

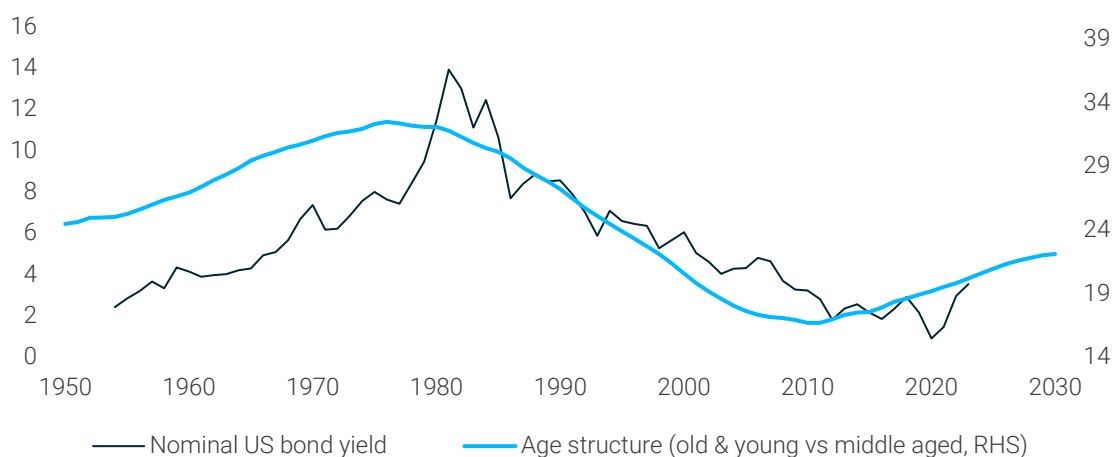
Macro Picture

REVENGE OF THE 3Ds?

Dario Perkins

Before COVID, the world was stuck in a secular funk, with economists blaming the “3 Ds” – demographics, debt and an increasingly uneven distribution of income. But these forces will not generate the same deflationary force in the 2020s. Demographics looks increasingly inflationary, while deglobalization will compound labour shortages and curb inequality.

Chart 1: Demographics not as deflationary as it seems



Source: United Nations, TS Lombard

THE THREE DS OF DISINFLATION

Aging demographics, record global debt levels and an increasingly uneven distribution of income produced a highly deflationary environment in the 2010s. Worse, these forces seemed to interact with one another to create a liquidity trap. Many investors think we are headed back to this environment – or something worse – once the distortions of the past three years eventually fade.

DEMOGRAPHICS AS DESTINY

The combination of globalization and the baby boomers entering middle age was a particularly potent mix. Savings increased, the wage share declined, inequality widened and interest rates plunged, which encouraged a rerating of global asset prices and a rise in leverage. Central banks took the credit, but they were not responsible for the Great Moderation of the post-1980s.

NO JAPANESE ENDGAME

Contrary to what many investors assume, the deflationary impact of the 3Ds is set to reverse. The baby boomers are retiring – which means less saving and fewer workers – and globalization is in retreat. The wage share could trend higher, and inequality narrow. This new environment is not necessarily bad for global growth. It could even spark a productivity revival.

REVENGE OF THE 3Ds?

Before COVID-19, the world seemed to be stuck in a secular macro funk, which most investors thought would never end. Mainstream economics blamed the “three Ds” – record global debts, bad demographics and an increasingly unequal distribution of income (as a result of globalization and new digital technologies). Interest rates would be stuck at zero, perhaps forever, with the whole global economy in effect “turning Japanese” – since Japan was the first major economy to experience these dynamics. While the momentous events of the past few years have created a very different environment for financial markets and a new set of challenges for policymakers, the consensus is still assuming an eventual return to pre-COVID norms. Secular stagnation will ultimately retain its grip on the world economy, which means inflation and interest rates will settle back at historical lows. Our view, however, is somewhat different. Looking beyond the noise and distortions of the past three years, we think a subtly different macro regime is emerging, with COVID-19 and the war in Ukraine – like WW2 – set to mark a lasting inflection point for interest rates and inflation. And, contrary to the pushback we receive from clients, the 3Ds will not prevent this transition. In fact, they are part of the story.

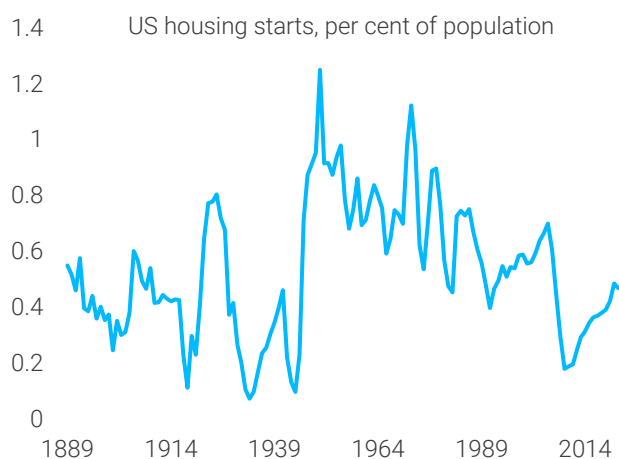
There is no doubt that aging demographics and rapid globalization were a powerful deflationary mix after the mid-1980s. Longevity increased and the baby boomers entered middle age, which raised desired savings rates, just at the point when China, Eastern Europe and various other developing nations became more integrated into the world economy. These structural shifts – combined with the neoliberal politics of the era – produced a massive increase in the effective labour force, a collapse in the DM wage share, a widening in domestic inequality and a plunge in interest rates. And lower interest rates, in turn, encouraged an historic rerating of asset prices and a vast accumulation of private debt. Initially celebrated as the Great Moderation, this new era of low interest rates became decidedly more sinister after the global financial crisis. The private sector entered a lengthy period of deleveraging, growth slumped and inequality (previously concealed by low-income borrowing) became increasingly untenable, contributing to an ever-more fractious and toxic political climate. Most alarming of all, productivity growth – the barometer of a healthy capitalist system – sunk to its lowest levels since the Industrial Revolution, as cheap debt, persistently lukewarm demand and low wages discouraged companies (with the exception of the tech superstars) from investing in new technologies.

Looking ahead, there are good reasons to think the secular disinflation trend of the past 40 years is shifting into reverse. Demographics alone – often misunderstood by investors – is likely to raise inflation and drive equilibrium interest rates higher. The baby boomers are retiring, which means saving rates are set to decline. During the pandemic, which accelerated the impact of population aging, we saw that when older workers drop out of the labour force, they tend to raise the bargaining power of younger workers, which can cause a significant acceleration in wages. Combine already tight labour markets with future demographic changes and deglobalization and it seems we are entering a world of structural labour shortages – a far cry from the glut of excess workers that defined the disinflationary era. While it is tempting to view these trends as inherently bearish – they will certainly make life more challenging for financial markets – the global economy that emerges from these structural changes could ultimately be stronger and more sustainable. Much will depend on what happens to productivity growth, which is where we see reasons for optimism, particularly after the disastrous performance of the past decade. While it would be going too far to hope for a new Golden Age similar to that after WW2, there is every reason to think the world can avoid a return to secular stagnation. Japan is not the endgame.

