



Global Macro Research - Insight

18 January 2024

8:45 minute read

#Global

/ #Demographics

/ #Geopolitics

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Eight long-term structural economic convictions

From low equilibrium interest rates and the shifting engines of global growth, to the changing nature of globalisation and the labour market effects of AI, we discuss some of our longer-term economic key calls.

Key Calls

- Equilibrium policy interest rates are still low.
- However, inflation has become structurally more volatile.
- Emerging Markets will drive three-quarters of global growth by 2050.
- Nevertheless, a genuine challenger to the dominance of the US dollar is unlikely anytime soon.
- Constrained fiscal space means tax takes and the term premium will increase over time.
- AI will not cause net long-term unemployment.
- The nature of globalisation will continue to change as the world fragments.
- Mounting political polarisation will create sharp swing in economic, regulatory and social policy.

1. Equilibrium policy interest rates are still low

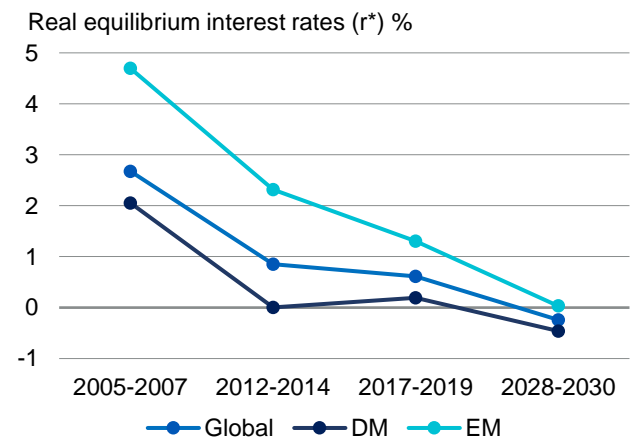
Before the onset of the Covid pandemic, global interest rates had been declining for approximately 30 years, driven by a fall in equilibrium real interest rates (r^*).

However, the rapid rise of inflation following the pandemic was evidence that short-run r^* had increased, with policy rates failing to keep up.

But, with pandemic distortions faded, our best assessment is that high interest rates are unlikely to persist, as r^* remains structurally low. Our modelling points to r^* around 0% and neutral nominal policy rates of 2-3% (see Figure 1).

This is driven by low and falling growth, demographic headwinds, and the global demand for safe assets.

Figure 1: We think long-term equilibrium real rates will return to around 0%



Source: abrdn, January 2024

We are not convinced that demographics will put upward pressure on r^* , as some argue. Aging populations may save less and put upward pressure on r^* , but fewer workers weigh on potential growth, which more than offsets the upward pressure.

Shifting attitudes to public investment and industrial policy could result in a step change in fiscal policy, which puts upward pressure on r^* . But, while there could be large impacts on sectors such as green technology, numbers are small compared to whole economy investment.

If AI significantly increases productivity growth, this will lead to higher rates, all else equal. But AI may also weigh on r^* if it contributes to greater firm concentration and inequality.

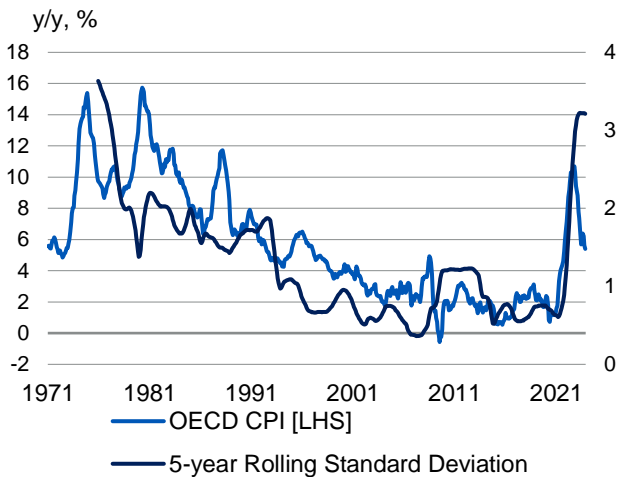
A still relatively low r^* means central banks could once again be challenged by the lower bound on policy interest rates during future downturns.



2. Inflation has become structurally more volatile

The period from the early 1990s to the onset of the pandemic was characterised not just by low inflation, but also by low inflation volatility (see Figure 2).

Figure 2: Both the rate, and volatility, of inflation fell during the great moderation, but this may be over



Source: Haver, abrdrn, January 2024

This in part reflected a benign global supply backdrop, with trends in demographics, globalisation, and geopolitics putting downward pressure on inflation.

