Workers vs pensioners: the battle of our time

The ageing of our society will reverse the trends of 30 years. Wages will rise, but working people will be locked in political combat with pensioners

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Workers on the production line at a Honda plant in Ozu. Japan has already undergone changes that are now happening elsewhere. © Tomohiro Ohsumi/Bloomberg via Getty Images

Demographics, the study of the changing structure of populations, is widely acknowledged to be critically important. But demographic changes occur so slowly that almost no one considers their impact on markets, the economy and society, except as something that will happen some day in the distant future.

Four key, long-running trends in the world economy have continued for more than three decades, and each of them is rooted in demography. Earnings have been slowing, in some cases even falling, in the advanced economies, with very little explanation as to why. Membership of trade unions in the private sector has been falling sharply. Inequality, within countries, though not between them, has risen, with Thomas Piketty, the French economist, famously ascribing this to a tendency for the rate of return to capital to exceed growth. Interest rates have been falling for the last 35 years and this has often been attributed to a decline in investment relative to savings.

All four trends were caused largely by a demographic "sweet spot" that developed some time around 1970 (sweet from the perspective of global growth, if not from that of workers). This was caused, in turn, by a marked decline in birth rates, especially but not only in advanced countries. As large numbers of young people entered the working population, the ratio of workers to dependents increased sharply (see charts 1 and 2 on p31). There was a sharp increase in the working age population since 1970 and then a doubling, and more, of the size of the global labour force thanks to the entry into the global economy of China and countries in eastern Europe from 1990 onwards.

A combination of these effects lowered incomes and labour productivity, relative to capital and management, and so raised inequality and reduced the incentive to invest in the advanced economies. The effect was to lessen the bargaining power and wages of workers, as businessmen could credibly threaten their employees with relocation of their operations to China or the Czech Republic. The resulting switch of such operations to cheaper offshore locations dampened inflation. This, together with the fall in the ratio of dependents to workers, drove up supply relative to demand. This in turn forced central banks to ease interest rates, thereby driving up asset prices and causing a further ratcheting-up of inequality.

Now, things are about to go into reverse. Global population growth has fallen to around 1.25 per cent. According to the United Nations, it will decline further to about 0.75 per cent per annum by 2040. Population growth in advanced economies has fallen from over 1 per cent per annum in the 1950s to below 0.5 per cent now, and may fall to near zero by 2040. The demographic “sweet spot” will now disappear quite fast. In particular, the ratios of workers to the elderly will worsen rapidly. We are at the point of inflection, and the rate of decline is predicted to steepen in both advanced and developing economies, especially China and Germany. The result is that the total working age population in the world, having grown rapidly between 1970 and 2005, will now grow much less quickly.

In advanced economies and north Asia, it will go into outright decline, while at the same time the ratio of workers to the elderly is already getting worse. As populations age, demand for medical services will grow. We should also be concerned about the impact of age-related medical conditions on the ability of people to work. Age-related illnesses such as dementia will require more patient care and will most likely tie up an increasing share of the labour force.

Unlike the illnesses we worry about most today, age-related illnesses do not diminish patient lifespans significantly. In advanced economies where labour is relatively expensive, a shift towards further labour-intensive patient care would add to labour supply and wage pressures. Just as the expansion in the global labour force pushed wages down—once inflation is taken into account—and inequality up in the advanced economies, a smaller labour force will inevitably lead to rising wages, a larger share of income for labour and a decline in inequality (relative to total population). These demographic changes will be particularly marked in China (see chart 3). It remains to be seen whether the Chinese government’s decision to reform the one child policy will have any significant effect on this.

As Piketty and also Anthony Atkinson have reminded us, inequality within most countries has risen in recent decades. At the same time, it has fallen between countries, as Asian economies have caught up with Europe. The demographic “sweet spot” raised inequality in at least three ways.

First, the positive labour supply shock lowered wages and productivity in the advanced economies. The return to labour fell relative to the return to capital, a trend made worse by the accompanying fall in interest rates. While this created greater inequality within economies, it led to greater equality between countries as productivity and wages in China and eastern Europe rose relative to Japan and the west.