1. THE THREE Ds

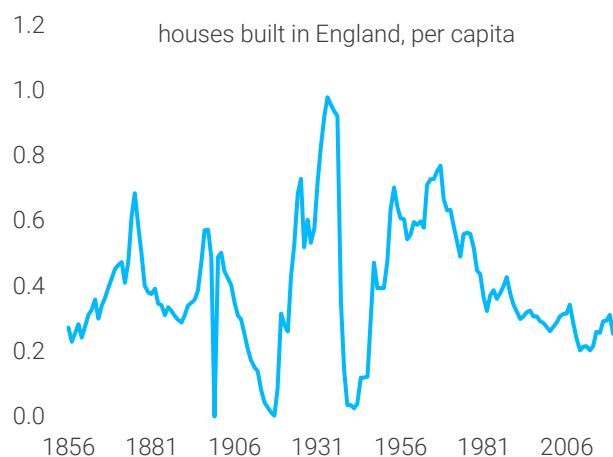
The [previous Macro Picture](#) compared today's global economy with the situation that prevailed after WW2. Both episodes involved severe supply disruptions, significant pent-up demand and huge sectoral shifts in activity, which combined to produce massive distortions in the economy. Like the period around WW2, the past three years have not been a normal business cycle. We argued that investors should be careful not to form an overly deterministic view about the short-term outlook because, as was evident in the mid-1940s, [fake cycles can have unusual endings](#). In this Macro Picture, we want to look beyond the distortions of the past three years and focus on the longer-term outlook. Ultimately, WW2 marked a crucial turning point in the macroeconomic supercycle. Despite a bumpy landing, the global economy that emerged from the other side of that conflict was fundamentally stronger and more inflationary. We think COVID-19 and the war in Ukraine could mark another secular inflection point. While the 2020s will not recreate the multi-decade boom of the 1950s and 1960s – [the golden age of capitalism](#) – there are good reasons to think the underlying macro environment will look subtly different from that of the pre-COVID era.

Chart 2: Demographic boost after WW2



Source: FRED database, TS Lombard

Chart 3: Slower population – less investment?



Source: Bank of England, TS Lombard

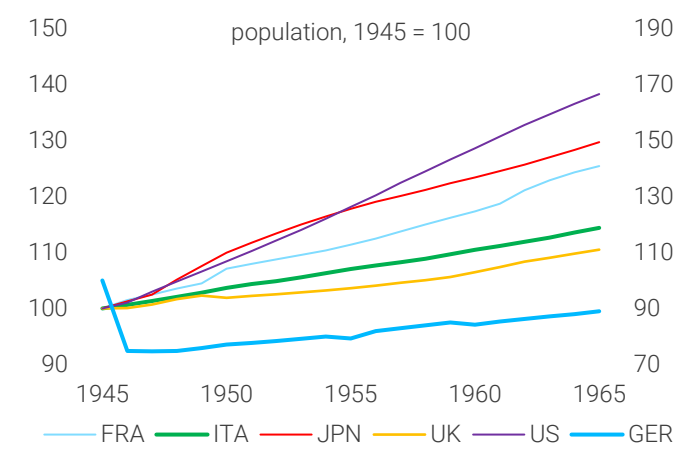
Back to secular stagnation?

Any attempt to forecast a new macroeconomic regime always meets stiff opposition. Indeed, most investors think the world economy is ultimately headed back to the secular stagnation that existed before COVID-19 – or something worse. The consensus assumes continued mediocre growth – at best – while bond markets are priced for persistently low interest rates. There is an assumption that QE and NIRP will eventually return, particularly if the current episode of monetary tightening delivers a global recession sometime during the next 12 months. The reason for this bearishness? The Three Ds – debt, demographics and the distribution of income. Before the pandemic, most economists believed that record global debt levels, poor demographics and extreme inequality had fundamentally hobbled the longer-term trajectory of the global economy. [These forces not only remain in place](#); some pundits believe they have also become more potent. Governments borrowed heavily during the pandemic and many older workers have retired.

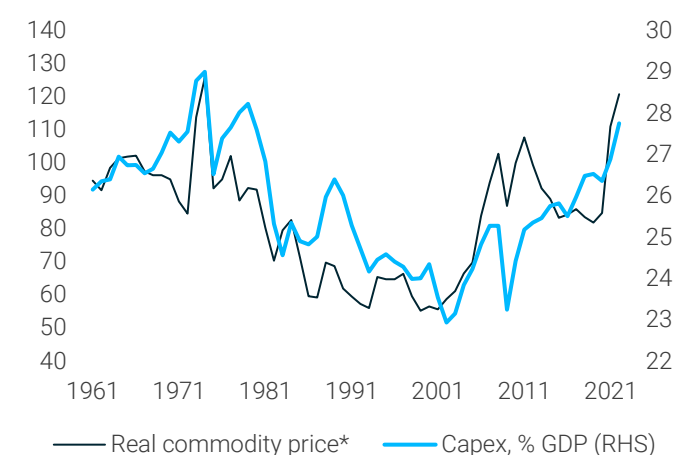
Stuck in a trap?

The alarming thing about the Three Ds is that they seemed to interact in dangerous ways during the 2010s, locking the global economy into a secular funk. Not only was the workforce slowing

and becoming older – which was leading to excess savings – but purchasing power was becoming increasingly concentrated among the groups least likely to spend. This caused persistently weak demand and low inflation, which central banks tried to offset with endless monetary stimulus. But low interest rates only encouraged rapid debt accumulation, which – by making the global economy even more sensitive to borrowing costs – made it even more difficult to escape the trap. Once debt levels reached unsustainable levels, prompting extended balance-sheet recessions after the 2008 financial crisis, the world appeared to be stuck in secular stagnation. There was even talk of the world economy “turning Japanese”, since Japan was the first major economy to struggle under the weight of excessive debts and souring demographics.