However, this is changing, with adverse supply shocks becoming more frequent due to geopolitical fragmentation, climate change, and the risk of pandemics.

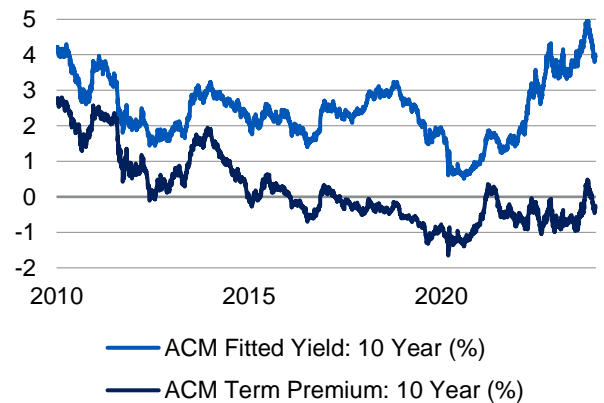
These shocks are painful for central banks because they push inflation higher but growth lower, which can lead to more uncertainty about how policy will be set.

Ultimately, monetary-sovereign central banks can bring inflation back to target – it’s just a question of the economic pain they are willing to accept.

But more supply shocks also result in higher inflation volatility. This, in turn, is likely to structurally increase the premium demanded by investors to hold government bonds from the extremely low levels after the financial crisis and pandemic. The sell-off in bond markets during Q3 2023, which has now reversed, was notable for being term-premia-driven (see Figure 3).

High inflation volatility also increases uncertainty around the path of inflation and interest rates. And more supply shocks weaken the diversification benefits of bonds, as the correlation between bonds and equities tends to be positive when growth is being pushed down and inflation up at the same time.

Figure 3: Term premia drove the sell-off in bonds last year, and may be moving structurally higher



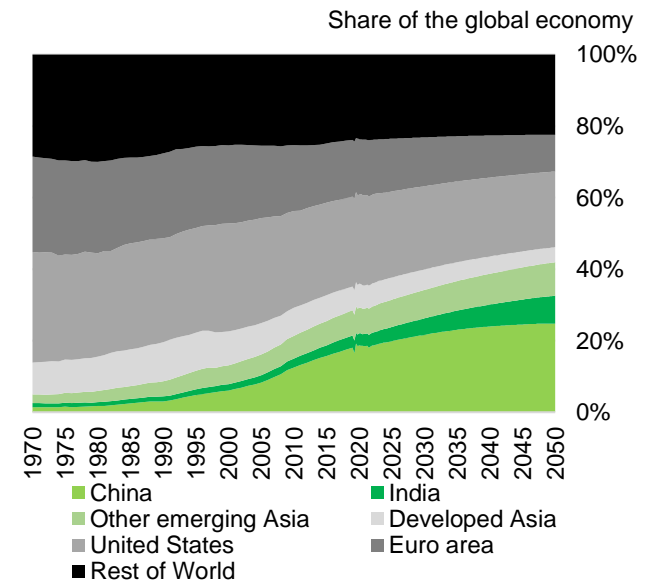
Source: Haver, abrdrn, January 2024

3. Emerging Markets will drive three-quarters of global growth by 2050

While we think global growth will decelerate from 2.5-3% to 1.5% by 2050 – largely reflecting slower population growth – Emerging Markets (EMs) will account for a larger share of that growth.

EMs are set to drive 75% of global growth by 2050, up from 60% before the pandemic. EMs will therefore account for a growing share of the global economy. Emerging Asia alone is set to produce more than 40% of global output by 2050 (see Figure 4).

Figure 4: By 2050, four of the world’s seven largest economies will be in Asia



Source: Haver, abrdrn, January 2024

The region is well positioned thanks to still favourable demographics and in many cases low income levels, which provides scope for ‘catch up’ growth.



The Philippines is likely to make significant progress up the ranks of GDP size (rising to 15th spot), while Pakistan, Bangladesh and Vietnam should break into the top 25.

China may face significant structural challenges – including a rapidly aging population, real estate distress and tensions with the US – but, together with India and Indonesia, it will increasingly dominate the global economic landscape.

We expect China’s economy to overtake the US sometime around 2035, but history has many examples of EMs failing to emerge.

