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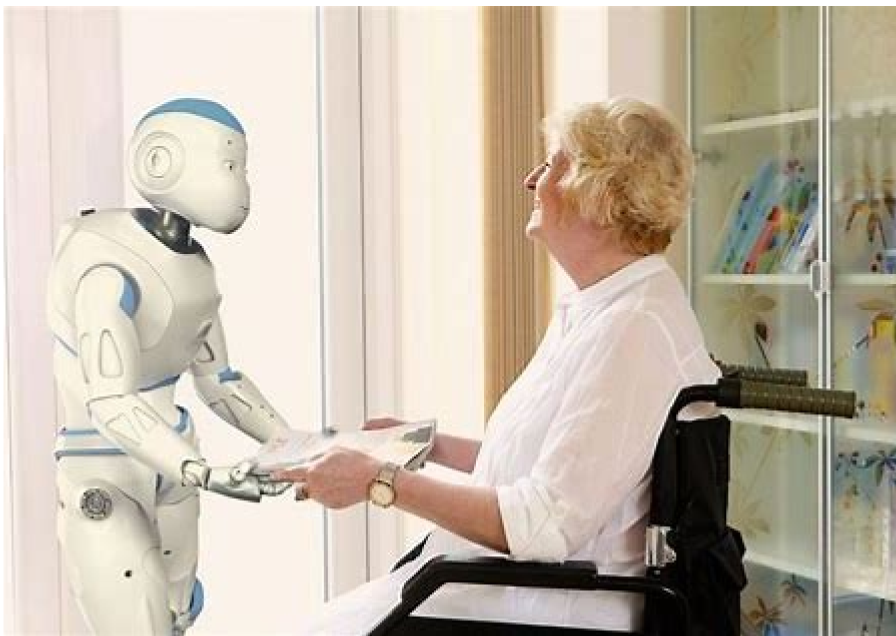


THE BRAVE NEW POST-PANDEMIC ECONOMY

Why growth, inflation, rates and debt may be higher for longer

March 2024

ABSTRACT

Shifting secular trends are transforming the post-pandemic economy. We see a new regime emerging, defined by a protracted period of excess demand over the next 3-5 years. Investors can expect higher macro and financial volatility going forward.

Robert Lavigne

Senior Managing Director

Economic Research

Robert Lavigne, OMERS Economic Research, March 2024

The brave new post-pandemic economy: Why growth, inflation, rates and debt may be higher for longer

Executive Summary

Secular trends are shifting:
The structural drivers that underpinned the pre-pandemic era (2010-19) of low inflation, negative real interest rates and mild business cycles have faded or even reversed.

Our research identifies 5 mega-trends that will shape the rest of this decade:
- *Global population aging* – falling birth rates, longer lifespans and Baby Boomer retirement are worsening dependency ratios, shifting consumption patterns, shrinking labour forces and increasing fiscal burdens.
- *Hardening geopolitics* – the shift away from US global hegemony to a more multipolar system is leading to rising military expenditures, a rewiring of global supply chains and greater restrictions on trade and capital flows. The era of hyper-globalization is over.
- *Accelerating climate change* – past emissions mean the planet will continue warming. The energy transition and the physical risks of climate change will require massive investment and public spending.
- *Ascending populism* – across the political spectrum, policies are more protectionist and mistrusting of markets and elites. Populism typically implies bigger governments, higher deficits and institutional erosion.
- *Surging innovation* – we are in the midst of an innovation boom. Breakthrough technologies hold out the hope of revived productivity growth, but also fears of labour market disruption.

These trends are complex and inter-related. Annex 1 describes the trends in our baseline scenario.

OMERS has developed a framework to project how the confluence of these structural drivers may impact the global economy and investment environment over the next decade. Our system, called FORECAST,[1] generates long-term quantitative macroeconomic projections based on the evolution of secular trends (see Annex 2). We use a scenario-based approach to manage the huge uncertainties involved in predicting the future course of these systems. Our baseline scenario, which focuses on the US, assumes the five above-mentioned mega-trends will essentially continue for the next few years. In this introductory note, we adopt a qualitative approach, seeking to lay out the essential relationships between the trends and macro variables. Quantitative forecasts will be available in H2 2024.

Our main conclusion is that a new economic regime is emerging, defined by a protracted period of excess demand in the US over the next 3-5 years. In our baseline scenario, the net impact of these secular forces will be to *increase aggregate demand* significantly in the next few years but *depress aggregate supply* gradually over the longer run, leading to an upcoming "hump" of excess demand in the US (see Part 1). A simple illustration of these dynamics can be shown with the example of aging: Baby Boomer mass retirement raises aggregate demand as retirees begin to dissave and medical expenses rise; however, retirement also shrinks the labour force, weighing on aggregate supply (absent productivity gains). Similar positive effects on net demand in coming years are expected from shifts in climate, populism and geopolitics (innovation is the exception, being a positive shock to demand and supply).

The hump is here and now. The period of excess demand is unfolding in real time. It is the main reason that the US did not experience a recession in 2023 following the significant tightening of monetary policy, and why it continues to outperform many other advanced economies.

Higher for longer. Relative to the pre-pandemic era (2010-19), our analysis suggests that the new regime of excess demand will likely feature *higher inflation and interest rates, but also*

[1] *Forward-looking Opportunity and Risk Evaluation for Countries Anchored on Secular Trends (F.O.R.E.C.A.S.T.)*

stronger economic growth. We estimate that inflation and real GDP growth, which averaged below 2% in the last decade, are likely to shift up to a 2-4% range in the new regime. Real ex-post interest rates, which were negative before the pandemic, are likely to turn resolutely positive. This sort of sustained "overheating" environment, where for the next few years secular forces push demand ahead of supply, investment ahead of savings, and labour demand ahead of supply, can also be expected to feature upwards pressure on real wages, fiscal and trade deficits, as well as more uncertainty (see Part 2).

Macroeconomic policy regimes will come under stress. In our baseline scenario, inflation-targeting may become more challenging and public debt sustainability concerns will likely rise over time. Fiscal and inflation targets will come under pressure, especially in countries with populist policies. We expect financial turmoil to increase in debt markets (see Part 3).

The hump won't last indefinitely. Once the demand shocks fade, the US hump will too. The nature of this reversal will depend on country policies and the impacts of innovation on productivity. However, the negative effects of the secular trends on supply will be more lasting. On balance, we expect real potential GDP growth to decline over the next decade to an equilibrium of 1.5% (or less) in the US. Average rates and inflation should also fall consequently.

Global rebalancing. We expect some degree of external and internal rebalancing across countries as the era of hyper-globalization comes to an end. In the post-COVID environment, economies will be pressured to shift their consumption and production towards greater autarky, or at least greater friend-shoring. The extent and timing of rebalancing is unclear, but could well span years if it requires structural reform and politically challenging shifts. The upshot of long-lasting rebalancing in major economies could be a less-synchronized global business cycle going forward.