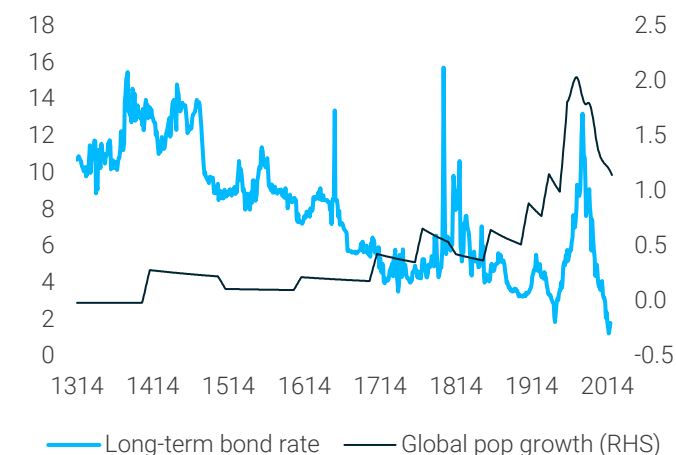
Chart 4: Rapid population growth after WW2


Source: MacroHistory, TS Lombard

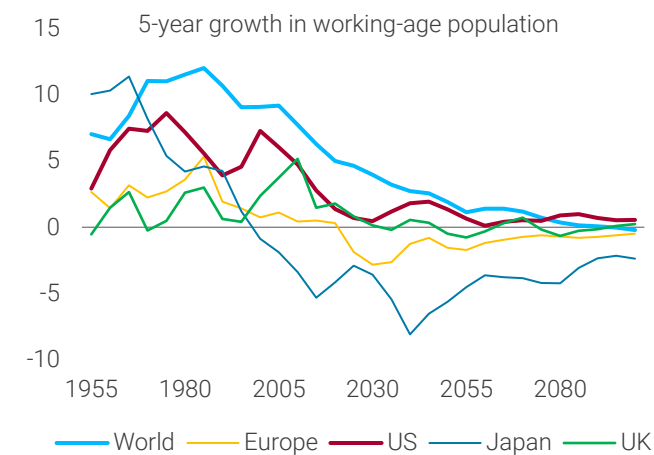
Chart 5: Capex drives commodity cycles

Source: [World Bank database](#), TS Lombard, *non-energy

Contrast with the 1940s

Turning Japanese or not, it is true that the Three Ds put today's economy at a clear disadvantage compared with the post-WW2 period. Not only was the population growing more quickly after the 1940s (thanks the emergence of the baby-boom generation), but private debt levels were low and governments used their new “mixed economies” to reduce inequality and deliver strong, socially inclusive growth. Investment spending was robust, thanks to the rebuilding of Europe and Japan and the suburban expansion of US cities. And there was a powerful surge in productivity, as new wartime technologies were redeployed for civilian uses. Naturally, it is stretch to think the world can recreate these favourable conditions during the 2020s. But that is not the point. Our thesis is that global economy is going to change in important ways and that there are echoes from the 1940s in how this might play out. Don't forget that when WW2 ended, most economists thought the economy would quickly settle back into the era of secular stagnation (the Great Depression) that had preceded the conflict. They failed to realize that the world had changed. We think investors are making a similar mistake today. And, contrary to what the consensus is assuming, even the Three Ds cannot suppress this (gentle) inflection point in the global macro supercycle. To explain why, we need to examine each of the “Ds” in turn – starting with global demographics.

Chart 6: Demographics through history


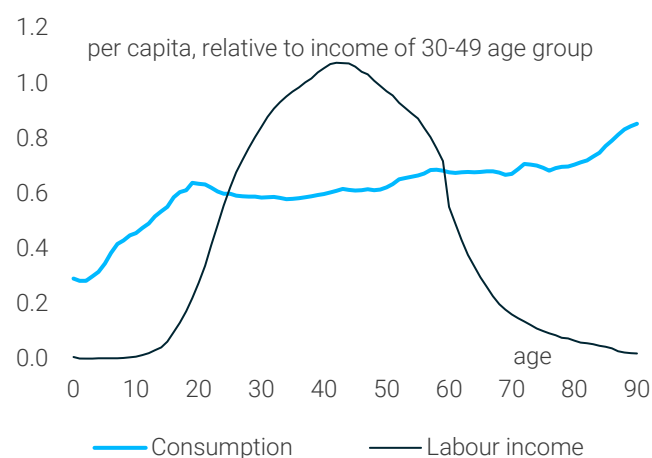
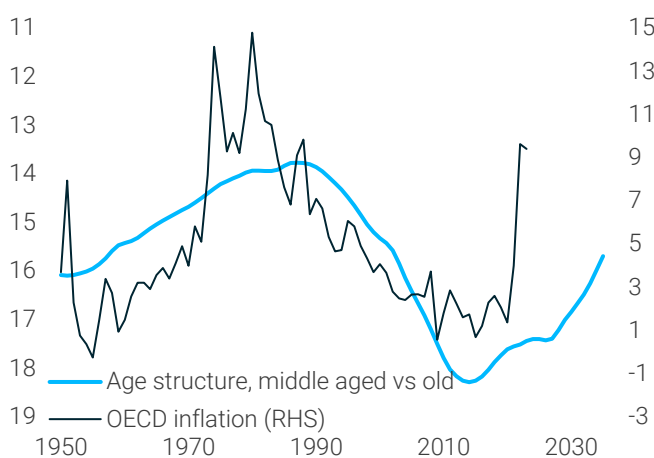
Source: worldometers.info, TS Lombard

Chart 7: Population growth set to slow


Source: United Nations, TS Lombard

2. DEMOGRAPHICS AS DESTINY

There is a widespread belief that aging demographics is inherently deflationary, guaranteeing a future of permazero interest rates. Japan, which was the first major economy to pass this demographic turning point, is always the benchmark for how many expect this process to play out. But the economics of population aging is more complicated than it seems; and there are good reasons to think the global demographic transition could, in fact, be inflationary and so push up equilibrium interest rates. This has certainly been the experience during the pandemic, where COVID-19 accelerated the retirement of many baby boomers, causing significant labour shortages, which increased the bargaining power of younger workers. Wages have accelerated at a pace that seemed unimaginable three years ago, particularly in low-earning occupations such as hospitality and transport. And older people spend a much larger proportion of their income, particularly compared with the middle aged, which also has important implications for inflation.

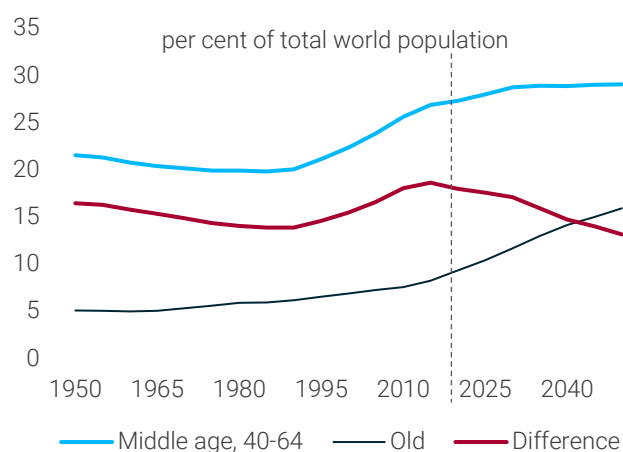
Chart 8: Life-cycle consumption patterns

Source: [National Transfer Accounts](#)
Chart 9: Global demographics turns inflationary?


