Risks & Rewards

February 2011 – Issue 57

TAKING STOCK: WHAT IS THE REAL PROBLEM WITH ECONOMIC GROWTH

By Nino Boezio

One of the major items of discussion and concern over the past several years has been the matter of economic growth. Central banks have been adopting various means to stimulate their domestic economies so that business activity and consumer spending will resume in a sustainable and predictable fashion, and then continue to grow at a healthy rate.

Given that various governments have also engaged in fiscal measures to stimulate their economies, it has raised uncertainty as to what will remain in terms of economic strength once fiscal spending has ceased. There has been varying opinions as to how much the consumer will be able to do in order to pick up any shortfall, especially if governments also cut-back services in order to pay down burgeoning debt.

But one thing that I have found rather disturbing is the pervading trend of negative demographics impacting much of the developed world. This is not new information to actuaries, but sometimes we may forget its connection to economic growth. We have an aging population in much of the Western world with many people now entering a retirement phase. Those entering retirement will have different spending patterns. In addition, the declining birthrate over the past 50 years (in large part due to the widespread introduction of the birth control pill) has resulted in a relatively smaller generation of younger people following those who are retiring. If we have a younger yet relatively smaller generation of people who are expected to assume the burden of health care and retirement benefits for the aged, while also assuming the costs of past incurred government debt, will they have enough to spend to keep economic growth going?

We have all lived under the presumption (which on an overall basis has been valid up to now) that for the long-term economies will grow, companies will grow, countries will grow, and the world will grow. The common factor underlying all these beliefs is population growth, which naturally under normal conditions will produce an increase in consumer demand, even if all other factors remain static.

Now there is a strong reality that population decline will be something most countries will need to seriously contend with. In itself, it will produce negative demand which in turn will produce negative growth. We can only compensate by increasing productivity and hoping somehow that younger generations become wealthier faster and will spend significantly more than prior generations, in order to compensate for the decline.

NEGATIVE DEMOGRAPHICS

Even though the theme of negative demographics is not new to us, I was intrigued by some of the comments made at a presentation in 2009, since I never thought about them to this depth before.[1] The following is summarized from that presentation.

- **The demographics in the world today is disinflationary**— for the first time ever, most generations are not replacing themselves in the population pool, since most countries have birthrates that are low and are declining. The global population is aging at an extraordinary rate, especially in the developing world (and particularly in Asia).
- **When population growth reverses (shrinks), Gross Domestic Product (GDP) and consumption also decline** (offset in part by any potential increases from technology). Population growth leads to labor force growth that then leads to higher GDP but also higher consumption. We should note that a declining population is bullish for productivity since the labor force shrinks and therefore there is more reliance on technology.
- **Inflation is not sustainable under a global scenario of declining population** (even though we can have higher commodity prices) since it is hard to pass the higher prices to consumers. *The world is now in a race to 0 percent interest rates*. Japan has been winning this race, but it is not a race that any country wants to win.
- **Nominal or account dollar GDP drives interest rates (and both consist of a real rate and inflation component and are highly correlated together).** The issues related to demographics means that nominal returns on investments should also be lower for some time to come.

CONTINUED ON **PAGE 10**

> "WE CAN ONLY COMPENSATE BY INCREASING PRODUCTIVITY AND HOPING SOMEHOW THAT YOUNGER GENERATIONS BECOME WEALTHIER FASTER AND WILL SPEND SIGNIFICANTLY MORE ... "

THE UNITED STATES AND CANADA

- **America has an advantage because it is the only developed country with a replacement level birth rate** (2.1 vs. 1.6 for Canada—replacement birth rates are quoted on a 2-person basis). This is because marriage rates in the United States have been rising (and divorce rates falling).
- **Types of spenders**. In the United States the population is younger and therefore its people spend more than they earn (so it is not just explained by claims of careless spending). China is actually frugal primarily because of its older age demographics (not because it simply has a better attitude towards excessive spending). The United States and Canada are higher in consumption spending due to better demographics relative to other parts of the world.
- **Type of immigration**. Population growth in the United States is only 20 percent related to immigration, whereas in Canada it is two-thirds. The United States also succeeds because its immigration consists primarily of families (and therefore households already exist). Canada unfortunately is highly dependent on immigration in order to grow, for its birthrate is too low.

OTHER COUNTRIES

- **Many of the countries in the developed world are missing people aged 20-30, and this age group is what really drives consumption—**they leave home and then establish their own households which in turn generate spending. After that age range, the purchases are incrementally smaller. Also as people get older, they will have a flat or declining demand for goods (i.e., have less demand for "stuff") and instead will have rising demand for experiences, e.g., nice dinner, good game of golf, see a movie, etc.
- **Retirement saving**. The non-oil Sovereign Wealth Funds are all based in Asia. They represent the efforts of these countries to save for their own "retirement" (and once many of the people in these countries reach retirement, these countries will become importing economies). We cannot push China to spend, for it will run out of money by the time its people retire. Even though China has \$2 trillion in reserves, this is not enough to support its population, for it would need at least \$5–\$10 trillion at this point in time for retirement purposes. We should note that Japan got rich before it got old and China will get old before it gets rich. The best 'retirement fund' for countries such as China is actually to have a strong family structure where kids support the parents (but unfortunately there are now few kids in China).
- **The BRIC countries (Brazil, Russia, India, China).** Brazil is the only country that is in relatively good shape. India has good demographics but does not have a sufficiently large educated workforce. Alternately, Russia has a shrinking population and a declining life expectancy due to alcoholism and suicide.
- **Japan**. Japan is in the worst financial shape (has chronic deflation) due to its negative demographics and this situation is not expected to reverse.