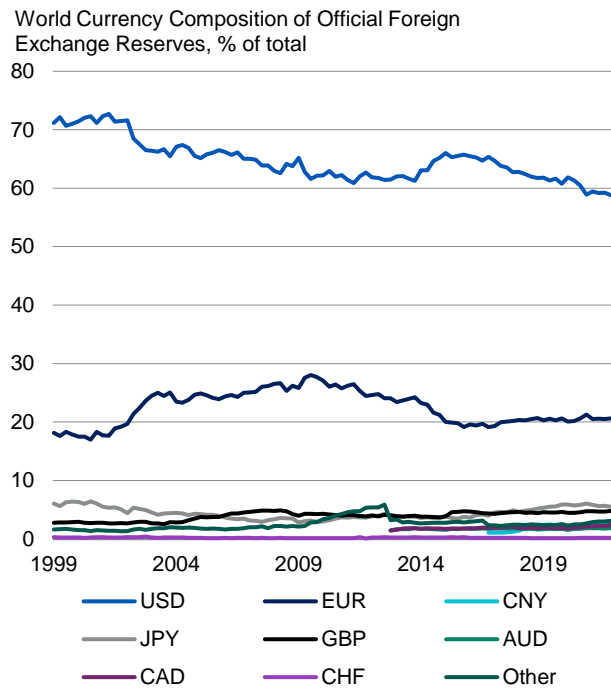
India could step in if China falters and it is one of the few countries with upside risks to growth, buoyed by favourable demographics, dynamic service sector, the potential to benefit from supply chain relocation and a large share of workers still in agriculture.

4. A genuine challenger to the dominance of the US dollar is unlikely anytime soon

The US dollar is the dominant currency in global trade and finance, far exceeding the US’ share of global GDP, trade or banking.

However, policymakers in other economies – led by China and Russia – are looking to alternatives for economic and political reasons. The dollar has indeed declined as a share of global FX reserves (see Figure 5).

Figure 5: Official reserves show only a very slow move away from the dollar



Source: IMF, abrdrn, January 2024

But we don’t envisage a genuine shift away from the dollar as the dominant currency in international trade, FX reserves, and as a safe asset, any time soon.

The factors that strengthen the dollar’s position, such as capital market openness, institutional quality, rule of law, and deep and liquid capital markets are hard to replicate.

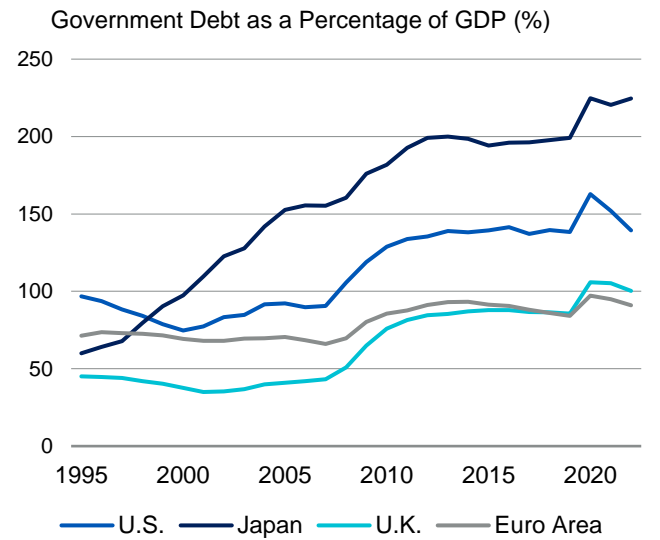
The Chinese renminbi may gain traction in trade flows. But capital controls and geopolitical tensions mean it is a long way from becoming a viable alternative. And major policy changes required to internationalise the RMB seem at odds with other priorities.

However, some further modest diversification in the currencies used for trade and FX reserves over the coming years is likely.

5. Constrained fiscal space means taxes and the term premium could increase over time

High government debt combined interest rates higher than in the post-GFC period mean there is limited fiscal space in many developed markets (see Figure 6).

Figure 6: Rising debt levels constrain the ability of fiscal policy to support economies



Source: Haver, abrdrn, January 2024

While the risk of widespread sovereign debt crises is low, high debt service costs will squeeze resources available to the rest of the public sector. High debt loads also reduce resilience to future shocks to interest rates or the economy.