Source: United Nations, OECD, TS Lombard

The impact of aging populations

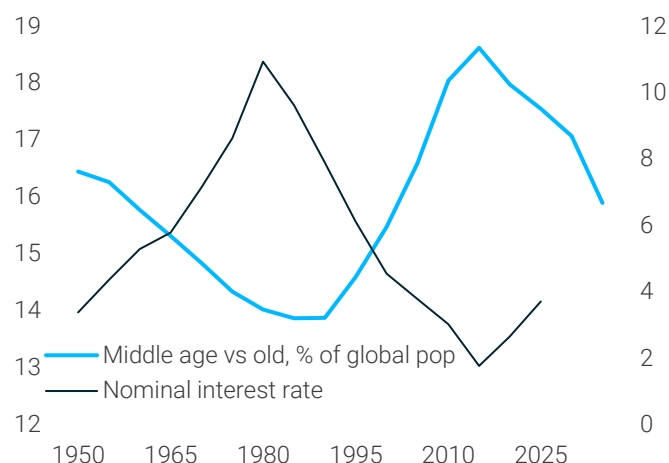
There is no doubt demographics is important. Some say it is “destiny”, largely because changes in the population are usually slow-moving, which means it is possible to forecast underlying trends over many years, sometimes decades. But most investors think about demographics in a relatively narrow context – they tend to focus on population growth. When the population is growing rapidly, as it was between 1945 and the 1970s, enormous pressure is put on the resources of the economy. Investment needs will increase, especially in areas like housing and infrastructure. And this will have spillover effects to the demand for consumer durables, household furnishings and a range of commodities. Conversely, when population growth slows, as it did after the early 1980s, all that pressure will fade. GDP growth will decline and investment spending will diminish, producing a disinflationary world. So, it seems odd that central bankers always downplay the significance of these forces. They prefer to think of inflation as a monetary phenomenon – because they believe they can offset the impact of demographics by adjusting interest rates. And, of course, they like to take the credit for post-1980s disinflation.

Chart 10: Shifting population structures



Source: United Nations, TS Lombard

Chart 11: Real interest rates set to rise?



Source: United Nations, Bank of England, TS Lombard

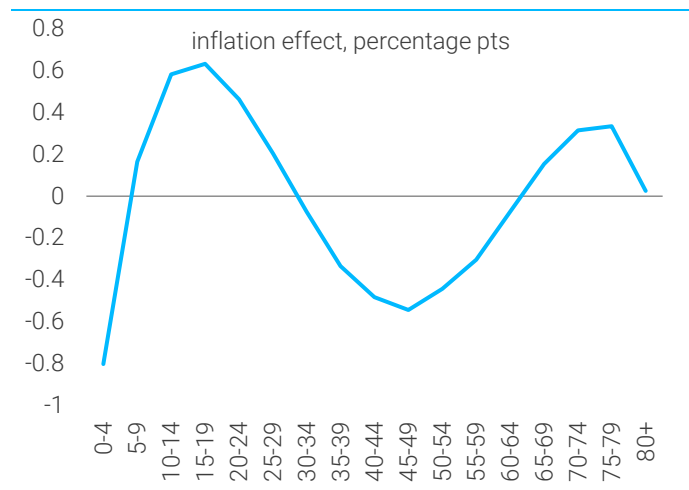
How to think about demographics

The impact of demographics is more complicated than just its impact on overall GDP growth. Changes in population affect not only investment needs but also the desire to save. And it is this balance between desired savings and investment that ultimately determines equilibrium interest rates (the level of interest rates that is theoretically consistent with stable inflation and full employment). If investment needs rise relative to desired savings, the equilibrium interest rate will increase – which means higher inflation, unless central banks fully offset the effects by tightening monetary policy. Thinking about demographics in terms of equilibrium interest rates means central banks retain some ability to influence inflation, but only if they are sensitive to these deeper structural changes in the economy. In practice, this may be difficult because demographic shifts are slow-moving and often have no bearing on their short-term policy decisions. And, of course, in the 2010s central banks faced the additional complication of the lower policy bound, which often constrained their ability to respond to persistent disinflationary pressures. Bearing these caveats in mind, it is evident that demographics can influence the *prevailing tendency* of inflation through several channels:

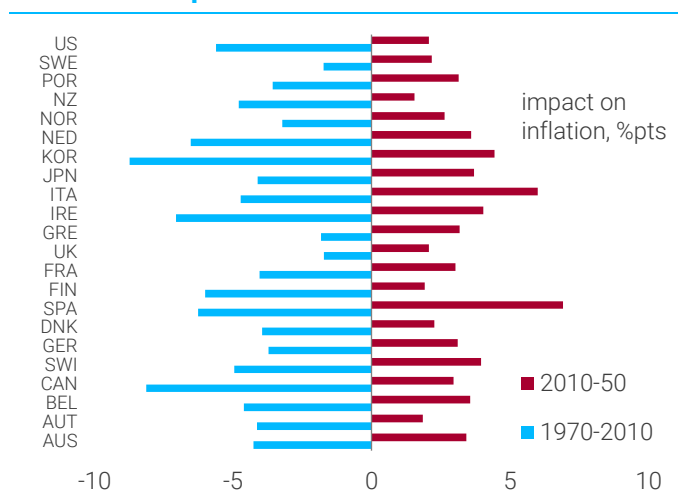
- (i) **Population growth** – a rapidly growing population needs more investment.

- (ii) **Compositional effects** – consumption patterns follow a “life cycle” profile. People borrow while they are young, save during middle age and spend down those savings after they retire. All else being equal, a population in which everyone is middle-aged will be more disinflationary than a population stacked with younger or older groups.
- (iii) **Longevity** – As life expectancy increases, people will need to save more for their retirement, particularly if retirement ages do not keep up with longevity. Life expectancy trended higher for decades, though progress has slowed recently.
- (iv) **Politics** – a particularly large cohort of a specific demographic group can tilt political outcomes. Take the baby boomers. In the 1960s and 1970s, as they entered the workforce, they had a strong incentive to support institutions that favoured full employment, such as trade unions. By the 1980s, as they accumulated wealth and savings, their preferences shifted to preferring price stability, so they favoured reforms that could deliver low inflation, including independent central banks.