Second, the relocation of labour-intensive production led to deflationary pressure, monetary expansion, higher asset prices and so higher inequality. Employers in advanced economies relocated production to China or eastern Europe. Along with the downward pressure on prices of manufactured goods, this led to deflationary pressures, on both domestic demand and inflation in advanced economies. This led to monetary policy becoming more expansionary, with both nominal and real interest rates trending downwards since the early 1980s. Lower interest rates raised asset prices.

"Demographic trends were one of the main causes of rising inequality within countries over recent decades"

Third, the relocation of production helped to raise the savings rate in China and raised the returns to capital. Providing the capital (and the management) to make these additional workers productive was easier than might have been expected. The dependency ratio in China (and eastern Europe) was also falling fast between 1975 and 2010. With fewer children to support them later in their old age, and faced with an inadequate social safety net, the growing population of China (and eastern Europe) saved voraciously, leading to massive export surpluses, a savings glut and other imbalances. In addition, governance issues encouraged excessive corporate saving in some countries (China and Japan, for example) and insufficient investment in others (for example, the United States and the UK).

Demographic trends were, therefore, one of the main causes of rising inequality within countries over recent decades. This had nothing to do with what Piketty has wrongly described as the innate tendency for returns to capital to exceed growth (r>g, as his famous formula has it). The reversal of these demographic trends will mean that the inequality is likely to reverse in the future, too. Rising wages will ensure a larger share of national output for labour and falling inequality within economies.

There is also likely to be a clear dividing line between advanced economies with adverse demographics that will face slower growth and those whose growth will continue to rise (India, Indonesia and some countries in Africa). In addition to their demographic advantages, developing economies can play catch-up with their advanced counterparts, though this will depend on a range of factors, including the ability of administrators and the quality of policymaking.

Whereas, in the past, the improvement in the dependency ratio was caused by falling birth rates, the worsening of that measure in the future will be caused by a massive rise in the numbers of old people (that is, over-65s). How we treat the swelling ranks of the old will be perhaps the most crucial social policy challenge in the coming years. Among the key issues will be medicine (can we overcome dementia, which is a growing threat?), housing (can we provide more custom-built housing for the old and persuade them to move into it?) and state pensions (what do we do with the destitute old who have failed to provide adequately for an extended old age?).

The consequences of these demographic changes will be profound. They will unwind the three multi-decade trends in the global economy that many today take for granted. First, inflation will rise, reversing the trend that we have witnessed for decades now. The ratio of the old to those of working age, and the overall dependency ratio, is about to get much worse. If the advanced economies continue with their present policies of relatively generous provision of pensions and healthcare to the old, so that consumption rises with age, then the tax burden on workers must rise, which will add to inflationary pressure. The two key cohorts of the population (see chart 4)—the prime working age population and the elderly—will become locked in a political battle. As the ranks of the elderly swell, their political clout will increase. The prime working age population will not be able to assert its influence through numbers in the same way. What they will have on their side, however, is a declining supply of a commodity—labour—whose price is likely to be on an upward trend. Workers may try to compensate for the loss of political power to the elderly by seeking higher wages.

