Flash Economics

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Demographic ageing is inflationary, unless there is no limit to external debt

Demographic ageing, over a long period of time, means that the number of working people falls relative to the number of retired people. This trend can be observed in all OECD countries.

The result is an increase in the demand for goods and services relative to the domestic supply of goods and services, and consequently:

- Inflation;
- Or a continuous deterioration in the current account balance and a continuous increase in external debt.

If countries are sufficiently attractive to non-resident capital, and can accumulate a very large external debt, they can avoid inflation due to demographic ageing; on the other hand, if their external debt capacity is limited, then demographic ageing is inflationary.

Moreover, this inflation may not appear in the short term if there is a rise in the domestic savings rate, which slows down domestic demand.

Inflation is emerging among the largest OECD economies—namely the United Kingdom, Germany, the United States, and Japan. In the cases of the United States and the United Kingdom, this may reflect constraints on external borrowing.

We assumed that the obstacle to growing external debt could be low international capital mobility. If protectionist barriers are now raised, the obstacle to external debt could come in the future from low international mobility of goods, but this has not been the case in the recent period.

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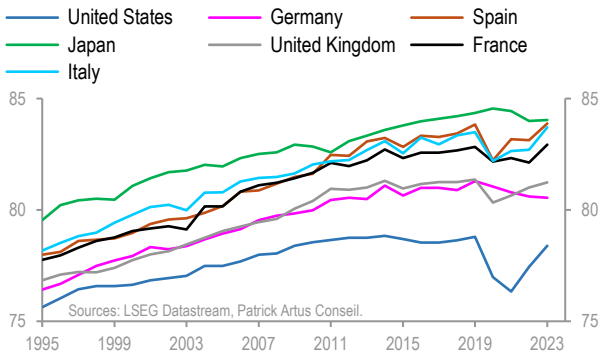
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Increase in the number of retirees compared with the number of working people

In all OECD countries, demographic ageing takes two forms (we are looking at the situation in the United States, the United Kingdom, Germany, France, Spain, Italy and Japan):

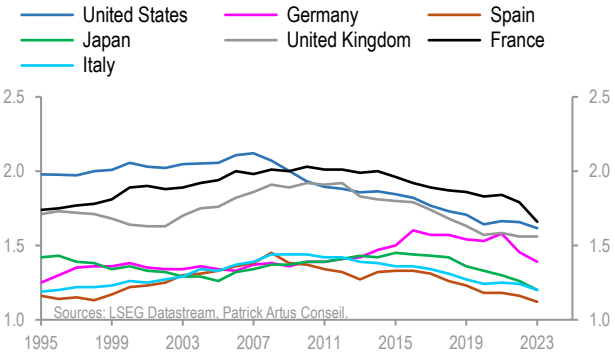
- Longer life expectancy (Chart 1);

Chart 1
Life Expectancy at Birth (years)



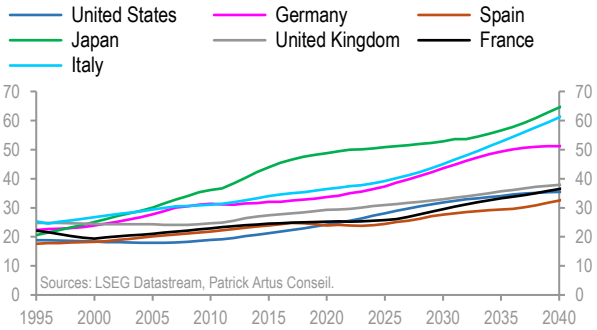
- The decline in the fertility rate (Chart 2).

Chart 2
Fertility rate (births per woman)



The result of these two trends is a fall in the number of working people relative to the number of retired people (Chart 3).

Chart 3
Population aged 65 and over as a percentage of the population aged 15 to 64



If the number of working people relative to the number of pensioners falls, there are two possible consequences

If the number of working people relative to the number of pensioners falls, we are clearly heading for a situation where there is excess demand for goods and services relative to the domestic supply of goods and services, because the number of consumers is increasing relative to the number of producers.