Every country will be impacted differently by these big secular trends and the consequent global rebalancing. Countries closer to the US's economic orbit, such as Canada, are likely to benefit from strong US demand for imports from a smaller number of potential providers in a less-globalized economic system. However, secular forces are pointing to a period of excess supply in China, prolonging the country's current economic slowdown (Lavigne 2024). Given the rising tide of protectionism and geopolitical tensions, it is no longer clear that Western economies will be willing to absorb China's excess production to the extent they have in the past.

Over the next few years, we see the global economy being driven by two economic engines that are no longer running in sync: the US facing overheating risks and China struggling with deflationary pressures. Of course, Europe, Asia-Pacific and the Global South will also be affected by these secular trends, with the overall effect being a function of their economic and geopolitical proximity to the two global engines. A forthcoming note will delve into the issue of global rebalancing in greater detail.

Bottom line for investors: In coming years, investors will likely face greater opportunities and risks. We expect there will be more investment opportunities at higher rates of return in the US, but the window of opportunity will not be indefinite. Moreover, the net impact on earnings in this environment is unclear due to counterbalancing forces of stronger demand and rising costs. Geography will matter more than ever. Broadly, we expect higher macroeconomic and financial volatility in the new regime, which will generate winners and losers–investors will need to choose carefully (see Part 4).

Part 1: The global economic paradigm is shifting

The pre-pandemic era, characterized by low inflation, mild business cycles and ongoing monetary policy support, seems remote now. Deep-seated secular trends are shifting, such that the structural drivers that underpinned this earlier era have faded or even reversed. While the new post-pandemic economy is still evolving, we can get some sense of its essential contours by examining the outlook for these mega-trends. OMERS has developed a framework called *FORECAST* (*Forward-looking Opportunity and Risk Evaluation for Countries Anchored on Secular Trends*) to project the impact of the confluence of these structural trends on the global economy and the investment environment over the next decade. Recognizing the huge uncertainty inherent in such an exercise, we use a scenario-based approach. We are inspired by the framework developed by the United Nations (in conjunction with multi-disciplinary academics and research institutions) to produce their Shared Socioeconomic Pathways (SSPs), which are used to assess climate change using alternative global scenarios (see [IPCC, 2021] and [O'Neill *et al*, 2015]). In this note, we take a qualitative approach to assessing the overall impact of the trends on key macroeconomic variables in our baseline scenario, drawing conclusions based on the direction of the forces and the balance of probabilities. Quantitative forecasts will be available in H2 2024.

Our baseline scenario for the major trends

Our research highlights five inescapable mega-trends that will shape the global economy over the next decade. We recognize that these secular trends are complex and inter-related. While each is primarily driven by its own internal dynamics, they affect each other in myriad ways. There is no "right" scenario, but we have striven to make them consistent and research-based. Below is a brief overview of how we expect the forces to unfold in our base case, which essentially sees current trends continuing for the next few years. For more details, please see Annex 1.

Aging populations: Societal aging is driven by declining birth rates and rising longevity. As a global phenomenon, it accelerated recently due to the retirement of the Baby Boomers in the US and a much-faster-than-anticipated population decline in China. In our baseline, population aging is expected to lower aggregate savings because older generations tend to consume more once they retire, either through direct spending (especially on medical expenses, which are ballooning) or by pushing up fiscal expenditures via entitlement programs. In addition, the US boomers are different from earlier generations of retirees; so far, the data shows they are dissaving like no similarly aged generation before them. For instance, it is estimated that the consumption per capita of the elderly is almost twice that of prime age people. In sum, as US society ages and shifts towards retirement, the economy's propensity to consume should rise. We also expect a shift in spending patterns towards services, which the elderly disproportionately consume.

Yet at the same time, as global aging pushes up household spending, it is also shrinking labour forces around the world. This will depress output capacity over time, absent productivity gains. To meet the expected surge in demand with a smaller pool of employees, firms will likely retool their capital stocks over coming years to increase output per worker. Overall, we believe the combination of falling savings and rising investment should create excess demand and push up real interest rates. For a review of the impacts of aging, see Goodhart and Pradhan (2021).

In the face of these global demographic headwinds, those countries able to attract a significant share of rising global immigration flows (caused in part by deteriorating geopolitics and climate) may outperform their faster-aging peers. In this respect, Canada, Australia, New Zealand and the US stand out as large immigrant recipients relative to their populations. While short-term adjustment and integration challenges

(including the threat of populist anti-immigration policies) are not to be minimized, the longer-term advantages of a relatively balanced demographic profile are considerable, including a higher growth profile, improved dependency ratios and larger market size.

Accelerating climate change: We assume that the climate continues to warm as per the IPPC's baseline forecast. Our focus on the next 3-5 years allows us to abstract from the ultimate trajectory of emissions and planetary temperatures over the longer run. We assume that private and public spending (including tariffs and subsidies) aimed at climate mitigation, adaptation and broadly fostering a green economy will continue to rise across the board. There will be a lot of transition spending up front (more than outweighing any decline in hydrocarbon investment globally), which will only gradually translate into an upshift in green productive capacity over time. Focusing on supply, in our baseline scenario we see the frequency and size of extreme weather events increasing year after year, weighing on productivity and raising costs. It remains unclear whether currents investments in mitigation and adaptation measures can eventually stabilize or even reverse these climate-related headwinds to potential output. For overviews, see ECB (2020), BoE (2022), IMF (2019) and Davidson (2020) for work by the Federal Reserve.

Hardening geopolitics: the risk of great power conflict has resurfaced, with tensions increasing in East Asia, the Middle East and Eastern Europe (for a "realist" overview, see Mearsheimer, 2019). In our baseline, these tensions worsen at the margin over coming years, but there is no major conflict between major powers. Such ongoing pressure has and will continue to boost military spending in most economies, thereby raising demand (and very likely public deficits) in the short run. We also expect upwards pressure on investment and fiscal spending as governments adopt industrial policies to secure domestic supply chains of strategic goods/services. Geopolitical tensions will continue to be a force rewiring global supply chains, energy networks and capital flows, all of which will require more investment. However, the new re/friend-shoring regime will likely be less efficient than the pre-pandemic era of globalization (see Ramirez and Buhay, 2023). Post-Ukraine invasion shifts in international reserve holdings are likely to persist, leading to some deterioration in the demand for US dollars. However, we assume no change in the dollar's global reserve currency status over the coming years.

Populism ascendant: In our baseline scenario, populist policies are expected to increase globally, fuelled by rising economic hardship (i.e. the cost of living crisis), elevated inequality, immigration and political polarization. We define populism as a political approach that appeals to ordinary citizens who feel that their concerns are disregarded by established elites. Populism is typically associated with anti-establishment, protectionist and anti-immigration views, and their policies are characterized by short-time horizons and a pro-deficit bias. In terms of structural economic impacts, history suggests that populist policies undermine productivity over time through institutional erosion (e.g. undermining the rule of law or central bank independence) and protectionist measures. On the demand side, the effects are more immediate – populist governments are prone to generate higher fiscal deficits. Eventually, fiscal laxity and the inability to implement reforms can raise debt sustainability concerns. See Funke et al (2022) for an overview.

