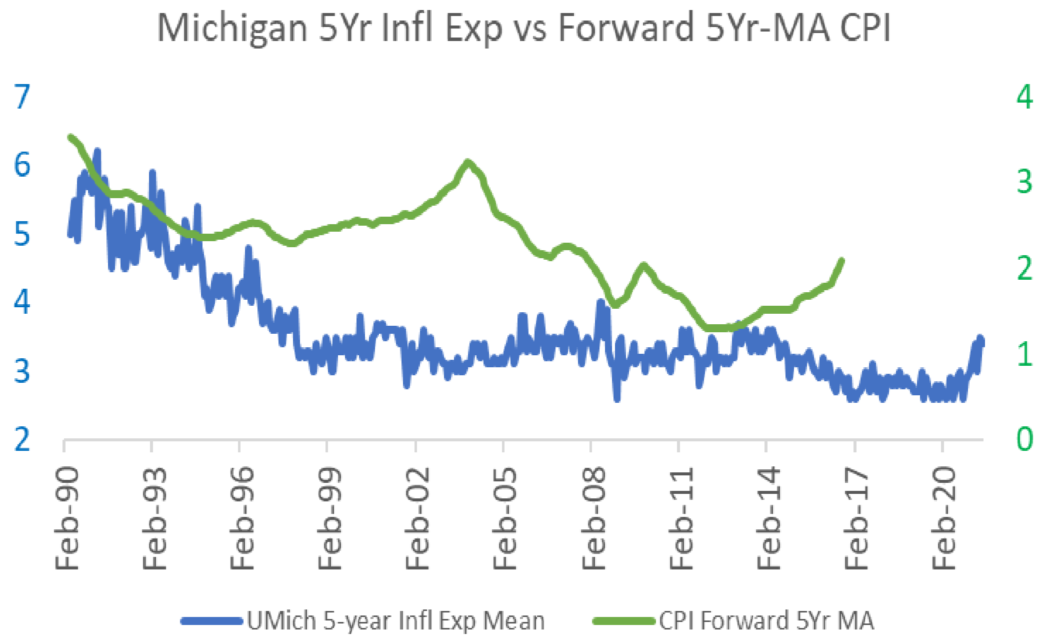
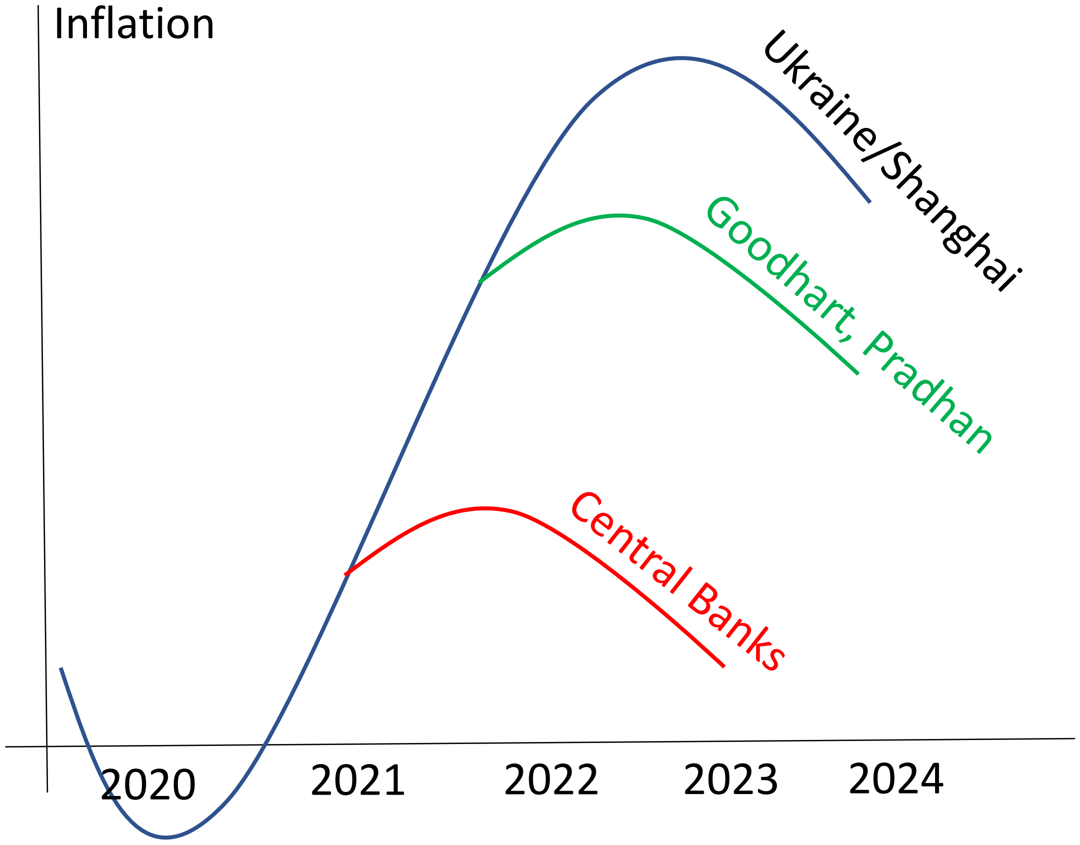
What About Inflation Expectations?





