



## Weekly Economic Briefing Global Overview

### Age is not (just) a number

18 November 2014

Global population growth is slowing. After peaking at just over 2% per annum (p.a.) in the late 1960s, the world's population is currently growing at 1.1% p.a. and is expected to moderate to 0.5% p.a. by 2050. As population growth slows, the world is also ageing. In 1950 there were just 9.9 people aged over 65 for every 100 people aged 20-64. Today, there are just over 14 and that is likely to rise to 28 by the middle of the century. Naturally, these trends vary significantly across countries and regions (see chart 1). Population growth in the least developed countries did not peak until the 1990s and will probably remain above 2% p.a. until 2030, while the old-age dependency ratio is not likely to reach the current global average until 2055. By contrast, population growth in the most developed countries is not far above zero and is anticipated to turn negative in the 2020s. Meanwhile, there are already 28 old people for every 100 working-age people and this ratio could reach 50 by 2050. These demographic trends are worst in Europe and developed Asia. Japan, Korea, Germany, Italy, Portugal and Spain all have very low fertility rates and are likely to have a dependency ratio of two-to-three by the middle of the century.

Demographics are not the be-all and end-all of economic growth, but they are very important. The sweet spots for economies are the decades after a surge in the birth rate, when rapid growth in the working-age population is boosting growth in the labour force and the vast majority of resources are being devoted to society's most productive cohorts. The developed economies' demographic dividends are well behind them, China's has just expired, while India, the Philippines and Vietnam are coming into theirs now. On the other hand, ageing populations have to deal with increased demand for healthcare and public pensions at a time when the number of workers is growing slowly or even contracting. Such negative effects are compounded, when, as is the case for many OECD countries, relatively generous public pension schemes have not been pre-funded in an actuarially sound manner. Although there is plenty of scope for productivity enhancing reforms to partially offset these demographic headwinds, they are unfortunately in short supply at present.

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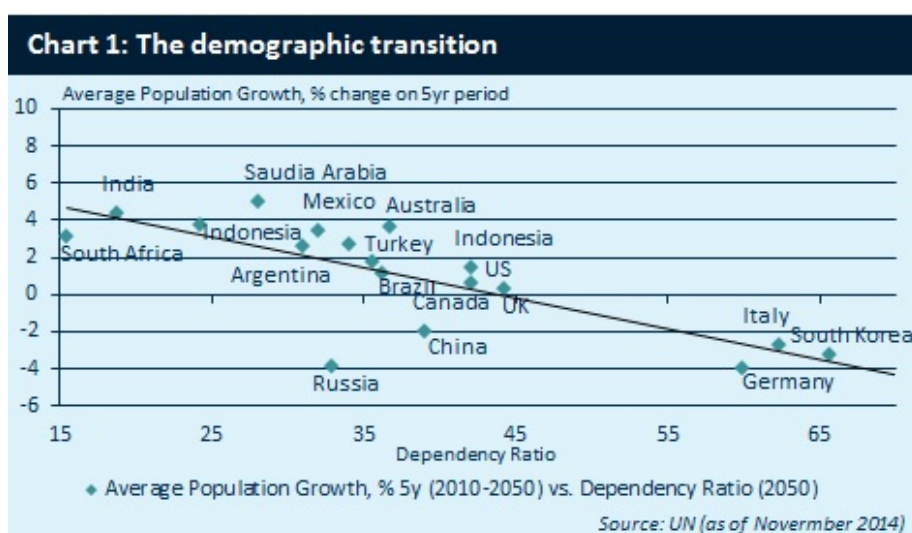
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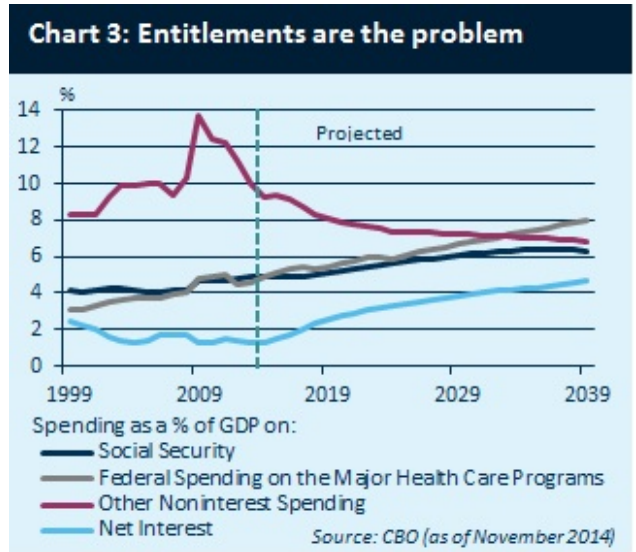
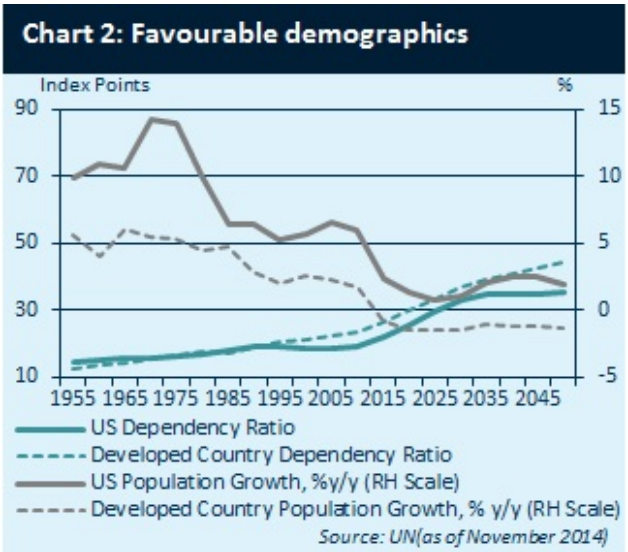