There may then be two possible developments:

- either inflation, because the supply of goods and services becomes insufficient;
- or a deterioration in the current account balance, because the shortfall between the supply of goods and services and the demand for goods and services is offset by additional imports.

This will distinguish between countries that can attract sufficient non-resident capital and accumulate foreign debt without difficulty to finance a current account deficit (these will have a deterioration in their current account and little inflation) and countries that are not very attractive to non-resident capital (these will have inflation).

Charts 4A/B show the current account balances of the 7 countries reviewed, Charts 5a/b their net external assets or debt, and Charts 6A/B their underlying inflation rate.

Chart 4A
Current account balance (as % of nominal GDP)

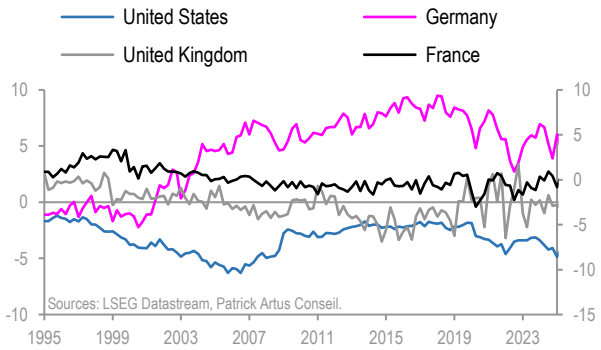


Chart 4B
Current account balance (as % of nominal GDP)

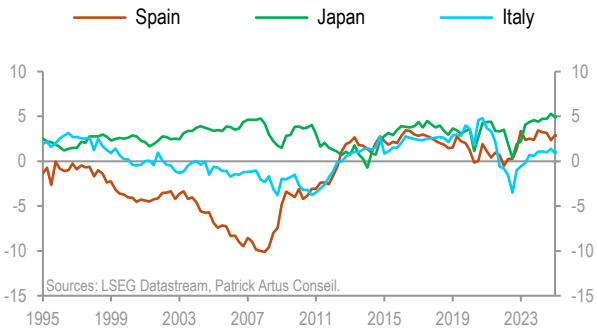


Chart 5A
Net foreign assets or liabilities (as % of nominal GDP)

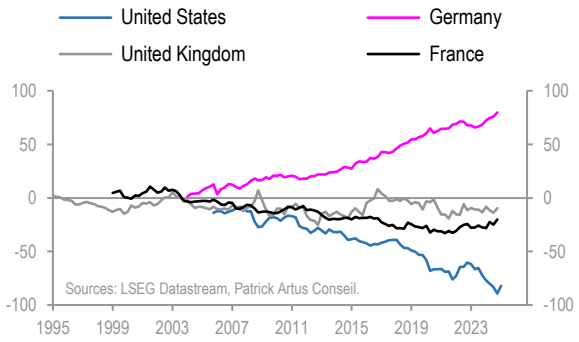


Chart 5B
Net foreign assets or liabilities (as % of nominal GDP)

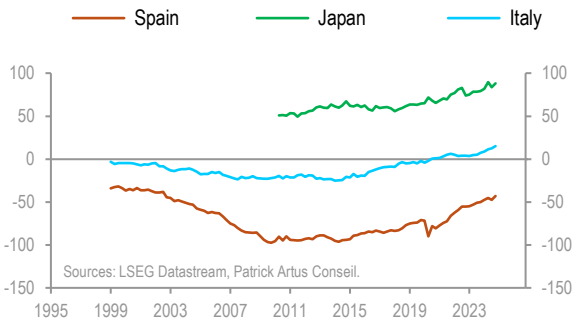


Chart 6A
Core inflation (CPI excl. food and energy, Y/Y as %)