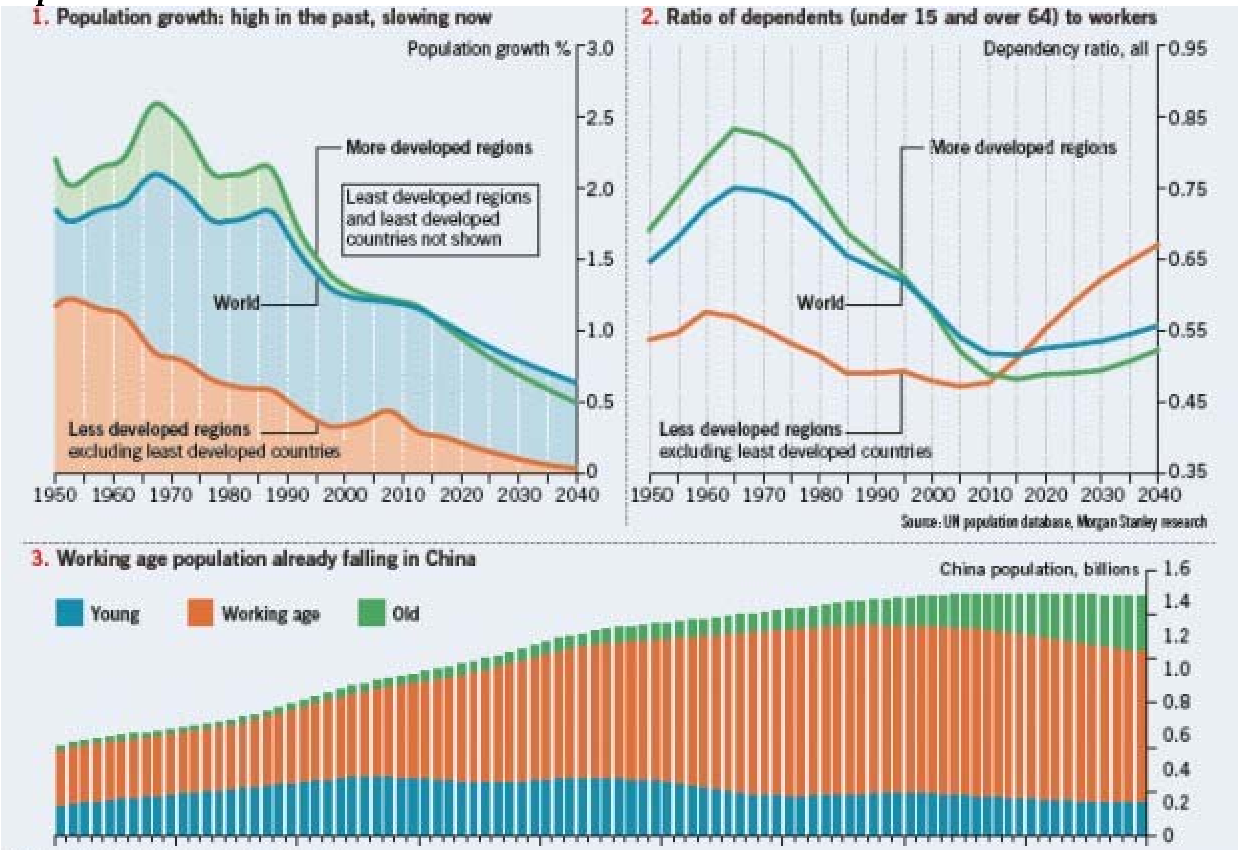
Second, demographics will raise the interest rate level that is consistent with full employment and stable inflation in the global economy, reversing a three-decade-long decline. Known as the "equilibrium real interest rate," this is likely to rise because savings will fall more than investment due to demographic headwinds. There are four reasons for this: China's demographics will lead to lower savings and a smaller current account surplus—this process is already under way and has further to go; inequality will fall and this means income growth is more likely to go into spending than saving; the old in advanced economies show significant inertia when it comes to housing, which means that further residential investment will have to be made in order to house the young; and higher real wages will encourage investment in order to hold down labour costs. North Asia has already seen its demographics turn (Japan's turned in the 1970s).