## Ageing badly

**By developed country standards, the United States is not in bad demographic shape.** Although population growth has slowed significantly in recent decades, it is, and will continue to be, around 0.5 percentage points (ppts) per annum faster than the median rich economy due to higher than average fertility and migration rates. As a consequence, it is also ageing more slowly than the majority of other developed countries (see chart 2). For example, in 2050 there are expected to be 39.5 people aged over 65 for every 100 people of working age, compared to 49 for the average country. With trend productivity growth also higher than average, US potential growth will hold up better than most.

Of course, that does not mean that the country is managing its demographic transition perfectly. In fact, there are two critical areas of policy where it could do a lot better. The first is the labour market and broader economic policy. Although the level of employment has now regained its pre-crisis peak, and the unemployment rate has fallen substantially, the employment to population ratio remains only a little above a 30-year low. Some of the decline in labour utilisation was inevitable as population ageing weighed on the labour force participation rate, but not all. **For example, many people have chosen to retire not because they do not want to work but because they cannot find it.** Others without the means to retire have opted instead to go onto disability support rolls. Meanwhile, some of the younger people that have surged into higher education since the crisis have been motivated primarily by the lack of available work. But what could policy have done? The answer is plenty. On the positive side, all levels of government could have done more to promote active labour market policies for the long-term unemployed to help them back into work rather than incentivise them to leave the workforce all together. More generally, government spending should also have been stimulatory for longer so that GDP and employment growth were both stronger and spells of shorter-term unemployment were less likely to become permanent. On the negative side, more could have been done to reduce the flow of unemployed workers onto disability payments.

The other area of policy that is failing is long-term fiscal policy. While the budget deficit has declined substantially since 2010, much of this has been cyclical rather than structural, and the structural initiatives that have passed Congress have been of the wrong kind. In particular, fiscal consolidation efforts have focused much more on reducing discretionary government spending (which is often on public goods that enhance potential growth) than on reforming the entitlement programmes that will drive the deficit and public debt higher over the longer term. For example, federal spending on Social Security, Medicare, Medicaid and other major health programmes is currently projected to increase from around 9% of GDP to around 14% of GDP in 2039 (see chart 3). This spending math will force future governments to make difficult choices. **If entitlement programmes are unchanged, taxes will need to rise substantially and discretionary spending cut to the bone.** If voters will not accept higher taxes, entitlement programmes will need to be cut. Neither option will be popular.