We see the populist trend continuing regardless of who wins the White House in November, though a Republican victory would accelerate the populist impulse. Since the Brexit vote and the election of Donald Trump in 2016, a wave of "National Conservatism" has emerged globally. Its leaders and policies represent a new brand of populism, with a twist: they are also anti-globalist and favour a type of interventionist statism that stresses national sovereignty over the individual (see The Economist, 2024). Regardless of the outcome of the US elections, the current trend toward bigger governments,

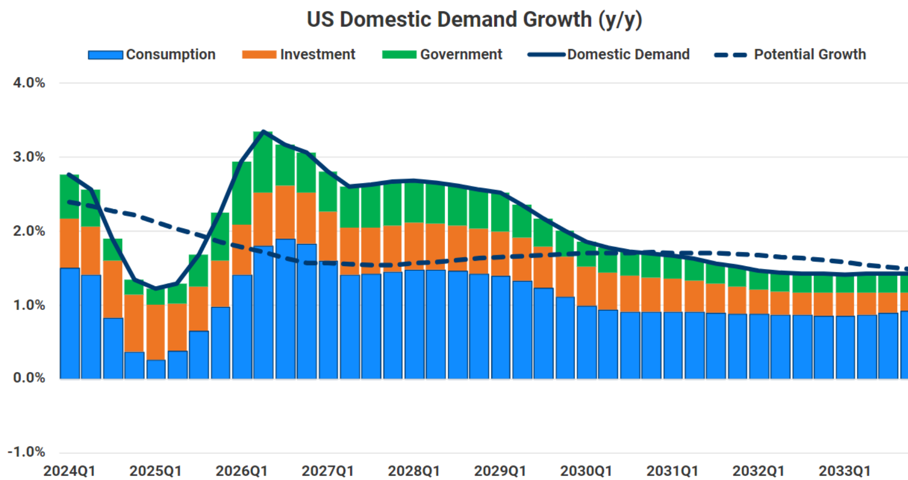
more borrowing, greater interventionism and mercantilist industrial policy is likely to continue. Policies are likely to increasingly focus on national benefits and preferences, through the continued usage of distortional trade policies and incentives to favour domestically located firms.

Surging innovation: our baseline scenario takes the position that we are in a new era of technological innovation, holding out the promise of revived productivity growth. We abstract from the specifics of these technologies, focusing instead on the bottom-line impact on productivity. Of our top five secular trends, innovation is the only one that is unambiguously positive for both aggregate demand (at first, through higher investment) and supply (later on through higher productivity). However, there is some concern that excessively rapid change caused by breakthrough technologies such as AI could worsen inequality through a disruptive transition (see Susskind, 2020). Significant technologically induced job losses are a real risk (Poloz, 2022), which we think could fuel the flames of populism. For an optimistic overview of innovations' impact on productivity, see Baily et al (2023); for greater pessimism, see Gordon and Sayed (2022).

Watch for the hump

Our central conclusion is that these secular trends are leading the global economy towards a new macroeconomic regime of excess demand. Put simply, we think the evolving mega-trends will both push up aggregate demand in the medium-term and weigh down on aggregate supply over the long run. Such a combination would lead to a "hump" in excess demand that may last for several years. Figure 1 shows a stylized version of this dynamic for the US (our best estimate as of March 2024). The hump would likely be accompanied by rising fiscal and trade deficits.

Figure 1: An estimated "hump" of excess demand in the US



On the **demand side**, consumption, investment and government spending are all expected to rise over the next few years, though not indefinitely. The new regime would likely include higher consumption in Western economies as aging populations begin to draw down on their savings and scarce workers put upwards pressure on real wages. More investment would be needed because firms must retool to meet stronger demand with a smaller workforce, rewire their global supply chains to adapt to new geopolitical realities and adjust to the demands of the energy transition. If we are right in our view of ascending populism, then many governments, increasingly short-term in focus and unable to enact entitlement reforms, would see deficit spending rise on deteriorating dependency

ratios, persistent inequality, as well as higher health, pension and military costs.

On the **supply side**, we believe that, in aggregate, the secular trends will likely weigh on the global economy's productive capacity over the next decade. Shrinking labour forces, more erratic weather and stalled globalization would spell weaker output growth globally. Rising geopolitical uncertainty would erode the peace dividend and potentially lead to some degree of economic decoupling between the West and select geopolitical rivals (notably China, Russia and Iran). Increasingly populist policies would undermine institutional credibility and policy coherence. Over time, these forces would collectively depress global potential growth.

Could surging innovation offset all these headwinds to global supply, and thereby prevent a decline in potential growth? It is possible, and this assumption forms the basis of our upside scenarios. However, to achieve such an outcome, new technologies (e.g. AI, biotech) would need to boost productivity more than recent technological breakthroughs, such as computerization in the 1980s or the widespread adoption of the internet in the 2000s. Our base case is that innovation is only a partial offset to the supply-side headwinds in coming years. Regardless, innovation is not expected to alleviate the "hump" much. Even if productivity does surge, improvements will not be immediate, as technological diffusion takes time (though we readily admit AI has much faster adoption rates than earlier technologies). Moreover, these technologies will require more investment up front, which only adds to excess demand in the short term.

Global rebalancing

It is beyond the scope of this note to fully consider the impacts of the shifting secular trends beyond the US. However, we do expect the secular trends have and will continue to induce some degree of global rebalancing. This rebalancing is coming about from the end of the era of hyper-globalization that characterized the period of US hegemony. More specifically, the US-China economic nexus that lay at the heart of globalization has been severely weakened. Moreover, obstacles to the free movement of resources are increasing, protectionism is on the rise and industrial policies are making a resurgence.

Globalization allowed for the build-up of internal imbalances within countries – the free flow of trade and capital helped to make them sustainable in a wider global system. Countries with low savings rates, like the US, could over-consume by running large current account surpluses, while surplus countries, such as China, could produce more than they consume by exporting their excess output to the rest of the world. Globalization also meant that locally isolated recessions or high-inflation episodes were short-lived. The movement of capital, goods and even labour, allowed for a synchronization of the global business cycle.

In the post-COVID environment, economies will be pressured to rebalance towards greater autarky, or at least greater friend-shoring. This rebalancing could well take a long time, especially when it requires reform and politically economy shifts (such as entitlement reform in the US, or rebalancing toward consumption-led growth in China). Increasing "sand in the wheels" of globalization likely means that the business cycles of large economies in separate blocks can become de-synchronized.

For instance, the current slowdown in China, itself partly driven by reversing secular trends (Lavigne 2024), would have been partly offset by increased exports to the West in the previous era of hyper-globalization. It would have also served to temper the inflation pressures in the US. Such a movement of goods and prices now seems less likely in the post-COVID environment, due to geopolitical and protectionist forces. In this context, a US "hump" could well persist with a China "slump" for several years.

Looking ahead, we see the global economy being driven by two economic engines that are no longer running in sync: the US facing overheating risks and China struggling with deflationary pressures. Canada, Europe, Asia-Pacific and the Global South will also be affected by these secular trends, as well as their economic and geopolitical proximity to the two global engines. A forthcoming note will delve

into the issue of global rebalancing in greater detail.