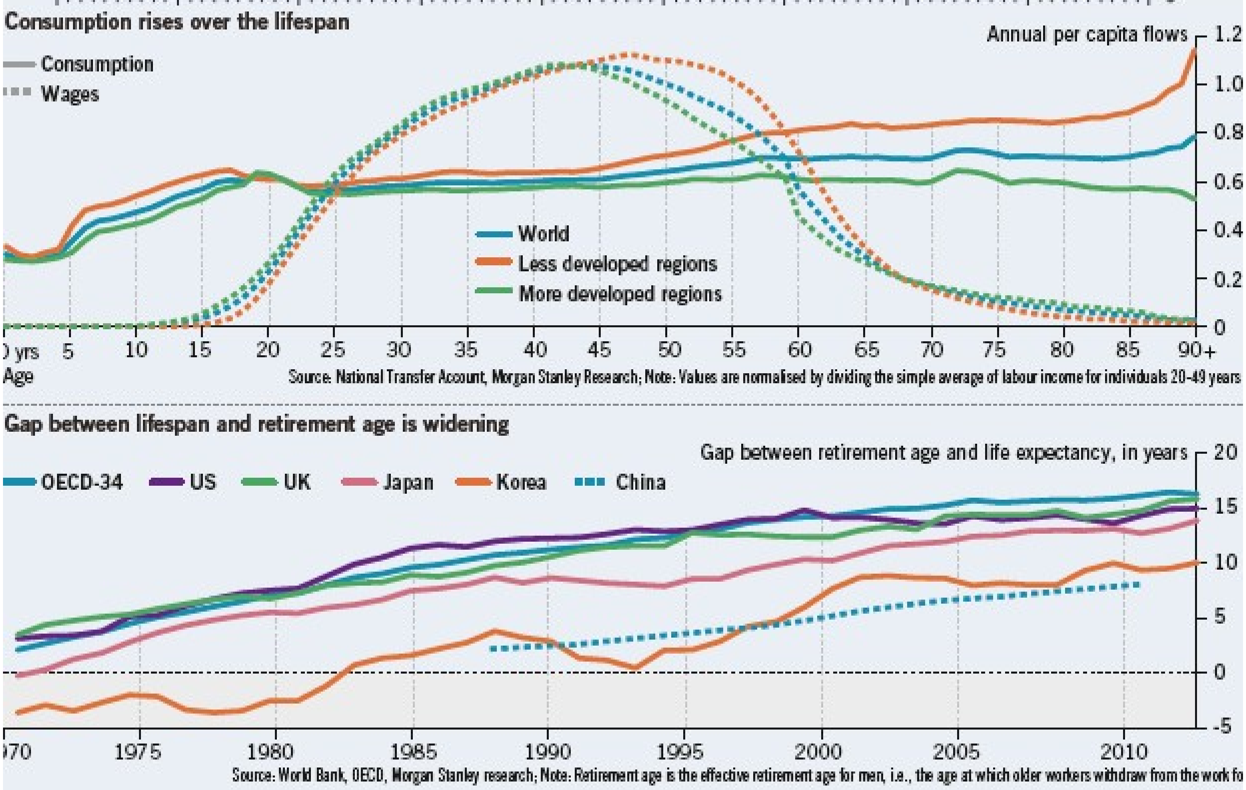
However, north Asia and Japan are not necessarily a guide to the effects that demographics will have on other economies. Why? Japan's demographics were turning at a time when demographic pressures were still very benign. Despite labour getting scarcer in Japan, Japanese firms were able to move production offshore in order to keep wages down. This led to employment moving from manufacturing to services and an excess supply of labour kept wage growth controlled. Demographics elsewhere in north Asia are now turning, but the starting point is severe over-investment and over-indebtedness.

During the period when excessive investment is being reduced, growth will be weak, the returns accruing to capital compared to labour could easily fall even though labour supply is shrinking and deflationary pressures could persist because of excess capacity. These effects may get attributed to demographics, although they are not necessarily related to them. The third long-term trend about to go into reverse is rising inequality. As wages and the share of labour in national income rises, and rising interest rates keep asset prices under control, workers and those who derive their incomes from economic rather than financial activity will do better, relatively speaking. The result, if these dynamics do occur, will be a fall in inequality.

Is this script written in stone? Are there factors that could offset the demographic headwinds that we are about to face? Consider three possibilities. First, participation of the over-65s in the labour markets of advanced economies has been rising from the lows reached nearly 20 years ago, but it varies quite a bit from country to country. Moreover, the "obvious" ways to increase the incentive to work for longer—raising the retirement age, lowering pension benefits and reducing healthcare benefits—are all politically controversial. Even if the political will to implement such changes were strong, participation of over-65s would be unlikely to change overnight. We would begin to see the effects only after the demographic headwinds had started to take a serious toll on the economy.