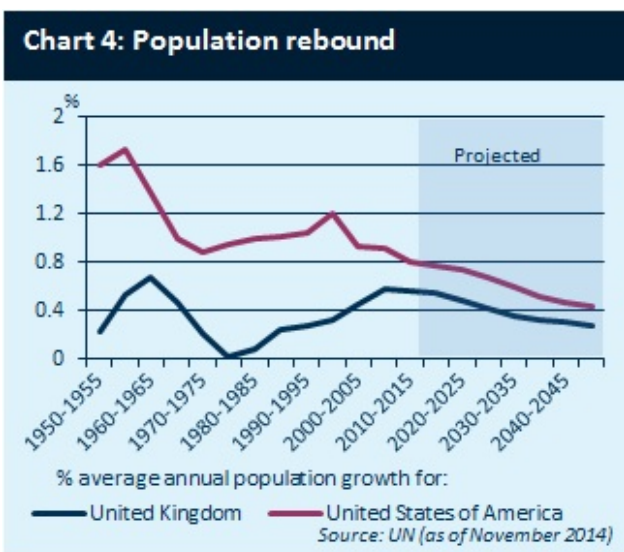


## Demographic dilemmas

Population growth in the UK has been generally weak in the post-war period. The baby boom generated average annual growth of just 0.4% year-on-year in the 1950s, significantly lower than the 1.6% seen in the United States and also slower than Europe. Matters got worse thereafter, as population growth slowed through the 1960s and stagnated in the late 70s and early 80s. However, this proved something of a watershed, with growth rates accelerating through the 1990s and even more so in the 2000s (see chart 4). There are two explanations for this turnaround. **Immigration flows to the UK began to support population growth, with the proportion of non-UK born people living in the UK having doubled from 6.7% in 1981 to 13.4% in 2011.** This reflects a combination of increased immigration from European Union (EU) partners and non-EU countries. Second, we have seen a rise in fertility rates in the UK. Fertility had been steadily declining through the 1960s and 1970s, but stabilised in the 1980s before rising moderately more recently. The immigration story has again been a factor here with foreign-born women tending to have higher fertility rates than UK-born women. Additionally, there has been an increase in fertility rates among older women.

The rebound in UK population growth provides a number of benefits for the economy. The rise in the labour force supports potential growth rates, allowing the economy to grow more quickly without generating inflationary pressures. This has been well-illustrated over the course of the recent crisis. **A combination of continued strong immigration inflows and labour market reforms encouraging participation have supported resilient labour force growth** (see chart 5) – even in the face of an ageing population. The Bank of England has flagged this positive labour supply shock as one of the key reasons why record-breaking employment growth has not yet resulted in tangible inflationary pressures. Indeed, while wage growth showed some signs of life in the most recent data, it remains unusually low (weak productivity is likely an additional factor here). In contrast to its European neighbours the UK is set to continue to enjoy the benefits of population growth in coming decades. The UN's estimates for future population growth shows the UK averaging 0.5% annual over the next 20 years (0.3pps owing to net migration).

One caveat is that this growth will increasingly reflect an ageing population. The UK has a younger population profile than the EU average at present with 17% of the domestic population aged over 65. However, the dependency ratio is set to rise in coming decades. This will place an increasing strain on public finances due to rising healthcare and pension costs. The IMF has attempted to quantify the size of budgetary adjustments required to meet these challenges in the context of already high debt levels. It estimates that in order to maintain current social security policies, and reduce the gross debt-to-GDP ratio to the 60% demanded under the Maastricht Treaty, the UK would need to run a structural primary budget surplus of 3.3% of GDP through to 2030. Frankly, this looks like an impossible task, meaning that debt will probably remain very high. **Setting the public finances on a sustainable trajectory should be high on the agenda for the next government, although this does not have to mean accelerated austerity in the short term. Instead, long-term, credible fiscal panning is required.**



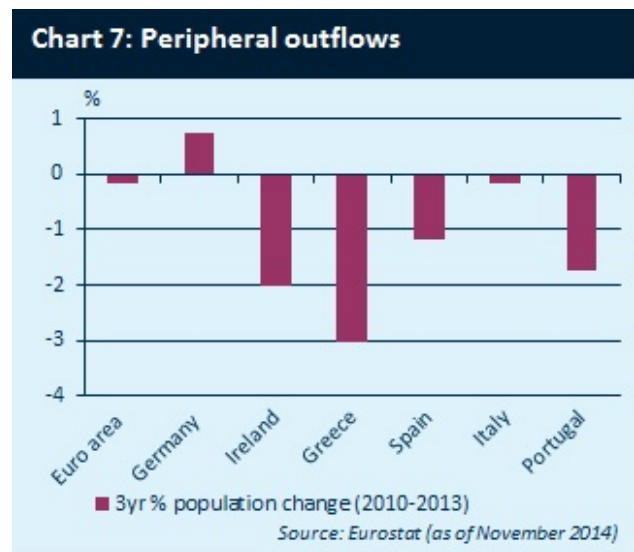
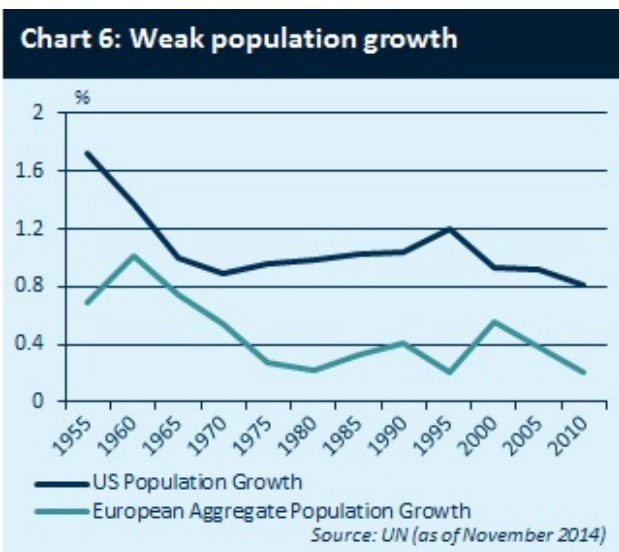