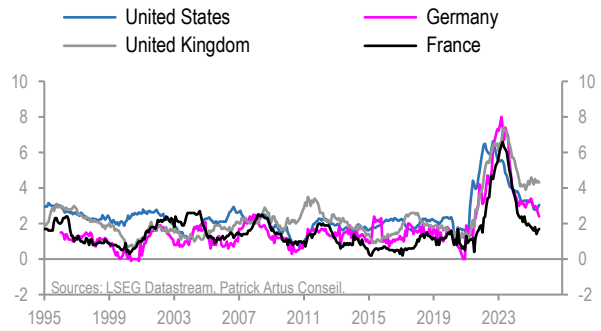
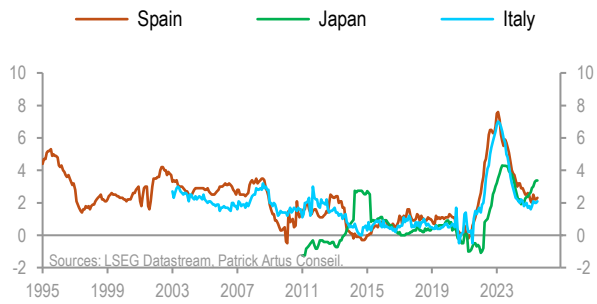


Chart 6B
Core inflation (CPI excl. food and energy, Y/Y as %)



One can see:

- **A deterioration in the current account balance in Germany**, **the United States** and, in the recent period, **Italy**, **and an increase in external debt only in the United States** ;
- **Additional inflation** in the recent **period in the United Kingdom**, **Germany, the United States and Japan**.

In the short term, there may be an increase in the savings rate, which temporarily avoids the effect of demographic ageing on the goods and services market

While the rise in the number of pensioners relative to the number of working people inevitably leads to a situation of excess domestic demand for goods and services (corrected either by inflation or by additional imports and foreign debt), in the short term **this effect of demographic ageing on the goods and services market can be corrected by the rise in the savings rate**, particularly the household savings rate, which reduces domestic demand.

Charts 7A/B show that this is currently the case in **Germany, France, the UK and Spain**.

Chart 7A
Gross household saving rate (as %)

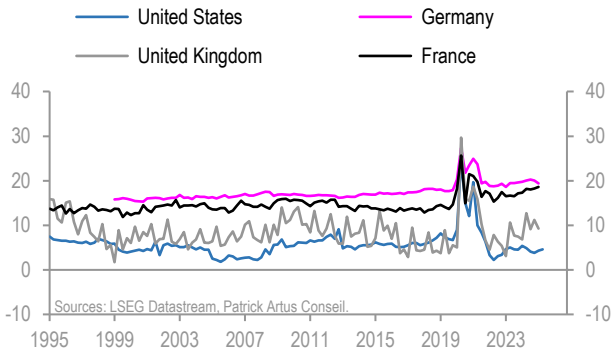
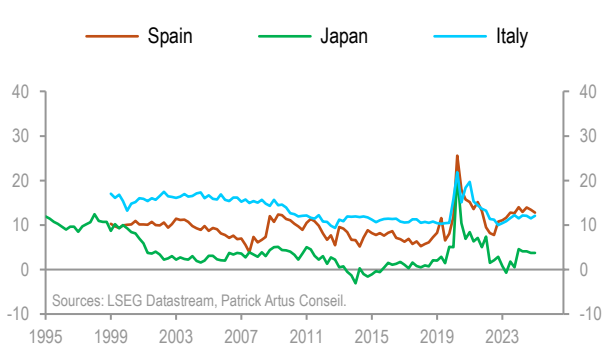


Chart 7B
Gross household saving rate (as %)



Summary: two possible consequences of demographic ageing, a new regime if protectionism appears

Demographic ageing leads to an increase in the demand for goods and services relative to the domestic supply of goods and services, since the number of consumers increases relative to the number of producers.

We have considered two possible consequences, **which depend on the ability of countries to attract international capital and increase their external debt**:

- inflation, if additional external debt is difficult to obtain ;

- a deterioration in the current account balance, if additional external debt is easy to obtain.

This implies that **the limit on the deterioration of the current account may be the difficulty of financing additional external debt**. **If protectionism were to develop today**, an additional limit on the deterioration of the current account balance would be tariff or non-tariff barriers to imports, whereas the world has long been in a situation of virtually free trade (**Chart 8**).

Chart 8
United States: Duties collected on total imports (as %)



Demographic ageing can therefore be inflationary if the mobility of international capital is reduced, or in the future if the mobility of goods is reduced, which would prevent ageing countries from importing more from countries with excess capacity (e.g. China).

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