Source: Talking Heads Macro

The Current Inflation Surge



Demand shock:
Fiscal policy, especially in USA
Monetary surge, especially in 2020
Summers/Blanchard

Supply shock:
Labour tightening, widespread
The Great Resignation
Covid supply shocks; not over, China
And now Ukraine

Central Banks a long way behind

Taylor rule:

$i = r^* + 1.5\ (\Pi - \Pi^*) + 1.0\ (Y - Y^*)$

How to Respond to this Surge?

When the disturbance is large, both expectations and wage/price adjustments will react to what *has* happened, not just to expectations of *future* inflation.

Central Bank confidence in anchored expectations is overly optimistic.

A wage/price spiral is beginning in the USA/UK, if perhaps not yet in EU.

Source: Talking Heads Macro

The Medium-Term Future

The **ECB, BoE** are currently accepting arguments for slow and steady.

The **Fed** has recently turned more hawkish.

Some **EME** Central Banks have already been forced to respond more urgently.

It will be a difficult exercise to return inflation to target without having to raise unemployment, perhaps significantly. Concerns about the stability of employment and financial markets may restrain the speed with which interest rates are raised. This makes it quite likely that the result, at least for the time being, might be stagflation.

If stagflation, then following concerns:-

- Central Bank Independence
- Fragmentation in EU
- Effects on Politics more broadly.

The Search for ‘Neutral’

The Search for 'Neutral'

As inflation rates rise markedly above target, markets remain on a path of 'price discovery' for the neutral nominal interest rate – both 1y1y (terminal rates) and 'neutral' (5y5y) estimates for markets have risen as inflation has surged.

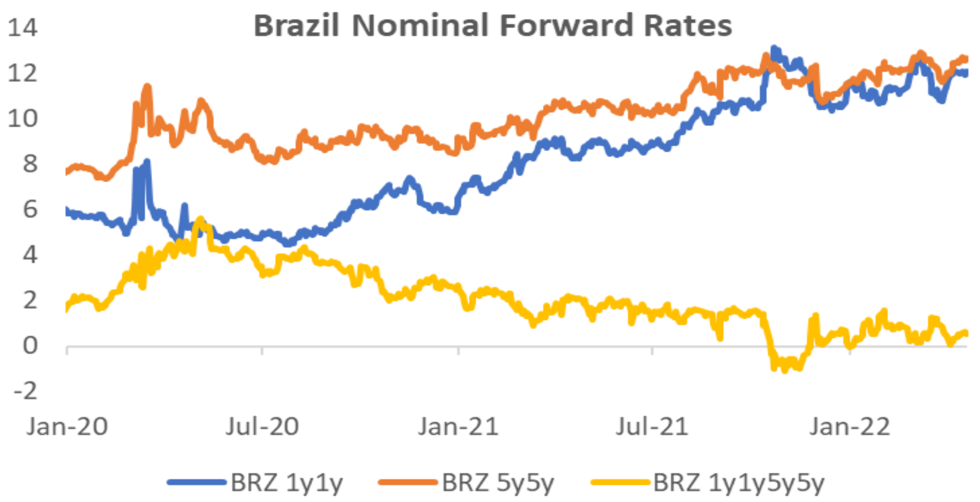
The actual nominal interest rate needed to drive inflation back to target will depend on current levels of inflation, expectations thereof, and the current level of demand.