Explore the data:

- 

- 

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It has become easier to work beyond the age of 65. Life expectancy and health-consciousness have both increased significantly. But the difference between life expectancy and the retirement age has widened consistently over the past 40-45 years. In advanced economies, the difference between life expectancy and retirement age has increased in a straight line; in developing economies, too, this difference has increased, although from a much lower starting point in many instances (see chart 5). The irony, of course, is that it is advanced economies that will probably find it more difficult politically to persuade citizens to work beyond the current retirement age.

There is also still a modest gap, globally, between male and female participation in the labour force. In India, which could potentially be a source of young labour to the developed world, the gap has actually increased in recent years and is now double that of any of its peers. Reducing this gap will not be easy as it is the consequence of deep-seated social issues such as the lack of child security, social care and insurance. But doing so could be important in order to mitigate the effects of demographic headwinds.

Greater labour force participation will depend on education and training for jobs that require verbal skills and experience. A more educated labour force is likely to be able to remain in work for longer. Advanced economies might have to change to provide and then to exploit a greater supply of educated labour. It is education that separates those willing to participate in the labour force beyond retirement age from those able to do so. The evidence bears this out, with labour-force participation by over-55s being higher among those with bachelor or graduate degrees. For the moment, however, involvement remains too low.

A second possibility would be to capitalise on those economies benefiting from demographic tailwinds (Africa and India, in particular). In theory, this looks plausible. But in practice, net immigration into advanced economies has, at least until recently, been pitifully small compared to the size of the labour force, and the political will to change immigration laws dramatically is lacking. Could capital flow to these countries instead of labour flowing to the developed world? Yes, but the bureaucracy, human capital and infrastructure in these economies probably won’t be able to absorb large capital inflows efficiently for quite a few years yet. Migration is unlikely to help if current trends continue. Net migration flows into advanced economies and out of developing economies peaked in 2007 at about 24m each. When adjusted for the size of the population, however, these flows are far too small to make a difference.

For all the fuss about immigration, there is simply too little of it to show any significant global economic impact at all on the kind of demographic changes we are discussing here. Much more would be needed, but this is a politically charged issue. Why not export capital instead to economies with growing populations, produce there and import finished goods from there? Some of this will happen naturally, but exporting capital to economies where the labour force is growing is not easy. There won’t be another “China” for a long time, if ever. Certainly, given where developing economies are starting from, rapid growth is likely, but the likelihood that any of them will be able to transform itself into the next China is small.

With overall growth in developing economies slowing, India, Africa and Latin America will provide a buffer against the global demographic headwinds, but will not be able to mitigate them fully. Perhaps the economy best suited to marrying its generous demographics to an extensive inflow of capital is India. However, such a change is unlikely to occur over the next few years, and could only happen over the next decade with the help of significant tailwinds behind both the domestic and global economy. This is because India's economy is starting from an extremely low level of sophistication. This should allow rapid development, but it is presently in no shape to absorb a large flow of capital and put it to work in a short period of time. If India is to beat the odds and transform itself into a manufacturing powerhouse, global demand will have to become much more supportive. A major factor in keeping India and Africa from becoming economic powerhouses is the lack of an administrative infrastructure. Such infrastructure is critical to help deploy domestic or imported capital and to take advantage of the growing supply of labour.

Could fertility rise again as incomes increase? It could, but there has been little previous evidence that fertility has responded to higher income and wealth even in the advanced economies. Those who predict the future on the basis of current problems—such as deflationary pressures, ever-rising inequality and stagnant growth—have not taken into account the ongoing dramatic reversal of demographic trends.

There were huge increases in the available workforce from 1970 until now, but in the future the workforce will decline by a few million each year, while the number of old people will explode. The future will have its own difficulties, but they will not be the same as those in the past. Piketty is history.