Based on these transmission channels, it should be clear that the prevailing tendency of demographics shifted from inflation to disinflation during the 1980s. The baby-boom generation, which required big increases in investment after WW2, were entering middle age – which raised desired savings – just at the point when overall population growth had slumped (reducing investment demand) and longevity had increased (providing an additional boost to savings). Equilibrium interest rates collapsed. This was the start of a multi-decade bull market for bonds – and of a period that central banks would affectionately label the Great Moderation. Unfortunately for policymakers, it is unlikely these trends will continue. In fact, the world seems to have recently passed another demographic inflection point, which could turn the Great Moderation on its head. With the baby boomers retiring, savings rates will plunge, equilibrium interest rates will rise and the prevailing tendency of inflation could shift higher – particularly if central banks fail to respond. This a point Charles Goodhart and Manoj Pradhan have made repeatedly in recent years.

Chart 12: Demographic impact is complex


Source: [BIS study](#)

Chart 13: BIS predicts secular inflation


Source: [BIS study](#)

The BIS findings

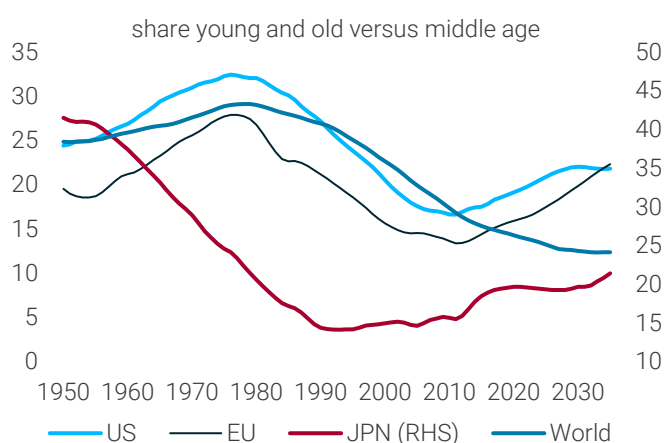
While [Goodhart and Pradhan](#) are the names most readily linked to the inflationary impact of future demographics, their ideas are consistent with several recent empirical studies. [A BIS paper from 2019 is arguably the most important of these](#). The BIS estimated the effects of the demographic structure—not just aging—on inflation using data from 22 advanced economies

from between 1955 and 2014 and found a robust relationship (Chart 12). In particular, the researchers identified a stable U-shaped pattern: the young (aged 5-29) and the old (65+) are inflationary, whereas the prime working-age cohorts are disinflationary. This U-shaped pattern is robust and did not disappear when other variables that are often associated with inflation—such as output gaps, oil prices, real interest rates, population growth, and fiscal policy – were included. The relationship also survives different time periods and alternative country samples. The BIS believes age structure can explain the bulk of what they call “trend inflation” and about a third of the overall variation in OECD CPIs. Looking ahead, they predict a sustained inflationary impulse over the next 20 years – as the share of people in middle age continuously dwindles (Chart 13).

But what about Japan...?

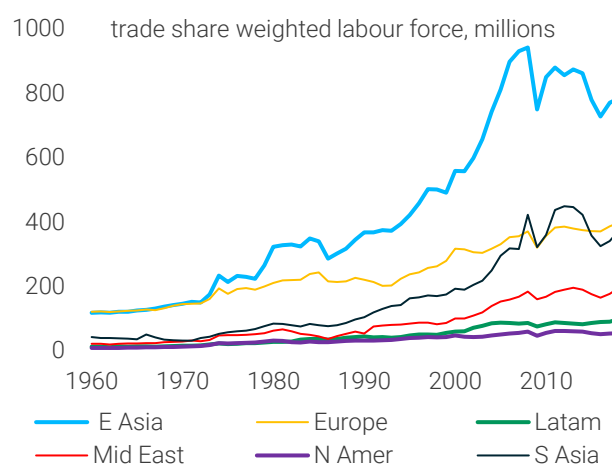
Demographics as an inflationary force seems counterintuitive to many investors. Certainly, it is at odds with Japan’s experience, which has long been the posterchild for how these trends were expected to play out. So why has Japan suffered relentless deflation since it passed its demographic inflection point in the early 1990s? We think there are two explanations. First, while the proportion of the Japanese population that is very old has grown over the past 30 years, that increase has been offset by a collapse in the proportion that is very young. The balance between the high-inflation groups and the low-inflation groups has, in fact, been quite stable since the early 1990s, particularly compared with what is expected to happen to most developed economies (and a number of emerging economies) over the next 20 years. The US and Europe, by comparison, are set to move to an age structure that is (on balance) significantly more inflationary. The second reason we should not pay too much attention to Japan’s experience is that we need take account of the interaction between demographics and other structural macro trends. Since the aging of Japan’s population happened alongside deep domestic vulnerabilities and strong disinflationary forces in the rest of the world, it is unlikely to provide a useful guide to what happens elsewhere.

Chart 14: Japan’s age structure wasn’t inflationary



Source: United Nations, TS Lombard

Chart 15: Globalization caused a glut of labour



Source: United Nations, TS Lombard estimates

3. NO JAPANESE ENDGAME

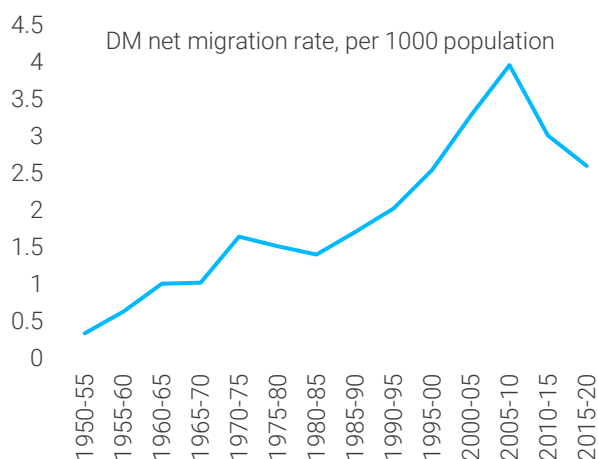
The Japanese demographic inflection point happened during a period of rapid globalization, which produced a massive (offsetting) increase in the effective supply of labour. Meanwhile, the domestic economy struggled under the weight of huge private-sector debts, large internal income

imbalances and a relentless decline in inflation expectations. The demographic transition that is about to hit the rest of the world is likely to play out rather differently. Not only will rising dependency ratios reduce the desire to save; the combination of an aging workforce and deglobalization could create persistent labour shortages. Wages are likely to grow at a faster pace, while the profit share could decline and inequality narrow. To many investors, this will sound like a recipe for stagflation and dismal asset-price returns. But it is important not to overlook the potential benefits of a higher-pressure economy with a more equal distribution of income. Productivity is likely to improve, which could drive a revival in overall GDP growth. Unlike the situation in Japan after the 1990s, “excessive debt” is not a barrier to this new macro regime. Private-sector deleveraging is over and DM governments will run persistent fiscal deficits.