## Union of the elderly

European population growth has generally lagged its developed world peers in the post-war period. The baby boom seen in the United States was less pronounced in Europe, with population growth only reaching 1% year-on-year (y/y) during the 1950s before slowing markedly from the 1960s onwards (see chart 6). At present, population growth for the Eurozone is running at a paltry 0.2%/y. This story becomes even more alarming when we look at changes in demographics. **The working age population of the Eurozone, defined as those aged between 15 and 64, is already shrinking.** It fell by 0.3%/y last year following a 0.2%/y decline in 2012. A declining working age population raises a number of challenges. First, it weighs on potential growth as a country with a falling labour force will need to generate greater investment and productivity to maintain a given level of growth, which is usually hard to achieve. Second, a declining working age population adds to pressures on already stretched public finances. The proportion of the population in the Eurozone aged 65 or over has risen to 19% and is set to continue to rise. The healthcare and pension cost of this ageing on shrinking working-age populations will provide a challenge in a region where debt levels have already risen markedly since the crisis.

**Trends in population growth have varied significantly within the Eurozone.** The German working-age population had been declining through much of the past decade. Indeed, in 2013 there were some 1.4 million fewer people of working age compared to 2003. However, there has been something of a reversal in this trend more recently. Working-age population growth turned positive in Germany in 2011 as the relatively strong performance of the domestic economy attracted immigrant workers. This movement of labour has exacerbated the declines seen in the working-age populations of many of the peripheral member states. Since 2010, Ireland (2.0% y/y), Greece (3.0% y/y), Portugal (1.7% y/y) and Spain (1.2% y/y) have all seen material declines in working-age populations (see chart 7). These outflows are not surprising given chronically high unemployment rates.

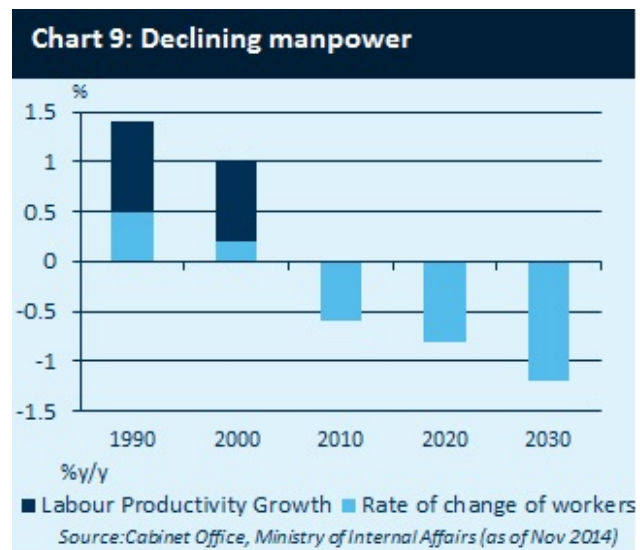
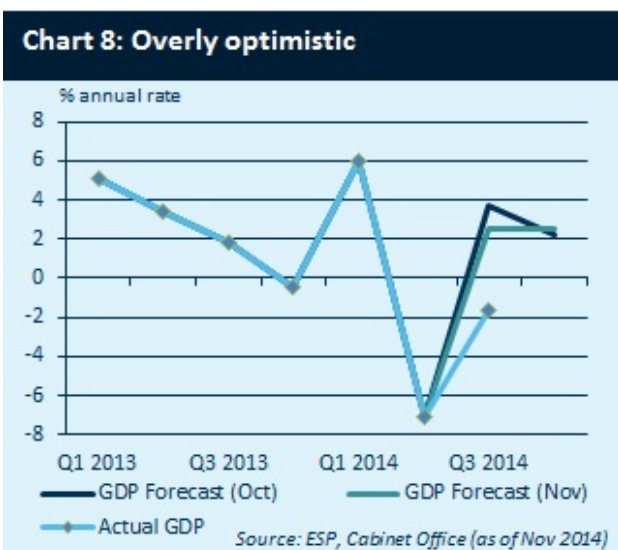
Economic theory suggests that high levels of labour mobility are a vital component of a well-functioning currency union, providing a mechanism to smooth the effects of asymmetric shocks. The movement of labour from distressed member states helps reduce unemployment in these regions, while alleviating labour market tightness in better performing economies. Do the recent trends in Eurozone migration prove that the union is functioning well? Not necessarily. Evidence suggests that **intra-Eurozone labour mobility remains low compared to that of the United States.** Language barriers may provide an intuitive explanation for this, although domestic labour market institutions are also important. Migration should have been much larger to smooth the differing impacts of the crisis. This becomes apparent when looking at record-low unemployment in Germany and well over double-digit rates in the periphery. These rigidities make it even more important to build other mechanisms for dealing with asymmetric shocks. Closer fiscal integration accompanied by larger transfers would help, though it does not look politically feasible at present. The Eurozone will therefore continue to struggle with deficiencies that delay the vital rebalancing process.