Part 2: The macroeconomic effects of sustained excess demand

Our FORECAST system will be used to generate quantitative estimates for these key variables for the major economies over the next decade. The system is built on four interlinked groups of models (see Ramirez, forthcoming) that project out our five secular trends and estimate their joint impacts on macroeconomic variables defining both long-run supply (e.g. potential growth and neutral interest rates) and medium-term demand (e.g. primary balances and upshifts in consumption and investment). These estimates then serve as long-term anchor-points in our general equilibrium macro model OGEM (Thanabalasingam, forthcoming). See Annex 2 for an overview of FORECAST.

In this introductory note, we take a conceptual, qualitative approach to predicting the directional impact of the secular trends in our baseline scenario on important macroeconomic variables. It foreshadows upcoming estimates produced by our FORECAST system, and is aimed at explaining the key intuitions and drivers behind them.

In Table 1, we lay out the net expected impact of the five secular forces on aggregate demand and supply, savings and investment, government spending and taxes, and firm revenues and costs in our baseline scenario. From these, we can infer the medium-term implications for inflation, economic growth, profits, interest rates and public debt. We recognize the inherent uncertainty in this approach and accept that some of these trends may not end up having the expected impact. We only draw conclusions when the net impacts clearly point in the same direction. On balance, we expect the five secular trends to result in the following impact over the next 3-5 years in the US: a period of excess demand (first two columns), a savings deficit (columns 3 & 4), increasing fiscal deficits (5 & 6) and an ambiguous effect on profits (7 & 8).

Table 1: Net directional impact of secular trends on the US economy over the next 3-5 years

	Aggregate Demand	Aggregate Supply	Savings	Investment	Government expenditure	Taxation	Firm Revenue	Firm costs
Aging population Post-retirement consumption boom	+		-		+		+	
Shrinking workforce	+	-		+				+
Hardening geopolitics	+	-		+	+			
Accelerating climate change	+	-		+	+		?	+
Ascendant populism	+	-		-	+			
Surging Innovation	+	+		+			+	-
Net impacts of the secular trends	On balance, aggregate demand exceeds supply, implying excess demand and likely above-average growth and higher inflation.		On balance, investment outstrips savings, implying higher real interest rates and deteriorating trade balances.		On balance, government expenditures outpace revenues, implying higher deficits and a growing debt burden.		On balance, the net impact on firms' earnings is ambiguous, likely depending on the extent of productivity gains.	

+/- implies a positive/negative directional impact over the next 3-5 years in our baseline scenario relative to 2010-19 averages

Impact on economic growth: The cycle will probably be more volatile in the new regime. In our baseline scenario, we see three stages: first, a slowdown in late 2024 and early 2025 as the weight of monetary tightening comes to bear, followed by a period of above-trend activity (the hump) that is driven by a transitory surge in aggregate demand.

We estimate that real GDP growth, which averaged below 2% in the last decade, is likely to shift to a 2-4% range in the new regime in the US, a material upshift. But we don't think it will last indefinitely. In the third stage, the corrective forces of the economy should bring aggregate demand and supply into balance. In all likelihood, the negative supply shocks stemming from the identified secular trends will last

significantly longer than the demand shocks. The upshot is that the lasting supply constraints will eventually lead to lower growth in the longer term (e.g. the next 10 years). We estimate that long-term potential real GDP growth in the US will settle around 1.5%.

Impact on inflation: In a broad sense, excess demand raises the risk of economic "overheating", a situation in which demand growth outpaces the ability of the economy to produce goods and services. It is also an environment where the economy is more vulnerable to negative supply shocks, which we think will be more frequent in the new era of constrained resources (see Rendell [2024] for work by the Bank of Canada). There are several longer-term inflationary drivers that are likely to play out over time. China's rapid aging and possible decoupling from the global labour pool is already reversing the disinflationary impacts of the country's entry into the global system in the late 1990s. Going forward, we expect real wages to rise globally due to protracted labour scarcity. Populist policies such as distortive trade measures and reduced immigration may add to price pressures. We also expect upwardly trending commodity prices as the energy transition proceeds and rising geopolitical risks threaten the security of supply. Overall, it is our view that the major Western economies have probably shifted from a 0-2% pre-pandemic inflation regime to a 2-4% one now (see Lavigne 2021).

Impact on interest rates: In line with higher inflation, we also expect "higher for longer" yields relative to pre-pandemic times. We are not alone; many central banks also see this as a risk (see Beaudry, 2023). On balance, the persistent real negative rates experienced over the past decade will be replaced by a robustly positive equilibrium rate in the new regime. Several factors are at play. First, real rates can be expected to rise due to the decline in savings (and hence a decline in the supply of loanable funds), and the increase in investment (meaning higher demand for capital). At a global level, investment should be higher than savings in coming years, reversing the global savings glut that characterized the early 2000s. Second, if productivity rises (as we expect) due to fewer workers and more innovation, the natural (or neutral) rate of interest (i.e. R^*) should increase as well. Third, higher term-risk premia are likely due to significant rises in inflation and government debt, as well as economic and political uncertainty. Finally, these forces should find their counterparts (i.e. be reflected in) tighter monetary policies, as central banks act to contain inflation in the new regime. However, once the period of excess demand is over, we would expect real interest rates to decrease in line with lower potential growth (Rachel and Smith, 2015).

A note on current monetary policy - one reason the US has not experienced a recession so far despite massive monetary tightening over two years is likely because the secular forces mentioned above have sustained demand in the post-COVID period, acting like an acyclical buffer against the contractionary forces of policy tightening. The persistence of these forces is a key ingredient of the market's soft-landing scenario. However, if the economy is heading into a protracted period of excess demand as we expect, central banks will be hesitant to ease as aggressively as markets are thinking, out of concern of "falling behind the curve" in a higher-inflation regime.

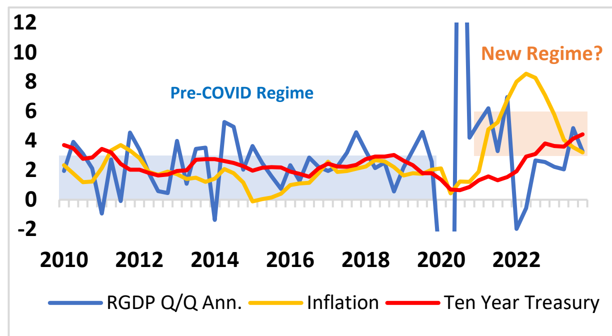
Impact on fiscal deficits: Government spending is expected to rise structurally on the higher costs of aging (especially public pensions and health care), greater military expenditures and larger climate and strategic spending programs. In the short run and notably in countries with more populist governments, these spending pressures are likely to translate directly into rising deficits and public debt.

Impact on earnings: The impact of the secular trends on earnings in the new regime is ambiguous. On the one hand, higher demand is supportive of growing revenues over the next few years, and above-target inflation in certain countries suggests some degree of pricing power

could persist. On the other hand, costs will likely be steeper than in the past; real interest rates will remain elevated, and there will be upward pressure on real wages due to the shrinking labour force. Ultimately, the deciding factor may be productivity growth. If firms can produce more per worker, then rising real input costs need not weigh on firms' bottom line.