A new era of labour shortages

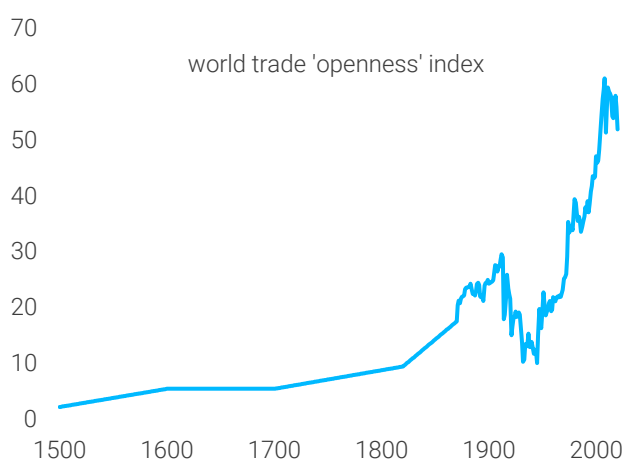
One of the important things about an aging population – often forgotten in economists’ discussions about the impact of demographics – is what it means for the labour market. Yet the recent pandemic should have made its impact abundantly clear. Many older workers dropped out of the labour market, taking early retirement in order to avoid exposure to COVID-19 (because they were particularly vulnerable to the disease) or to take advantage of rapid increases in their personal wealth (thanks to surging equity and home values). And this reduction in the labour force, in turn, had a powerful impact on wages. Younger workers, particularly in “high contact” occupations, discovered they suddenly had more bargaining power, with companies in those sectors forced to offer large pay increases in order to fill the huge number of job openings. Even now, with the effects of the pandemic fading, we still see acute labour shortages all over the developed world. Wages are growing at a pace few imagined three years ago, which is adding to the pressure on profit margins and services-sector inflation. Central banks believe this now represents a “fundamental imbalance” in the economy, the main obstacle to returning inflation to their 2% targets. It is the number one reason they are still tightening monetary policy.

Chart 16: Popular revolt against immigration



Source: United Nations

Chart 17: Globalization has peaked (again...)

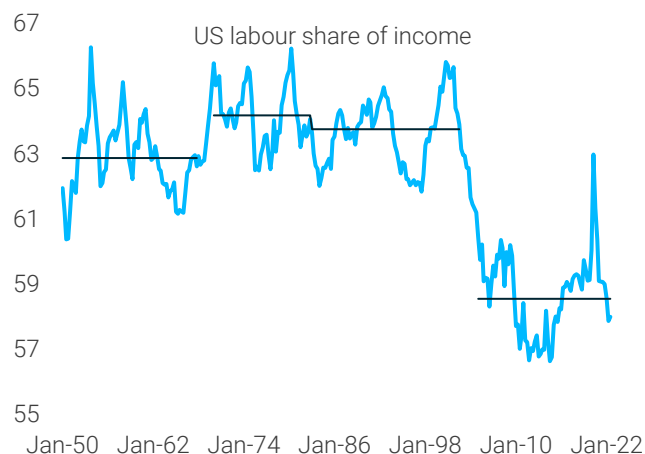


Source: Ourworldindata.com

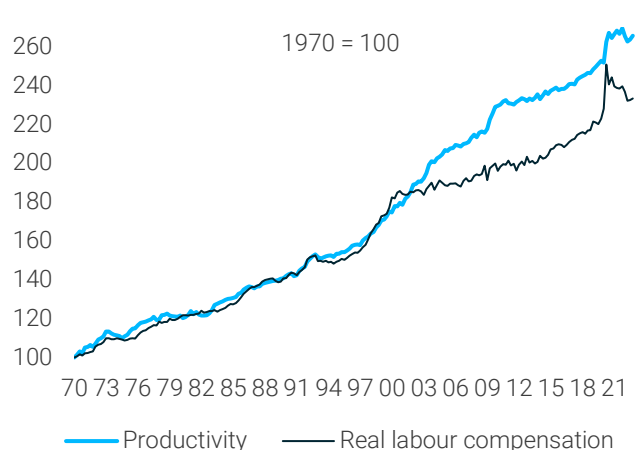
Deglobalization will compound the problem

Given the size of the current imbalance in labour markets, we are doubtful central banks will be able to eliminate these labour shortages even if they cause a recession during the next 18 months. Our estimates suggest it would need an extremely deep recession to achieve such an outcome, and the political appetite for such an adjustment simply does not exist. Today is not like the early 1980s, when a decade of stagflation had produced a new neoliberal consensus. More important, however, we doubt central banks could restore longer-term balance to labour markets even if they tried. This is because the structural forces that worked in their favour after the 1980s

are now turning against them. The neoliberal consensus is gone and globalization is becoming deglobalization. Just as globalization interacted with demographics to crush worker during the Great Moderation, deglobalization could now interact with new demographic trends to produce the opposite effects. This would mean persistent labour shortages, faster wage growth, a trend decline in the profit share, higher inflation and a secular bear market for government bonds.

Chart 18: Labour share collapsed after the 1990s


Source: BEA, TS Lombard

Chart 19: Wages fell behind productivity


Source: BLS, TS Lombard

The distribution of income

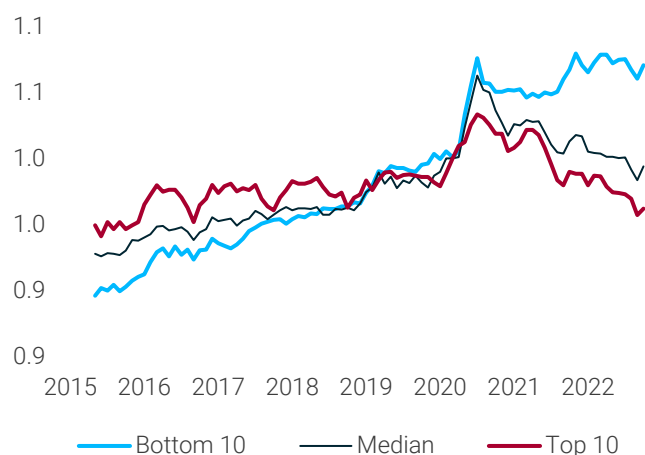
Most commentators take a pessimistic view about the structural forces we have examined in this Macro Picture. An era of labour shortages, aging demographics and deglobalization sounds like it will involve lower economic growth, perhaps even stagflation. And for existing equity holders – especially the big beneficiaries of globalization – there will be obvious costs. Friend-shoring, reshoring and the reconfiguration of global supply chains (which is now under way) will make parts of the existing capital stock redundant, damaging efficiency and draining profit margins. Prices will rise. But it is important not to overlook the weaknesses and deficiencies of the pre-COVID economy, particularly their impact on the distribution of income. Stagnant median incomes not only produced an increasingly toxic political environment; they also killed economic growth, with spending power disproportionately channelled to those groups that were least likely to spend. Inequality was not just an unfortunate side-effect of secular stagnation, as most economists assumed; it was also one of its major causes. An era of tighter labour markets would start to address these problems. The wage share would rise, but low-income earners would recycle their wages back into the economy, particularly in areas such as consumer durables.