## The technical recession

In recent weeks, there has been widespread agreement that growth expectations in Japan had been too bullish, with the Bank of Japan (BoJ) and the nation's economic community both revising down their growth forecasts. **Unfortunately, the chastening of optimism did not go anywhere near far enough, with the shock 1.6% quarter-on-quarter (q/q) contraction in real, annualised growth far below the 2.5% q/q growth** predicted in the November ESP survey of market economists (See Chart 8). The biggest source of surprise came from the 2.4 percentage point drag on growth from the private inventories - although this disappointment is likely to be tempered by a reversal in Q4. More worrying were the disappointments in other key contributors. Private capital investment dropped 0.8% in the quarter, defying the BoJ's assessment in its October Outlook Report that 'business fixed investment is projected to increase steadily'. That capex has remained lacklustre despite robust corporate profits and low real borrowing costs suggests that 'animal instincts' remain subdued in Japan's corporate sector. The Bank's supplementary arguments that investment needs are rising due to insufficient replacement capex, a need for greater labour-saving machinery and a rise in onshoring due to the weaker yen all appear to ring a little hollow in light of the latest numbers. Dig even deeper and it becomes increasingly difficult to see where the optimism for a recovery in capex in the quarter had come from. Yes, the BoJ's October Tankan Survey did suggest that corporates' capex plans remained relatively upbeat, but the rebound in partial indicators, such as core machinery orders and industrial production data, during the period did not occur until the end of the quarter and will therefore do more to boost Q4 activity. It is not just corporate management that appears to lack confidence in the domestic economy, there are also signs that overseas customers are far from enamoured with Japan's wares. Export growth remains lacklustre, up 5.2%, with the weakness in the currency still pushing up the import bill as much as it is helping external sectors. Net exports contributed only 0.1 percentage point in the quarter, although the recent fall in the yen to a seven-year low against the dollar should provide stronger support through 2015.

While we are worried about the ineffectiveness of recent policy prompting in driving both capex and net exports, **better signs in terms of private consumption and public investment mean that an extended downturn is unlikely**. Private demand grew 1.6%, with non-durables and semi-durables rebounding 8% and 14% respectively. Public investment was also a big contributor, up 8.8%, and, given rumours that a ¥3 trillion fiscal package is being prepared, further support looks likely. However, even with all hands to the pump, the latest growth figure is disconcerting. Japan faces unprecedented headwinds to growth with the decline in its labour force likely to accelerate in the coming decades (See Chart 9). With unemployment already near record lows at 3.6%, the prospect that labour market reforms will unlock sufficient supply-side improvements to ensure a sustainable increase in the nation's growth potential appears limited, with unprecedented productivity improvements needed to merely keep the country standing still. In addition, population ageing is likely to reduce the saving rate further still, reducing the country's capacity to invest at the same time as demographics crimp demand.