Beginning and ending of the hump
On balance, our qualitative analysis suggests that the brave new post-pandemic economy will likely feature higher economic growth, inflation, real interest rates, deficits (trade and fiscal) and uncertainty than we are used to. To a certain extent, these trends have already materialized in the US data (see Figure 2).

Figure 2: Is the regime shift already occurring in the US?



While it remains to be seen whether they will persist through 2024 due to the still-considerable risk of a slowdown, we believe that recent trends are indicative of what we can expect of the global economy over coming years. If there is a sense that the hump has already begun, forecasting when and how the hump ends is more difficult. The best we can do at this stage is consider alternative scenarios. In our upside scenario, technological innovation and the burst of investment that we expect in the short run leads to a rise in productivity over time that both drives higher potential growth and reduces inflation. This allows the hump to fade gently. A more dire scenario, in which populist policies prevent governments from properly adapting to shifting fundamentals, could see the emergence of debt sustainability issues. This could lead to an abrupt collapse in demand (as the hump turns out to be a bubble) and significantly weaker country fundamentals following the crisis. Our baseline scenarios lies somewhere in the middle, featuring a slower growth profile over time but no abrupt transition. We believe that macroeconomic policies will ultimately determine which of these scenarios ends up defining the next decade.

While secular trends are largely out of the control of governments, their policy choices will make all the difference.

Part 3: Policies are key
Regardless of the scenario, fiscal and monetary policies will be strained over coming years. Globally, central banks will likely face a higher-inflation environment; some may face populist threats to their independence. Governments will be confronted with rising public expenditures across the board. In countries with sound policy frameworks, low net public debt and expanding labour pools, such as Canada, existing policy frameworks can remain largely intact. But higher real interest rates will raise concerns about debt sustainability in many others, stressing policy paradigms.

What are the solutions? Austerity and entitlement reforms are necessary to curb expenditures over time, but such measures may not be politically feasible in the short run. In many countries there will be a need for greater coordination of fiscal and monetary policies to efficiently address the twin issues of higher inflation and rising public debt. Some central banks may need to consider higher inflation targets and/or more flexible inflation control frameworks, similar to the Fed's Flexible Average Inflation Target (FAIT). This, to a certain extent, could assist fiscal authorities in keeping real interest rates manageable, though potentially at a cost to central bank credibility.

The rise of populist governments will be a complicating factor. Populist regimes, which

historically tend to increase fiscal deficits, could seek unorthodox solutions to keep debt dynamics under control. Financial repression will be tempting to reduce borrowing costs. Fiscal policy dominance could be a major risk to the independence of monetary policy. Populist authorities, already suspicious of central bank technocrats in the first place, could put pressure on them to ease off on their inflation targets or engage in asset purchases to lower public borrowing costs. Yet even if populist governments do not force them to loosen policy, deteriorating debt dynamics could nevertheless put central banks in a bind. On the one hand, they could preserve their independence and fight against expansionary/populist fiscal policy by keeping rates elevated. This would raise the risk of a downturn and/or a debt crisis. On the other hand, they could accommodate the non-cooperative fiscal authorities by easing rates to stabilize debt dynamics, at least until a more responsible government comes into power. This would avert a crisis but at the cost of their inflation-targeting credibility. Many central banks could face difficult choices over the next few years.

Part 4: Paradoxes and opportunities

The new regime we see ahead will in many ways be paradoxical. There will be increasingly binding demographic, environmental and political constraints on the economy, but at the same time, we expect a surge in investment to adjust our productive capacities to these new realities. An aging society will be consuming more, just as mass retirement reduces the labour forces needed to produce those additional goods and services. Economic growth is likely to overshoot in coming years, but at the same time it will raise the costs of production (and hence inflation), leading to an ambiguous impact on real incomes and firm profitability. Innovation could potentially offset the expected growth headwinds, though technological disruption could also exacerbate inequality and populist sentiment. Monetary policy will likely need to be tighter, but that could endanger public debt sustainability at a time when citizens increasingly demand their governments shelter them from the winds of change.

In this complicated mix, some tentative conclusions for the investment environment can be drawn. In a broad sense, there will be more uncertainty than under the earlier pre-pandemic era, raising both opportunities and risks. In terms of opportunities, investors and firms who can get ahead of our five secular trends stand to prosper. The coming period should see a surge in investment prospects, as companies and governments need to retool their capital stocks to accommodate a smaller workforce and shift their products to the tastes of an older clientele. Returns can expect to be higher, in parallel with higher real interest rates. Growth will likely be above average for a while, but so will real wages and interest costs. The impact on aggregate profits is unclear in this complex environment - firms able to innovate and control costs will likely do best. The protracted period of elevated rates that we forecast will be a boon to savers and fixed income investors, provided that inflation is correctly priced in.

In many ways, the risks will be higher as well. Resources will probably be scarcer, be they labour, capital or commodities. Debt sustainability could become a major source of concern in many countries, raising the risk of financial crises. The new multipolar world will also feature a more divided and fractious global system. The rules of the game set by governments could be changing in an increasingly populist environment beset by debt concerns. In this new environment of higher macroeconomic and financial volatility, there will be winners and losers amongst countries, assets and markets. Investors will need to choose carefully, perhaps more so than in the recent past. Rigorous country assessment is likely an important tool for investors going forward.

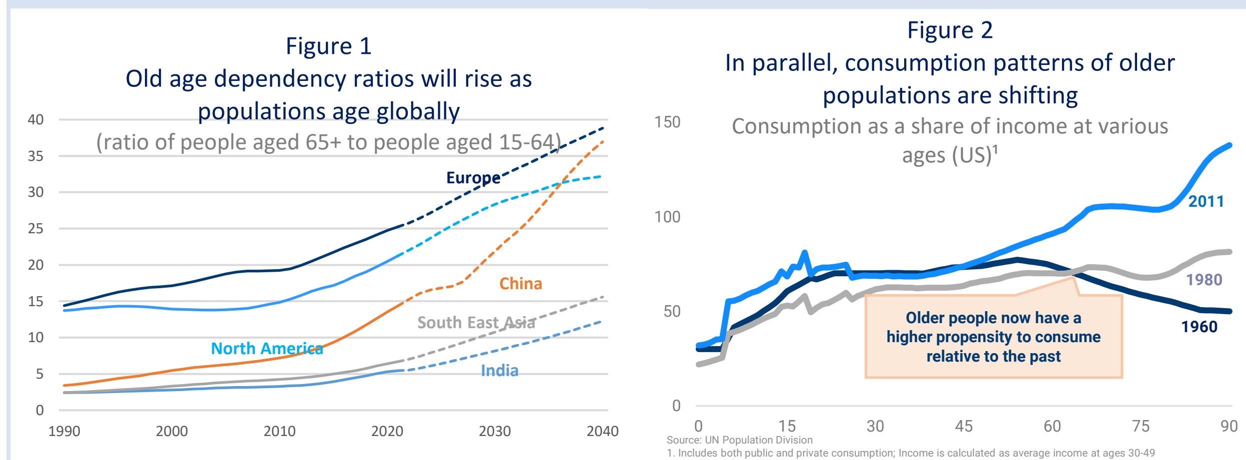
In sum, we expect the coming regime of excess demand will be more high-pressured, dynamic and uncertain relative to what we are accustomed to. Firms and investors that are flexible, forward-looking and creative will do

best as they find ways to seize opportunities in a rapidly changing environment.