Technology and productivity

A higher-pressure economy could also be good for productivity, whereas the decade before COVID produced some of the weakest gains in output per hour since the Industrial Revolution. The dismal productivity performance of the 2010s is not as “puzzling” as some economists like to make out. It was the result of persistently weak demand and a generally lukewarm economy, which provided no incentive for companies to invest in new technologies. Why bother, when they could rely on cheap labour and low borrowing costs? With only the big tech superstars making these investments, technological diffusion ground to a halt in the 2010s. But persistent labour shortages and higher interest rates could reverse these dynamics. In fact, as we examined elsewhere, this is exactly the sort of environment that typically boosts total factor productivity – the lifeblood of the capitalist economy. Pundits who are worried about machines replacing workers are thinking about this issue in the wrong way. Not only are they ignoring the lesson of

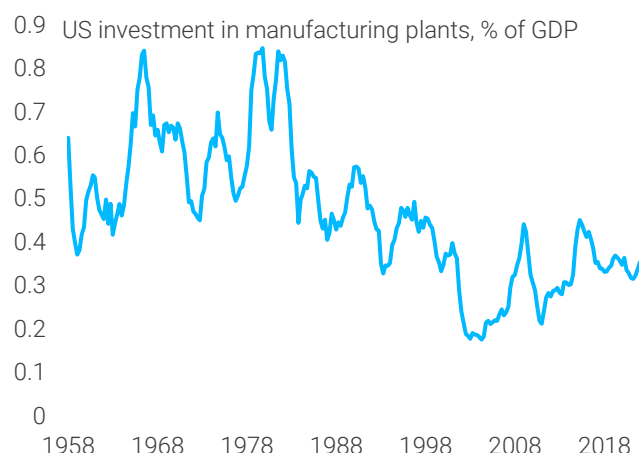
history – which illustrates the fallacy of “technological unemployment” – they are forgetting that in an era of deglobalization and aging demographics, we are going to need those extra machines.

Chart 20: Low-income real-wage preservation



Source: The Unexpected Compression (Autor et al. 2023), TS Lombard

Chart 21: US outsourced manufacturing

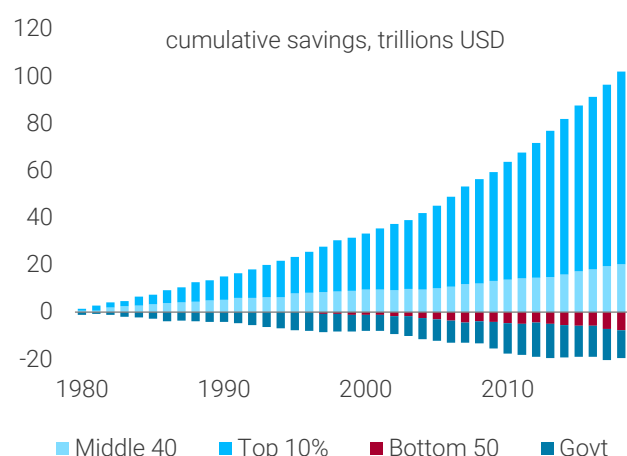


Source: BEA, TS Lombard

What about debt?

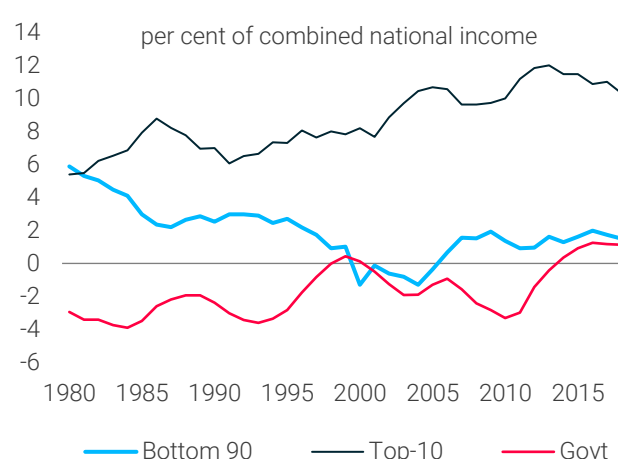
To recap, two of the 3Ds are no longer disinflationary. The combination of population aging and deglobalization is likely to add to inflation, boost wages and rebalance the distribution of income. If productivity accelerates – as we suspect it will – there could even be a secular improvement in GDP growth. But that still leaves the third of our 3Ds, the “debt overhang”. Until recently, most investors believed this was the main reason why the world was locked into a low-inflation “liquidity trap”. If central banks tried to raise interest rates, even modestly, the whole global economy would collapse. And when we look at Chart 25, it is easy to understand this logic. With the aggregate global debt-to-GDP ratio hitting record highs, the world economy would appear to be at a distinct disadvantage compared with the past. But there are good reasons why record-high global debt levels are not necessarily a structural impediment to sustained reflation.

Chart 22: The saving glut of the rich



Source: The anatomy of the global savings glut (2022)

Chart 23: Net national saving – US, EU and PRC

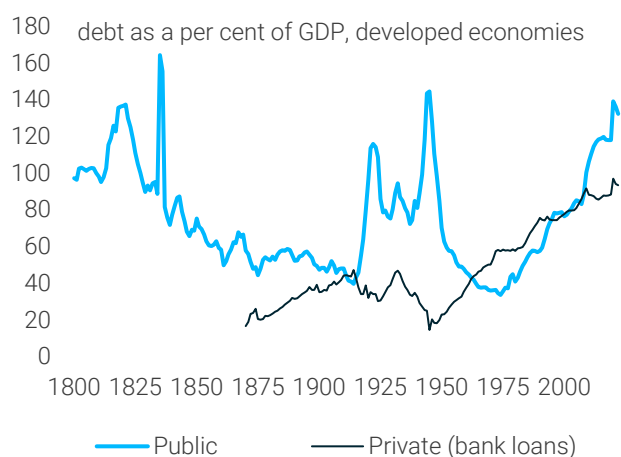


Source: The anatomy of the global savings glut (2022)

