The Telegraph

The world economy as we know it is about to be turned on its head

The demographic 'sweet spot' is vanishing. We are on the cusp of a complete reversal, spelling the end of corporate hegemony Also

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Workers of the world are about to get their revenge. Owners of capital will have to make do with a shrinking slice of the cake.

The powerful social forces that have flooded the global economy with abundant labour for the past four decades years are reversing suddenly, spelling the end of the deflationary super-cycle and the era of zero interest rates.

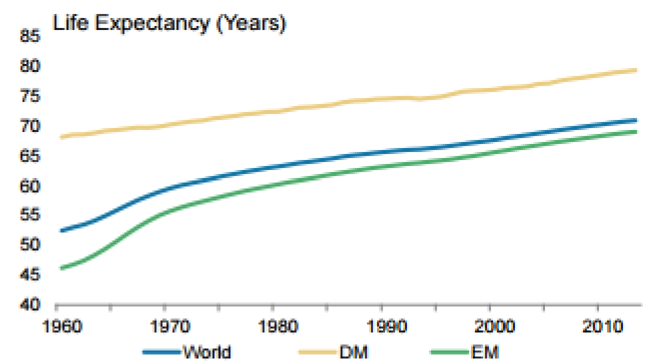
"We are at a sharp inflexion point," says Charles Goodhart, a professor at the London School of Economics and a former top official at the Bank of England.

As cheap labour dries up and savings fall, real interest rates will climb from sub-zero levels back to their historic norm of 2.75pc to 3pc, or even higher.

The implications are ominous for long-term US Treasuries, Gilts or Bunds. The whole structure of the global bond market is a based on false anthropology.

Exhibit 4

Life Expectancy: Up Sharply in EM, Slower in DM

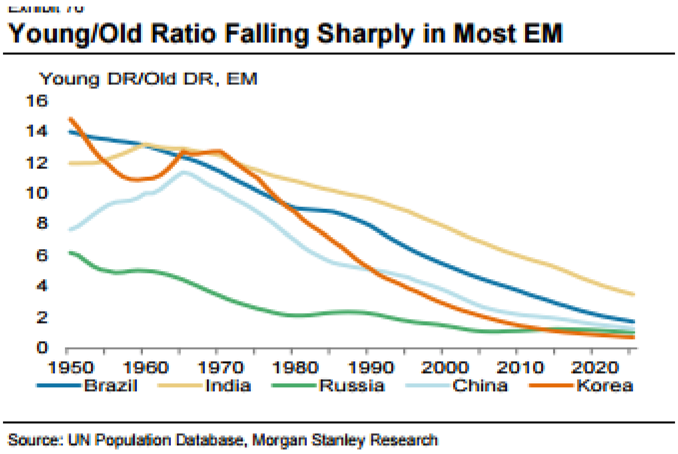


Source: World Bank, Morgan Stanley Research. Note: DM includes high-income countries (OECD and non-OECD), EM includes low and middle income countries.

Prof Goodhart says the coming era of labour scarcity will shift the balance of power from employers to workers, pushing up wages. It will roll back the corrosive inequality that has built up within countries across the globe.

If he is right, events will soon discredit the sweeping neo-Marxist claims of Thomas Piketty, the best-selling French economist who vaulted to stardom last year.

Mr Piketty's unlikely bestseller - Capital in the 21st Century - alleged that the return on capital outpaces the growth of the economy over time, leading ineluctably to greater concentrations of wealth in an unfettered market system. "Piketty was wrong," said Prof Goodhart.



What in reality happened is that the twin effects of plummeting birth rates and longer life spans from 1970 onwards led to a demographic "sweet spot", a one-off episode that temporarily distorted labour economics.