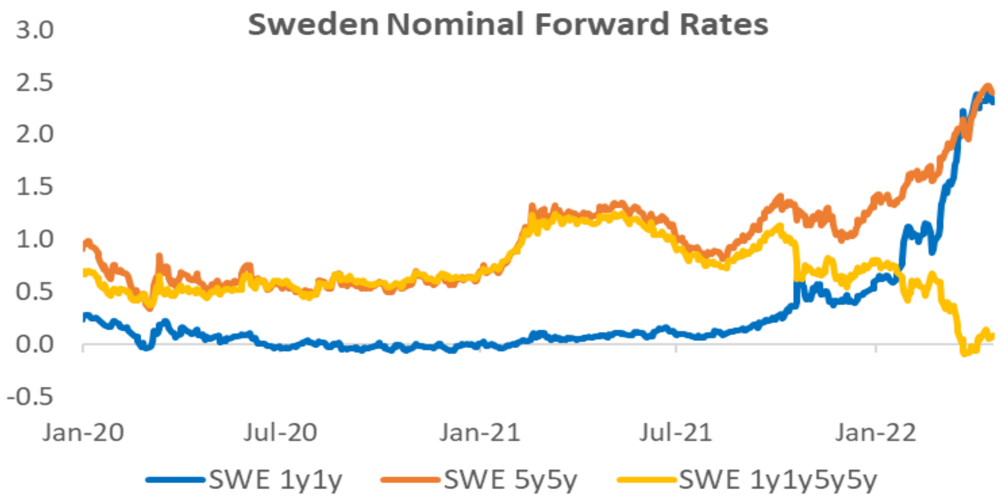
Assuming that these have already been hit would be premature. It would amount to assuming a success which has yet to be achieved and justified.

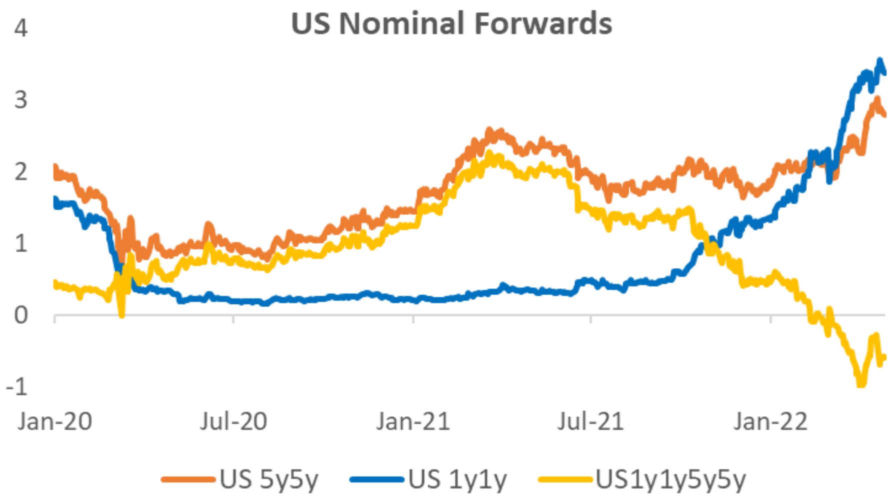
Without a peak in inflation (hard to say), positive real rates (Brazil, Mexico close), or significant damage to the real economy (Brazil, Mexico and housing markets in Korea, New Zealand), markets are not convinced that policy rates are near/above a neutral level.

The concept of a neutral nominal interest rate is of little consolation at this juncture.