Annex 1: Five secular trends in our baseline scenario[2]

In what follows below, we consider our baseline scenario for the five major secular trends, considering how they could impact aggregate demand and supply:

Aging populations: the world is aging due to declining birth rates and increasing longevity. While there are regions where population growth is still elevated, such as Africa and the Middle East, all the major economies are in a state of slowing demographic growth. China is in outright decline and will actually see its population shrink by over 50 million by 2040, according to UN estimates. Europe is expected to see its population decline by 30 million. The US is now past its peak of Baby Boomer retirements (Q4 2021 was the heaviest retirement quarter). The impact of aging on the labour force was accelerated by the significant increase in early retirements that took place during the lockdowns. For the next 20 years, dependency ratios are set to worsen in all major economies (See Figure 1).



Let's first consider the impact on aggregate supply. We estimate that the effective global labour force is shifting from a situation of rapid expansion since the early 2000s (when China integrated into the global trading system), to almost a complete standstill. In a broad sense, absent significant productivity gains, a shrinking labour force will put downward pressure on productive capacities and upward pressure on wages.

Aging will likely have the opposite impact on aggregate demand. Up until recently, a greying population was associated with higher savings, as people needed to prepare for their retirements. But theory suggests that there should be a behaviour change once people actually retire - from that point onwards, they should shift from being savers to dis-savers on net. 2021 was the peak year for US Boomer retirements, suggesting that soon an entire generation of retirees will be depleting their accumulated savings to finance their consumption. The data suggests that retirees are doing so, especially through health care expenditures. In fact, older people in their 70-90s consume per capita almost twice what prime age people do (see Figure 2). But it's not only about medical costs. There is reason to believe that the Baby Boomers are not going to reduce their discretionary spending when they retire, as their more frugal parents did. Indeed, over time, the propensity of older people to consume their incomes has been increasing (Figure 2). Thanks in part to their massive concentration of wealth and generous pension plans (at least relative to current workers), boomer spending on personal consumption is on the rise. Indeed, recent data has shown that elderly spending is more robust relative to average consumers, in part because they are immune to layoffs and are generally insensitive to interest rates as they mostly own their homes. Strong elderly spending is likely here to stay, notably as life expectancy rises. Moreover, we expect that Baby Boomers will put pressure on governments to maintain the generous entitlements that they currently have, even though these are broadly unsustainable over time. What this boils down to is lower savings over time, higher public deficits, and a tilt towards greater consumption.

[2] We would like to thank the OMERS Strategy team for assistance on the graphs in this annex.

Aging will probably demand greater investment as well. As firms strive to minimize the effects of higher wages, there will likely be more investment in labour-replacing technologies, boosting investment in advanced economies over the next few years. Moreover, shifting production to service an elderly population will also require some degree of investment. Real investment in Western economies, which has languished for years, may be on the verge of a renaissance. By combining the fall in savings and the rise in investment, we think aging is boosting equilibrium real interest rates as well as leading to a situation of excess demand over time.

Hardening geopolitics: Over the three decades following the end of the Cold War, during which the United States was the global hegemon, it modelled the world economy in its image. It was a prosperous time of rapid economic and financial globalization and the widespread adoption of liberal policies and democratic systems. That world system, often referred to as *Pax Americana*[3], is ending, brought about by three major shifts in recent years.

First of all, the possibility of great power confrontation, which was minimal during the US unipolar moment, has now resurfaced. The global geopolitical balance has shifted, with China's aspiration to become the dominant power in Asia and Russia's direct challenge to NATO through its invasion of Ukraine. China, Russia, North Korea and Iran are forming a loose alliance of autocracies that is challenging US leadership and putting into question the promotion of free markets and democracy as the baseline systems for the global economy. Potential flashpoints have arisen in Ukraine as Western support falters, the broad Middle East as the Gaza conflict regionalizes, and the South China Sea and Taiwan as recent elections brought a pro-independence government to power.

A second major shift involves the decline of US leadership among Western democracies. In recent years, populist governments on both sides of the Atlantic have put their national interests first, above the global liberal democratic agenda embodied in the "Washington Consensus". To a certain extent, this trend reversed in the first year of the Ukraine war, as Europe once again turned to the US for leadership in supporting democracy militarily. However, with the emergence of Biden's protectionist climate and security spending plans, and weakening Republican support for Ukraine, US leadership is being questioned once more. A major concern is that Donald Trump views NATO as a transactional accord rather than the rocksteady alliance it needs to be seen as to deter aggression. Should the US turn isolationist in coming years, the geopolitical landscape could change dramatically. The 2024 Presidential elections will be critical to determining whether the US is willing to maintain its global hegemon status.

Finally, the Global South, an assembly of large emerging economies, has become a geopolitical actor in recent years. *De facto* led by India, the Global South is generally uninterested in joining either the democratic or autocratic camps, preferring to prioritize its own development interests over joining yet another ideological struggle between major powers.

Collectively, these changes are resulting in the emergence of a geopolitical regime that can be thought of as a new form of mercantilism. In a general sense, there is a fraying of political and economic unity that once united the West and much of the world during the US unipolar moment. When it comes to their economic policies, countries are decidedly putting their own interests above the collective international good. Free trade and capital mobility are no longer the overarching guideline to the conduct of economic policy. Instead, reshoring, friend-shoring and preferential trading arrangements are the new *modus operandi*. Barriers to trade, capital and immigration are all on the rise. In a new age of government interventionism, economic policy has become a tool of statecraft.

From a demand perspective, military expenditures will likely need to increase to deal with the new security situation. Most Western economies spend considerably less than their NATO commitments and will need to ramp up defense expenditures in the next few years. The shift has already begun (The Economist 2024). It will require more than merely producing more equipment – they will need to rebuild their industrial bases to compete with the Chinese/Russian military complexes. The challenge will be especially acute if Europe loses confidence in US willingness to support them in the event of a conflict. Beyond the military, governments will be spending more on strategic aims, including developing technologies deemed key for national security, green and digital technologies, supply chain resiliency and reducing reliance on foreign supplies for critical materials and inputs (see Figure 3).

From a supply perspective, the shift toward a more multi-polar world has already stalled globalization (see Figure 4) and will likely erode the global peace dividend that has been widely enjoyed throughout Pax Americana.