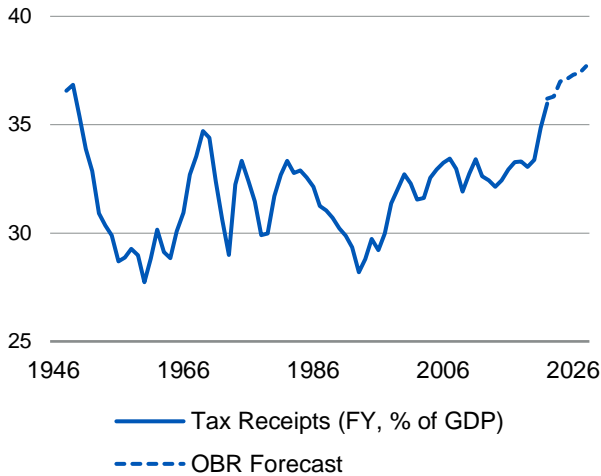
This means active fiscal policy will play a less important role in the stabilisation of the economy. Automatic stabilisers will still be allowed to operate in a downturn, but discretionary fiscal easing may become less viable, leaving more of the task of demand management to monetary policy.

Meanwhile, there will be growing demands on the state. Demographic transition is likely to cause spending to increase significantly.

Growing spending demands combined with already stretched fiscal positions mean that the tax burden is likely to increase in many countries (see Figure 7).



Figure 7: The UK tax burden is at post-war highs and likely to rise further



Source: Haver, OBR, abrdrn, January 2024

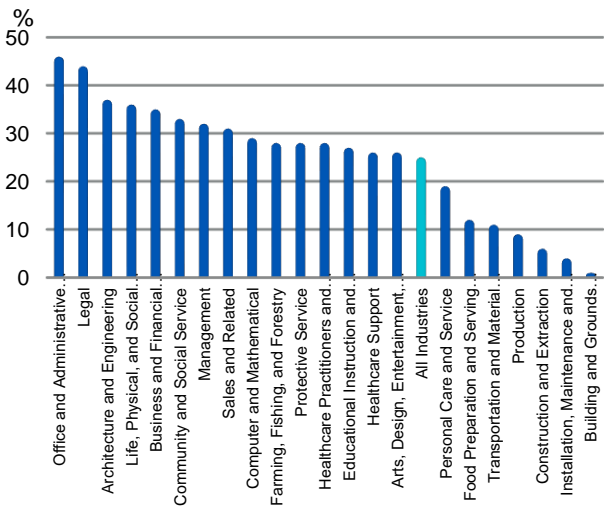
Markets have sometimes been able to look through the disruptive aspects of certain politicians if tax cuts are also a significant policy priority. With less space for large tax cuts, this dynamic could become less important in the future, increasing political risk in some elections.

Finally, very large public debt loads need to be held by the private sector, which is likely to require higher term premia in response to the increased supply.

6. AI will not cause net long-term unemployment

There is a growing sense that generative AI will automate “white collar” jobs. The widespread adoption of AI will almost certainly lead to some job destruction (see Figure 8).

Figure 8: Share of industry employment exposed to automation by AI

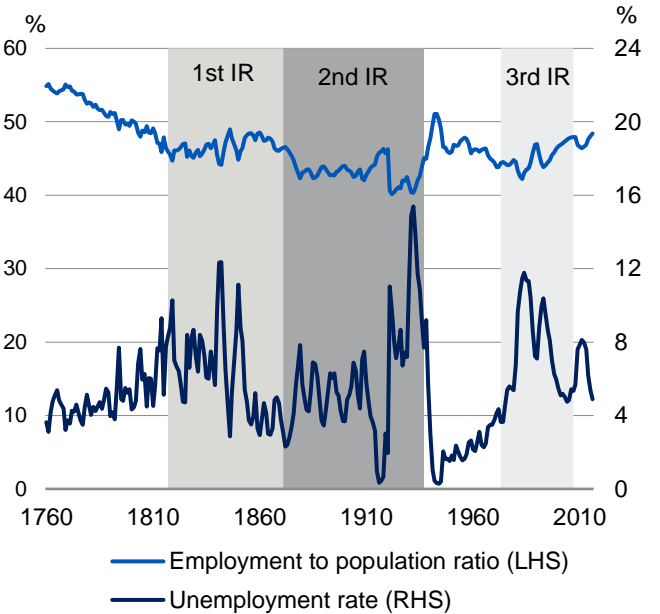


Source: Goldman Sachs, January 2024

But in the long run, there is little evidence of sustained technological unemployment (see Figure 9). Swings in aggregate demand result in cyclical fluctuations in

employment, but it is hard to see any impact from technological change in the average rate of employment.

Figure 9: There is little evidence of technological unemployment over the long term



Source: Bank of England, abrdrn, January 2024

To understand why, it is helpful to distinguish between three effects that technological change has on employment: job destruction, productivity enhancement, and job creation.

The combination of productivity enhancement and job creation has historically been much larger than job destruction.