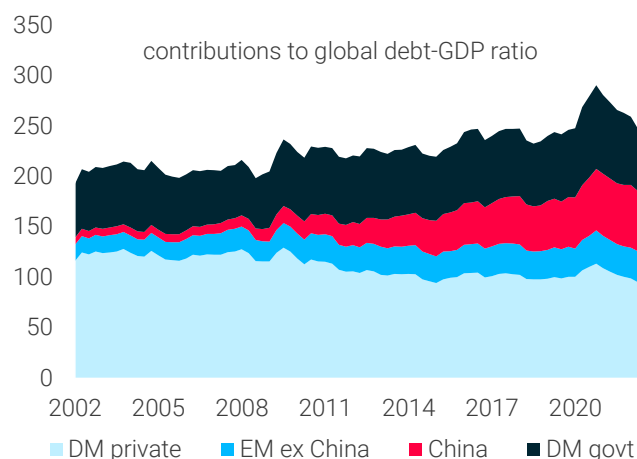
End of private deleveraging

The first thing to point out about the overall global debt ratio is that most of the increase over the past decade has come from China and DM governments. Most developed economies have, in

fact, experienced significant private-sector deleveraging – particularly among households – over the past decade. In their keenness to extrapolate from the secular stagnation of the 2010s, most economists are forgetting about the role these long “balance sheet recessions” played in keeping growth and inflation low in the decade after the global financial crisis. But for most of the developed world, this is a trend that is unlikely to continue in the 2020s. In fact, only a small number of developed economies are likely to face a period of deleveraging this decade, mainly because they avoided the 2008 financial crisis and have continued to accumulate private-sector debts. Our previous analysis identified Canada and several European countries as the main risks. But the US, the UK and much of the euro area are unlikely to face similar pressures. In fact, there is room for a period of the re-leveraging of these economies in a higher-growth environment.

Chart 24: Debt at record highs


Source: MacroHistory, TS Lombard

Chart 25: China drove 2010s debt growth


Source: BIS, TS Lombard estimates

China vs DM governments

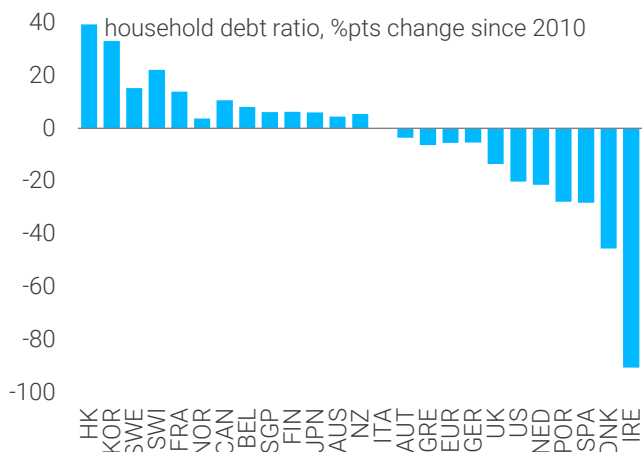
China is the one area of the global economy where debt is likely to become a more serious constraint on activity, particularly after the credit splurge of the 2010s. Given the vulnerabilities that have appeared in China's domestic financial system, not to mention its unhealthy reliance of a ponzi-financed property bubble, there is now a clear political determination to put the economy on a more sustainable trajectory. This means a significantly slower trend rate of growth, which is bound to weigh on broader global activity – particularly once the immediate reopening process is over. But just when China's debt accumulation is slowing, we are seeing more expansionary fiscal policy in the rest of the world. The era of DM austerity has ended and the pressure on the public finances is only going to increase during the next decade. After a massive fiscal expansion during COVID, governments will face additional pressures from climate change, defence spending, crumbling infrastructure, the emerging cold war with Russia/China, the new appetite for domestic industrial policy and a polarized electorate that finds it impossible to prioritize the needs of one group in society over another (which, as we saw during the recent energy crisis, means everybody gets a bailout). The CBO is already expecting persistent deficits and a rapid accumulation of public debt in the US, while the outlook for Europe is similar.

We can afford it

Some investors are worried that governments – or indeed the private sector – will be unable to finance their existing debts at higher rates, let alone support new borrowing. But when it comes to thinking about debt dynamics, it is important to consider the difference between borrowing costs and income growth – “ $r-g$ ” – not the total debt ratio. When interest rates are rising faster than incomes, there is a definite squeeze – which is what we are seeing currently. But in a world of secularly higher inflation, nominal incomes will eventually catch up, which means the squeeze

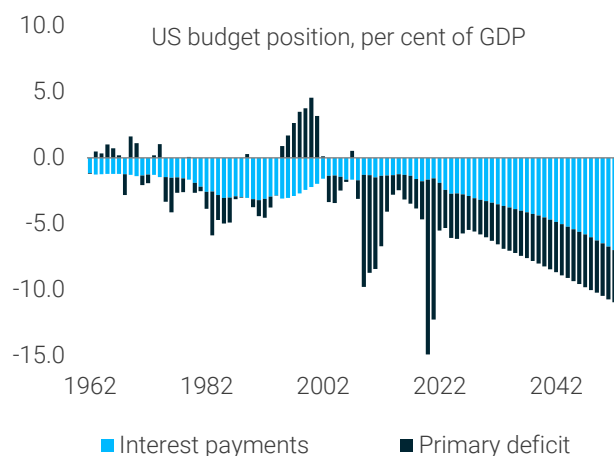
ultimately fades and debts become serviceable even at higher equilibrium interest rates. Investors often miss this point because they focus solely on “r” and assume the “g” is constant. History shows, in fact, that mild reflation is one of the most effective ways to put debt on a sustainable path, which is why we think central banks will be willing to tolerate higher inflation – despite their claims to the contrary (what do you expect them to say?). In fact, with structural inflationary forces now moving against them, they probably do not have a great deal of choice.

Chart 26: Private-sector deleveraging in 2010s



Source: BIS, TS Lombard estimates

Chart 27: A new era of big fiscal spending



Source: CBO projections, TS Lombard

Bottom line

Before COVID-19, there was a strong consensus that the world was stuck in a secular funk, with the Three Ds – record debts, poor demographics and an increasingly unequal distribution of income – combining to create a permazero interest-rate trap. Indeed, many investors still believe we are ultimately headed back to that situation, once the distortions associated with the pandemic eventually disappear. The 3Ds are the most common source of pushback to our idea that COVID-19 and the war in Ukraine, like the WW2, will mark a (gradual) secular turning point. Compared with the global economy that emerged after 1945, the world today is clearly at a distinct macroeconomic disadvantage because of the 3Ds. Yet our analysis suggests many investors are misreading their long-term impact. Not only are demographic trends becoming more inflationary; they are likely to interact with the other main legacies of the pandemic – deglobalization and more activist fiscal policy – to create structural labour shortages. And as labour becomes scarce, many of the big macro trends of the past 40 years will start to reverse, resulting in more inflation, higher interest rates, faster wage growth, reduced inequality and a trend decline in the profit share. The good news is that, contrary to what the consensus assumes, this new macro regime could also mean faster economic growth, especially if a higher-pressure economy boosts technological diffusion and raises productivity growth. The world will not find it easy to repeat the Golden Age of capitalism that followed WW2, but nor is it “turning Japanese”.