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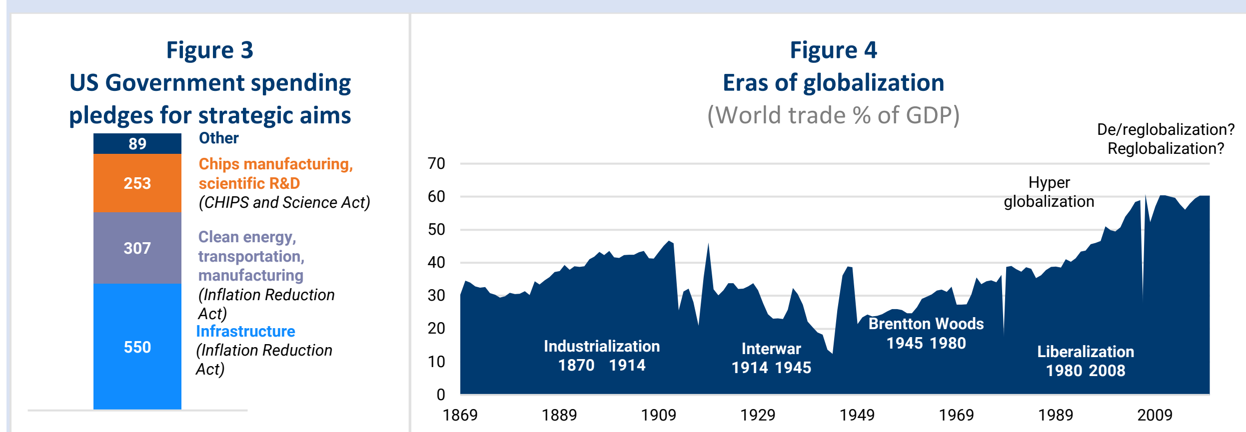
[3] American global hegemony lasted from the end of the Cold War to the Global Financial Crisis - roughly 1989 to 2007.

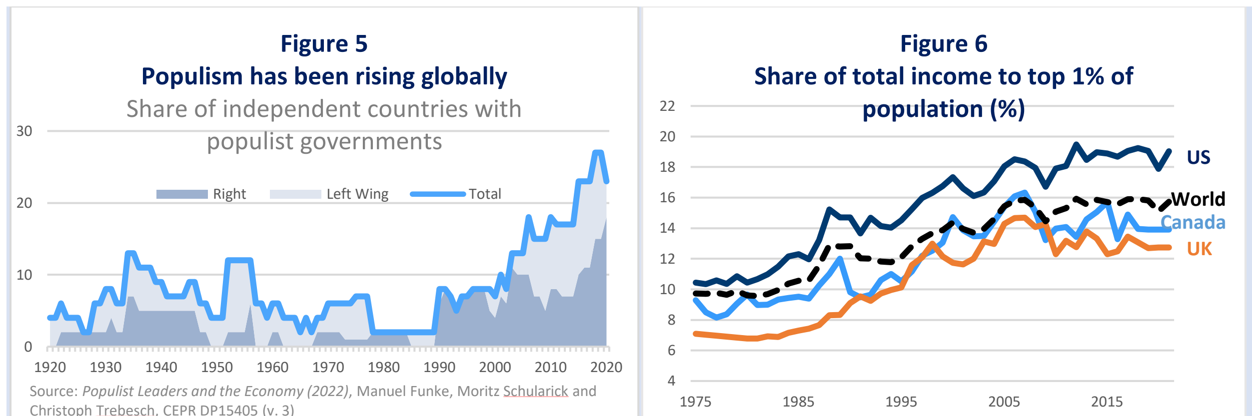
Historically, permanent shifts towards bigger governments and arms production have undermined growth over time, as military expenditures, to the extent they are ultimately less productive, crowd out private investment. However, in our upside scenario, military spending, which is increasingly a high-tech race, leads to publicly backed breakthrough technologies that ultimately improve productivity (akin to the Space Race during the Cold War).

Reglobalization: A direct consequence of a multipolar world is the erection of trade barriers between different actors according to security arrangements. We are not of the view, however, that the emerging system of New Mercantilism will evolve into a full decoupling of the US and Chinese economies (Russia, Iran and North Korea are already decoupled from the West). Rather, reglobalization is already taking place, as trade flows are reoriented to circumvent US-China barriers to operate through third countries. This will produce new winners and losers as global trade is rewired. In aggregate, however, the global system is less productive, as capital and productive capacity are now less-efficiently allocated. To the extent it occurs, economic decoupling between democracies and autocracies will weigh on the profitability of multinationals, who will no longer have unfettered access to resources and markets. Over time, this suboptimal capital allocation will slow global potential growth. However, in the short run, reglobalization will likely boost demand. Indeed, re-shoring productive capacity and rewiring global trade flows towards more friendly countries will require investment at first.



In sum, we think reglobalization will lead to rising demand at first but falling aggregate supply growth over time. This will naturally result in a situation of excess demand for the first few years, or however long it takes to "retool and re-allocate" global capital in response to a potential US-China decoupling.

Populism ascendant: Populism has been on the rise around the world in recent years (Figure 5). Historically, its drivers have been inequality, illegal immigration and societal fractionalization. The movement gathered steam during the decade of secular stagnation following the 2008 Global Financial Crisis, which ushered in a period of rising inequality (or at least the perception of this) in advanced economies, especially in the US (Figure 6). As workers' real wages stagnated but financial markets soared, there was a view that the elites had been bailed out by compliant governments. Illegal immigration was major factor in the Brexit vote and Trump's 2016 election. Political polarization in the US has never been higher.



Source: *Populist Leaders and the Economy (2022)*, Manuel Funke, Moritz Schularick and Christoph Trebesch, CEPR DP15405 (v. 3)

Populism can take on many shapes, from nationalistic strongmen to autocratic leaders. At the risk of overgeneralizing, populist policies essentially argue for lesser immigration, more protectionism and more income redistribution to workers. Populist governments tend to couch themselves as enemies of the elites and the establishment (see Rodrik, 2018). Many seek to undermine existing structures and the rule of law. In this sense, 2024 will be critical as many populist parties are up for re-election or aiming for a comeback.

Similar to most of the other secular trends, populist policies have differentiated impacts on aggregate demand and supply. On the one hand, they undermine long-term growth, confidence and investment. The broad erosion of institutional quality, the dominance of "short-termism" in policy making, the rise of interventionism and widespread use of redistribution policies are aspects of populism that have weighed on productivity growth in the past. Taken as a whole, a shift towards more populist policies can be considered as a persistent negative supply shock that reduces potential growth over time.