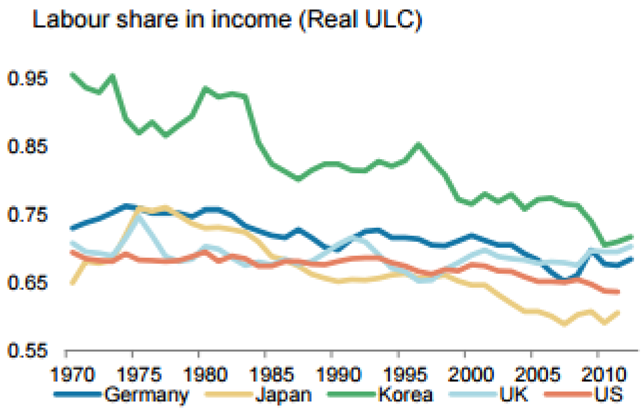
Prof Goodhart and Manoj Pradhan argue in a paper for Morgan Stanley that this was made even sweeter by the collapse of the Soviet Union and China's spectacular entry into the global trading system.

The working age cohort was 685m in the developed world in 1990. China and eastern Europe added a further 820m, more than doubling the work pool of the globalised market in the blink of an eye.

"It was the biggest 'positive labour shock' the world has ever seen. It is what led to 25 years of wage stagnation," said Prof Goodhart, speaking at a forum held by Lombard Street Research.

We all know what happened. Multinationals seized on the world's reserve army of cheap leader. Those American companies that did not relocate plant to China itself were able play off Chinese wages against US workers at home, exploiting "labour arbitrage". US corporate profits after tax are now **10pc of GDP**, twice their historic average and a post-war high.

Labour Share in Income Has Also Been Falling

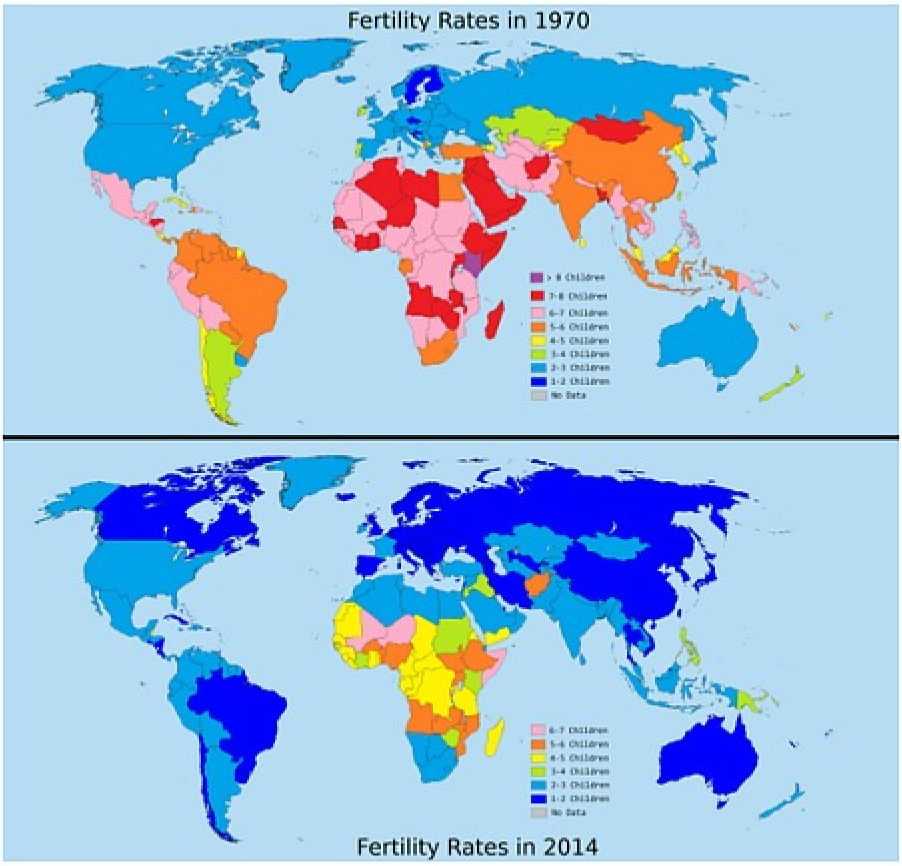


Source: OECD, Morgan Stanley Research; Note: The annual labour income share is calculated as total labour costs divided by nominal output.