Terminal (1y1y) *and* Neutral (5y5y) 'Estimates' Have Risen







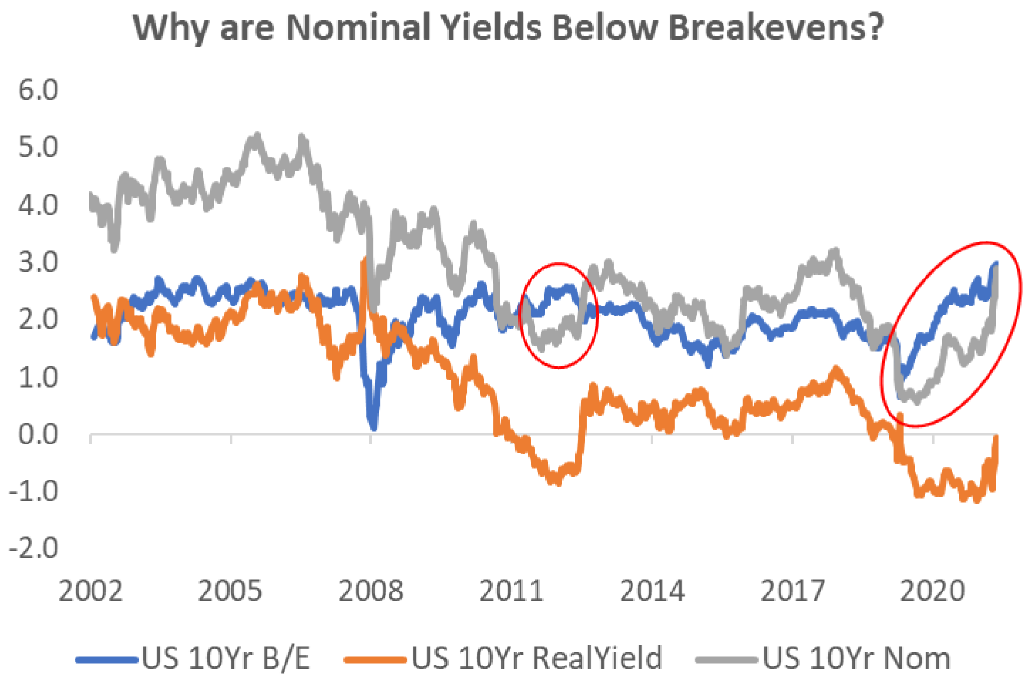
Source: Talking Heads Macroeconomics, Macrobond

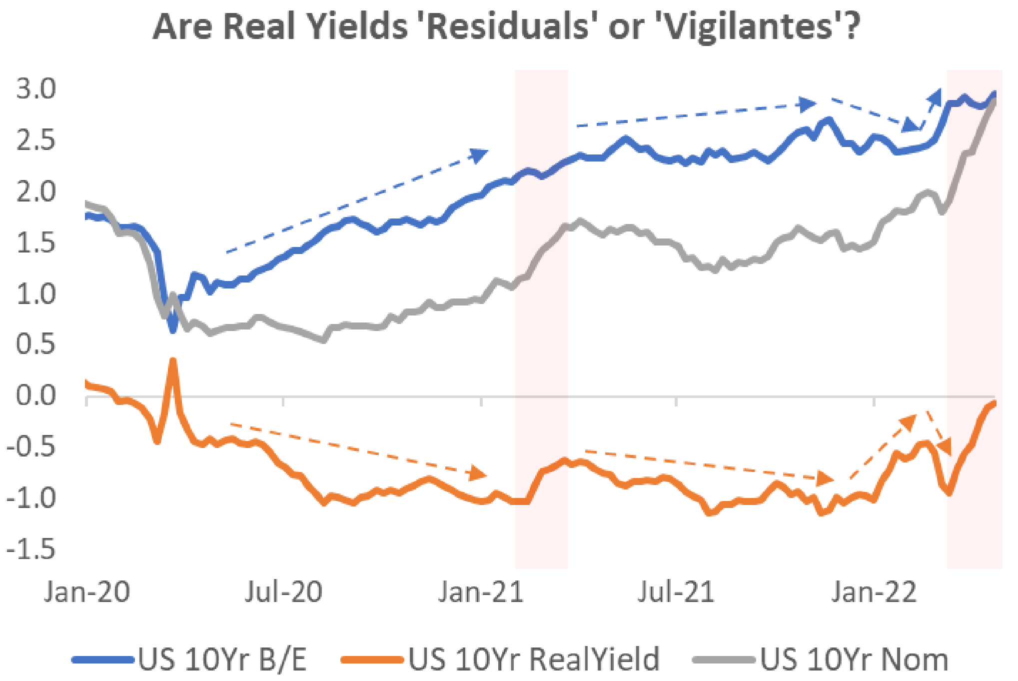
Conundrum 2.0? Why Were Nominal Yields Below Breakevens?

Do inflation-indexed/real yields reinforce ‘neutral’ if central banks are seen to be ‘behind’?

Residual? If nominal rates are ‘fixed’, then rising breakevens push real yield lower

Vigilante? If real policy rates seem too low, real rates rise despite rising breakevens





Source: Talking Heads Macro, FRED