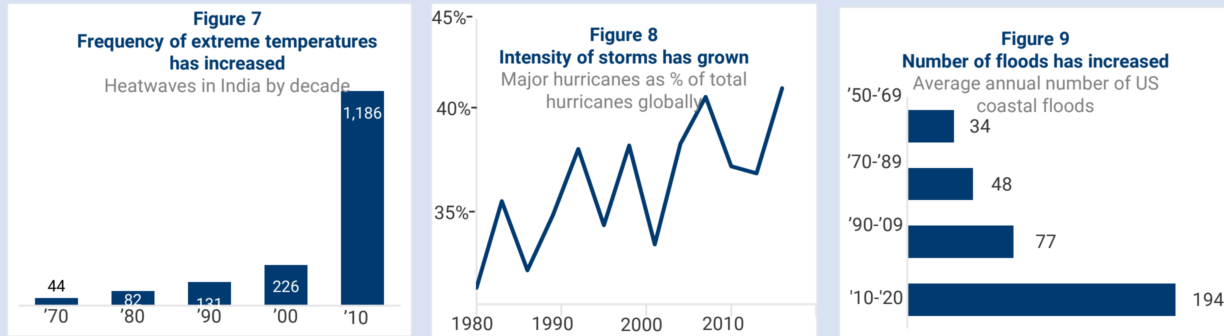
On the other hand, populist policies are frequently stimulative at the onset. Left-wing populist governments generally tend to boost government spending. The right-wing populists favour tax cuts. As their name implies, populists tend to avoid unpopular policies, such as structural reforms. We assume that populist governments will bow to demographic political pressure and not make the required entitlement or public health care reforms needed to curb the cost of aging. If the populist surge continues, notably in large economies like the US, we can expect continued deterioration in fiscal positions. These rising deficits will contribute to the situation of excess demand and increasing inflationary pressures, all while dampening long-term growth and increasing the odds of a fiscal crisis.

Climate change: the impacts of climate change on the economy are complex and will depend on the policies used to address it. In the short run, there is little that can be done to reduce global warming – the impacts over the next 3-5 years are the result of greenhouse gases emitted in previous decades.

Two types of risks are associated with climate: physical and transition risks. Physical risks stem from more frequent and severe weather events (see Figure 7-9). We expect them to act as gradually increasing net supply shocks on the global economy, pushing down productive capacity in the world and raising costs of production (especially in weather-sensitive industries such as agriculture). Physical risks will increase the more the planet warms and the less effort is put into enhancing climate resilience and risk mitigation efforts. The impacts of rising physical climate risks on economic activity will depend on the intensity of the climate impact in particular countries and the resources deployed to mitigate the risks. "GDP at risk" in any given year is expected to be limited in Europe and North America, but as elevated as 8-12% in South Asia (source: S&P Global).

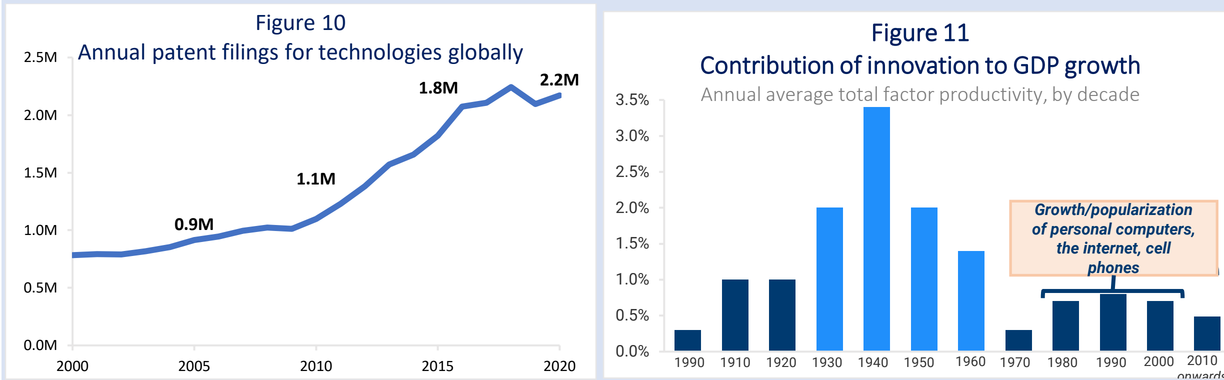
Transition risks are incurred as economies shift their energy production sources. They tend to be more short-term in nature. The energy transition tends to put upwards pressure on commodity prices through a variety of channels. Penalty-focused measures, such as carbon taxes or emissions trading schemes, aim to directly raise the price of hydrocarbons. Government subsidy programs, such as the Inflation Reduction Act in the US, tend to directly boost investment in renewable technologies, and, indirectly, the price of "green" metals. Broadly speaking, the green transition will require a lot more public and private investment to gear up over the coming years, putting upward pressure on investment and public deficits. McKinsey estimates that almost $4 trillion in annual investment is required on physical assets for energy and land-use systems over 2021-2050. This will more than offset whatever

spending declines in carbon-intensive assets are expected over the coming years, suggesting a strong net positive effect on investment.



Source: Assorted national and UN climate statistics

Innovation surge: Innovation has surged over the past decade in numerous fields. Overall metrics of technological innovation, such as patent filings, have notably increased (Figure 10). The advent of artificial intelligence as a general-purpose technology could potentially mean the current wave of innovation could last for some time yet. Innovation is different from the other secular trends in that it is a positive shock for demand and supply. Innovation matters for many reasons, but from a macroeconomic perspective the main question is whether it can generate enough of a boost in productivity growth to offset the headwinds posed by the other trends. On this highly uncertain issue, we take a conservative approach.



Source: World Wealth and Income Database

The scale of the needed increase in productivity is daunting. By our calculations, the required increase in productivity would need to be at least double currents rates of growth and remain sustained for years. Recent technological booms, including computerization in the late 1980s and the advent of the internet in the early 2000s, did not manage such a feat (Figure 11). Moreover, their impact on productivity growth was fleeting. Our working assumption in the baseline scenario is that the ongoing productivity surge will eventually lead to a boost in investment and in productivity, but that it won't be sufficient to significantly modify the coming period of excess demand.

Annex 2: Overview of the FORECAST system

The FORECAST system is built on five interlinked groups of models (see Ramirez, forthcoming).

1. The first group consists of an eclectic set of models producing holistic forecasts of the five secular trends we focus on over the next decade, with an emphasis on the next 3-5 years (see Annex 1). A baseline forecast is derived by extending recent trends established in the post-pandemic period. Alternative scenarios are created holistically, using judgement and research on trend interactions to modify the baseline inputs.
2. The second group forecasts aggregate supply using empirically estimated models of long-run potential growth and real interest rates inspired by Lanzafame *et al* (2016), IMF (2016) and Ferreira and Shousha (2021). Inputs

and assumptions for the forecasts are based on research on the secular trend scenarios (see Step 1). The predicted macroeconomic outputs serve as long-run anchors for the entire projection exercise.

3. The third group estimates aggregate demand anchors over the next few years, using a straightforward demand add-up approach. Estimates from the first three steps also serve to forecast structural primary balances.
4. A final step involves linking our general equilibrium macro model OGEM (Thanabalasingam, forthcoming) to the long-run anchors established in the earlier steps to derive a full suite of impacts on growth, inflation and policy rates over the next 3-5 years. Dynamic links between the groups of models (i.e. between the short and long-terms) include investment, real interest rates and public debt dynamics.
5. Financial market consequences consistent with the macroeconomic scenarios are then forecasted using our suite of macro-financial models (Ramirez, forthcoming, b). The entire process is carried out for eight major economies (US, Canada, Euro Area, UK, China, India, Japan and Australia).

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