# Emerging Markets

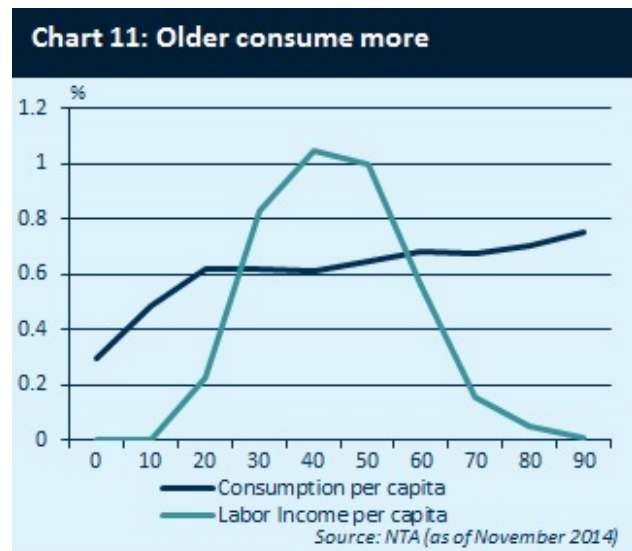
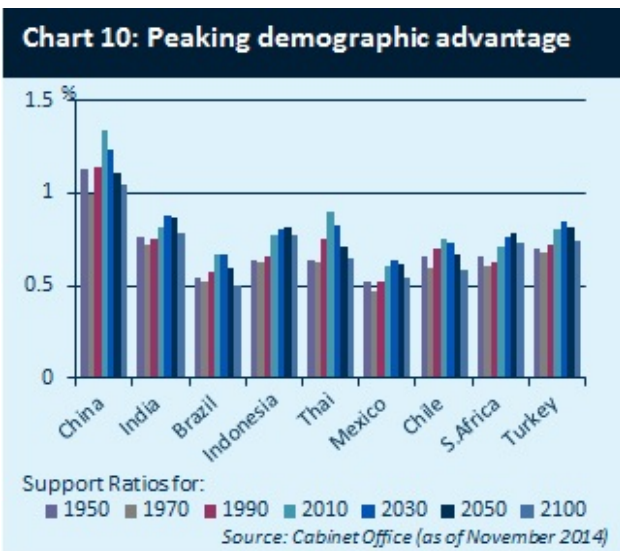


## Demographic dividends

The world is on the cusp of a dramatic shift in the composition of its populations as most countries grow significantly older. While the effects of an ageing population will be felt most intensely in developed markets, emerging markets will also be dramatically affected by the changing structure of their workforces and populations. **Most of the emerging world, excluding Africa and South Asia, are at the point where demographics are becoming less favourable for growth.** The support ratio or 'demographic dividend', defined as the ratio of workers to dependents, is now beginning to decline (see chart 10) across most major developing countries, ending a period of beneficial demographics and beginning a transition to a world of fewer workers. Furthermore, not only is the support ratio falling, but the absolute number of workers will decline in many countries. Changing demographics will present the biggest challenges to China, Brazil, and Thailand, while being beneficial to Indonesia, India and most of Africa over the next few decades.

China has already begun to feel the effects of its ageing population with rising wages and labour shortages. The population explosion that occurred under Mao Zedong boosted China's working population just as globalisation was taking hold. **The beneficial population shifts over the past four decades allowed China to gain a global advantage in manufacturing and the growing proportion of workers-to-consumers was extremely beneficial to China's rapid economic growth.** However, the one child policy launched by Deng Xiaoping in 1979 and only recently loosened as part of the Third Plenum reforms, skewed the structure of China's population and created a situation where China's once highly beneficial labour structure is turning from an asset to a liability. As China is attempting to rebalance its economy and deal with short-term risks to growth, the changing structure of its population presents a long-term challenge to sustained economic growth that has been largely ignored by policymakers.

The rise in the support ratio can be seen in most high-income countries and many developing countries that now have low levels of fertility following strong population growth. South Korea's support ratio, for example, increased from 0.67 in 1973 to 0.95 in 2006, a gain of over 30 percent. Indeed, Korea is projected to be one of the oldest countries in the world by the middle of the century, which will massively alter the dynamics of private and public savings. As support ratios decline and populations grow older, the shift from surplus savings to greater consumption is likely as the old consume more while workers save more (see chart 11). Typically, countries like China with high support ratios tend to have elevated household savings rates. **As the demographic dividend is moving from East Asia to parts of Africa and India this could affect the global distribution of savings and investment, with South Asia, Africa and Indonesia being best-placed to reap the benefits as they are approaching their demographic sweet spot.** Depending on the abilities of Indian sub-continent and African countries to improve governance and productivity, demographic dynamics would make them well-placed to grow faster over the long term.



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