It was much the same story in Europe. Volkswagen openly threatened to shift production to Poland in 2004 unless German workers swallowed a wage freeze and longer hours, tantamount to a pay cut. IG Metall bowed bitterly to the inevitable.

Cheap labour held down global costs and prices. China compounded the effect with a factory blitz - on subsidised credit - that pushed investment to a world record 48pc of GDP and flooded markets with cheap goods - first clothes, shoes and furniture, and then steel, ships, chemicals, mobiles and solar panels.

Lulled by low consumer price inflation, central banks let rip with loose money - long before the Lehman crisis - leading to even lower real interest rates and asset bubbles. The rich got richer.



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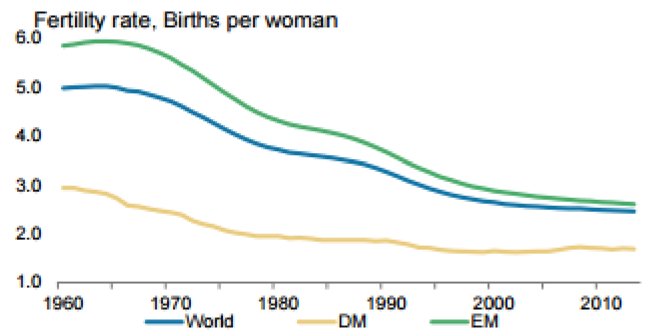
This era is now history. Wages in China are no longer cheap after rising at an average rate of 16pc for a decade.

The yuan is overvalued. It has appreciated 22pc in trade-weighted terms since mid-2012, when Japan kicked off Asia's currency war. Panasonic is switching production of microwaves from China back to Japan.

But the underlying causes of the deflationary era run deeper. The world fertility rate has steadily declined to 2.43 births per woman from 4.85 in 1970 , with a precipitous collapse over the past 20 years in east Asia.

Exhibit 2

Fertility Rates Falling All Over the World



Source: World Bank, Morgan Stanley Research; Note: DM includes high-income countries (OECD and non-OECD), EM includes low and middle-income countries

The **latest estimates** are: India (2.5), France (2.1), US (two), UK (1.9), Brazil (1.8), Russia and Canada (1.6), China (1.55), Spain (1.5) Germany, Italy, and Japan (1.4), Poland (1.3) Korea (1.25), and Singapore (0.8). As a rule of thumb, it takes 2.1 to keep the population on an even keel.

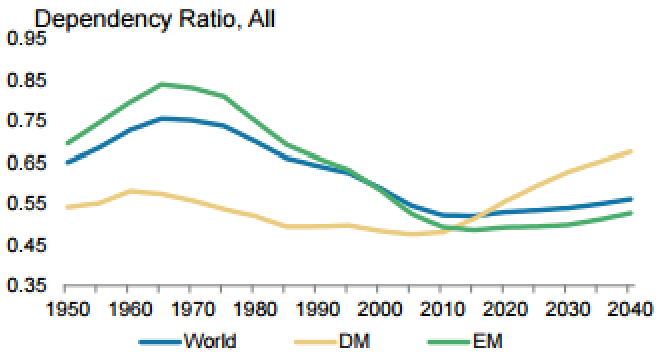
The numbers of working-age rose sharply relative to children and - for a while - the elderly. The world dependency ratio dropped from 0.75 in 1970 to 0.5 last year. This was the sweet spot.

"We are on the cusp of a complete reversal. Labour will be in increasingly short supply. Companies have been making pots of money but life isn't going to be so cosy for them anymore," said Prof Goodhart.

The dependency ratio has already bottomed out in the rich countries. It is now rising far more quickly than it fell as baby boomers retire and people live much longer.