We think AI will be a “general purpose technology”, with pervasive impacts on the economy because of its widespread applications and scope for continuous improvement.

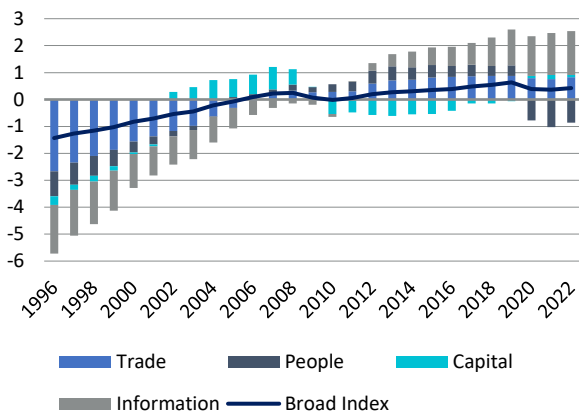
The adoption of new technologies also helps create new jobs. These might be linked to the new technology or in unrelated sectors that emerge as a result of the spending power created by higher productivity.

7. The nature of globalisation will continue to change as the world fragments

Our globalisation index suggests globalisation has stalled over the past decade (see Figure 10). Trade and capital flows – the traditional engines of globalisation – have stagnated. But information flows continue to increase.



Figure 10: Globalisation has stalled



Source: Haver, abrdrn, January 2024

A greater focus on national security and supply chain resilience may throw globalisation into reverse in the coming decade. The legal environment in which globalisation evolves has become more restrictive, which is already reorientating trade and investment.

The US election will be a key factor. A second Biden term would continue the “friend-shoring” of strategic supply chains, maintaining the “small yard, high fence” strategy that is focused on restricting China’s access to high-end technology.

Trump would likely use across-the-board tariffs, impacting a much wider range of countries and economic activity.

While onshoring isn’t yet showing up in macro-level data, Mexico is already benefitting from a reconfiguration of supply chains, while geopolitics could push investment out of China and into the rest of Asia.

APAC’s centrality within the global trade network provides it with a strong advantage, as manufacturers there do not need to “nearshore” to gain access to the fast-growing consumer markets of China and Asia more broadly.

8. Mounting political polarisation will create sharp policy swings

Political polarisation is increasing in many countries, with old political coalitions fragmenting, questions of identity becoming more salient, and the space between parties increasing.

This has increased the stakes in many elections, with changes in government leading to more substantial shifts in economic and social policy.

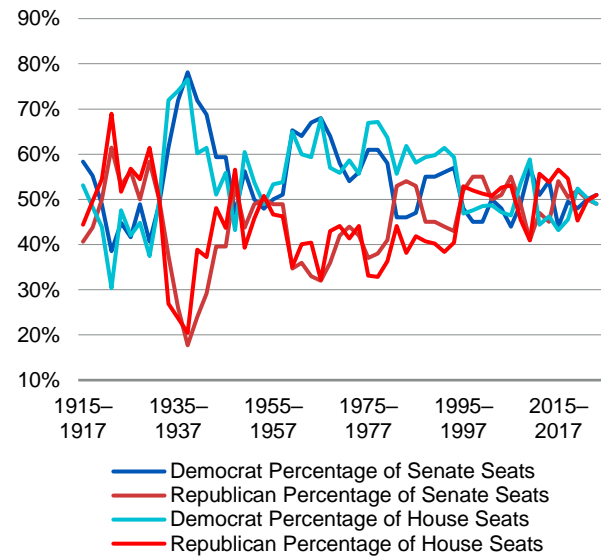
Author

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Meanwhile, changing voting patterns have sometimes reduced the accuracy of polls, decreasing the predictability of elections.

As a result of these trends, divided government is becoming more common in the US (see Figure 11). When control of Congress is divided, presidents find it difficult to implement their legislative agenda. Presidential candidates are increasingly running on a platform of undoing the actions of their predecessor. Major policy initiatives are limited to short periods of unified government, while divided government is characterised by a lack of legislative activity and impasses over fiscal policy.

Figure 11: US Congressional majorities have narrowed and control of both chambers changes more frequently



Source: Haver, abrdrn, January 2024

This also has implications on the international arena, where allies’ faith in consistent US geo-political leadership is diminishing.

This trend is also apparent in Europe, where faith in establishment parties is fading. Populist political outsiders gaining office in Europe may increase the risk of policy missteps, including confrontation with the European Commission and Europe’s fiscal rules, although the exit of a country from the EU or Eurozone remains unlikely.



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