Exhibit 5

Dependency Ratios Were Falling, Should Now Rise

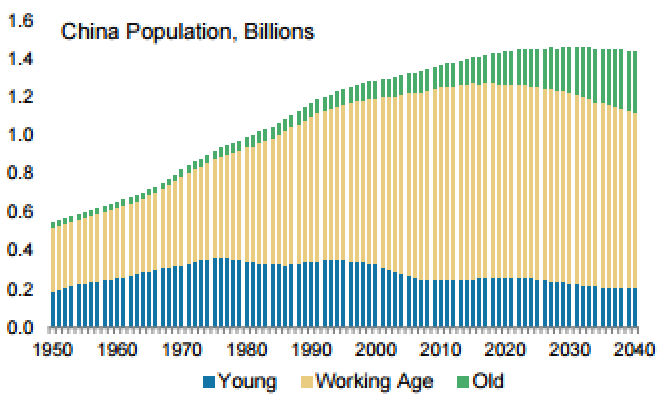


Source: UN Population Database, Morgan Stanley Research

China will face a double hit, thanks to the legacy effects of the one-child policy. "They kept it going 15 years too long, disastrously," said Prof Goodhart. China's workforce is already shrinking by 3m a year.

It is widely assumed that the demographic crunch will pull the world deeper into deflation, chiefly because that is what has happened to Japan - probably for unique reasons - since it pioneered mass dotage 20 years ago.

Working Age Population Already Falling in China



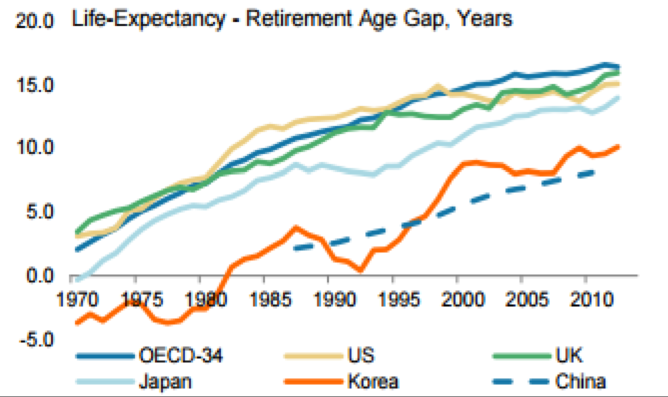
Source: UN Population Database, Morgan Stanley Research

The Goodhart paper makes the opposite case. Healthcare and ageing costs will drive fiscal expansion, while scarce labour will set off a bidding war for workers, all spiced by a state of latent social warfare between the generations. "We are going back to an inflationary world," he said.

China will no longer flood the world with excess savings. The elderly will have to draw down on their reserves. Companies will have to invest again in labour-saving technology, putting their great stash of idle money to work.

Exhibit 39

Gap Between Longevity and Retirement Age in Selected Countries Is Rising



Source: World Bank, OECD, Morgan Stanley Research; Note: Retirement age is the effective retirement age for men, i.e., the age at which older workers withdraw from the workforce.

We will see a reversal of the forces that have pushed the world savings rate to a record 25pc of GDP and created a vast pool of capital spilling into asset booms everywhere, even as the global economy languishes in a trade depression.

The "equilibrium rate" of real interest will return to normal and we can all stop talking about "secular stagnation". Central banks can stop fretting about the horrors of life at the "zero lower bound" (ZLB), and they are certainly fretting right now.

The Bank of England's chief economist, Andrew Haldane, warned in a**haunting speech** last week that we may be stuck in a zero-interest trap for as far as the eye can see, with little left to fight the next downturn - typically requiring three to five percentage points of rate cuts to right the ship.

"Central banks may find themselves bumping up against the ZLB constraint on a recurrent basis," he said. His answer is a menu of quantitative easing so exotic it trumps Corbynomics for heterodoxy.

Professor Goodhart makes large assumptions. He doubts that robots will displace workers fast enough to offset the labour shortage, or that greying nations are culturally able to absorb enough immigrants to plug the jobs gap, or that India and Africa have the infrastructure to repeat the "China effect".

The world has never faced an ageing epidemic before so we are in uncharted waters. What is clear is that the near vertical take-off of the dependency ratio is about to shatter all our economic assumptions.

The last time Europe's serfs suddenly found themselves in huge demand was after the Black Death in the mid-14th century. They say it ended feudalism.