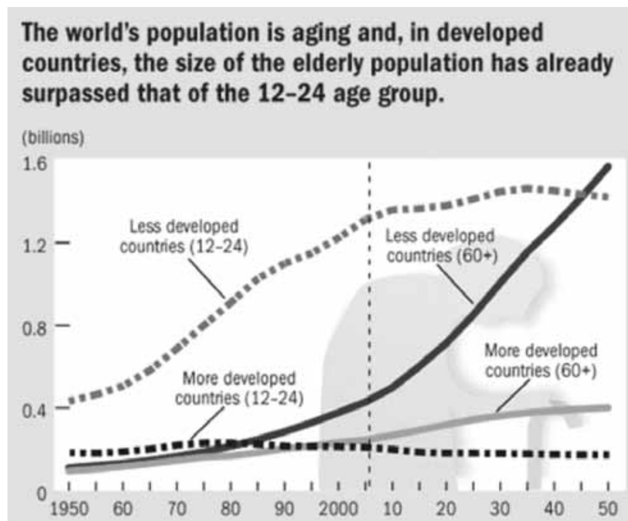
ADDRESSING THE DEMOGRAPHIC PROBLEM

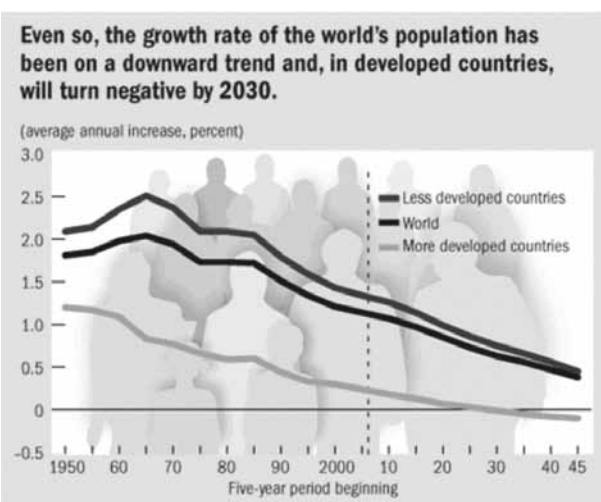
- **One of the greatest catalysts for change is women going to school, that also results in a lower birth rate**. When women achieve education they are less likely to get married, and even if they do get married they then tend to have fewer children. The birthrates in the Muslim world are the highest in the globe but are also falling, for women in this part of the world are also going to school.
- **Immigration**. With so many developed countries having below-replacement birth rates, immigration has become a much more important driver of country-specific population growth. However, Europe, as an example, used to rely on immigration but is now more restrictive because of concerns over religion (extremism).
- **Japan has become #1 in robots by necessity in order to replace its declining workforce.** Japan has needed more workers to serve in places such as nursing homes. But it has had to resort to technology to help cover its labor shortages.

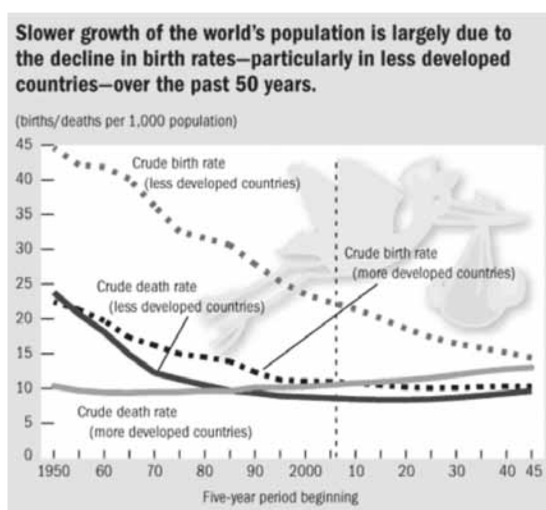
- **Basically, a country needs to fix its marriage rates.** This is the only effective approach to achieving a higher birth rate. Enhanced government maternity benefits, baby bonuses, improved paid leaves from work, and subsidies for domestic home help, are expensive and have had only a small overall impact.

As I already mentioned, population growth naturally produces increasing demand. It also enables increasing productivity in absence of technological advances. Technology may solve at least part of the decline in productivity resulting from a declining workforce which ultimately follows from a declining population. But hoping and wanting a smaller working population to buy "more stuff" in order to satisfy the need for high consumer demand will be increasingly difficult, especially if working incomes are not also rising dramatically. Perhaps if there is a large wealth transfer (due to inheritance as the older generation passes, for the older generation may be wealthier than what we have seen in past history) then some of this may actually occur.

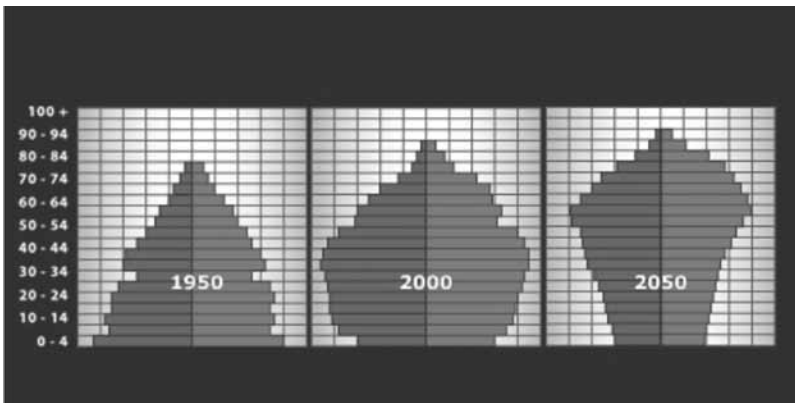
The four charts below published by the IMF give a more graphic perspective [2]:

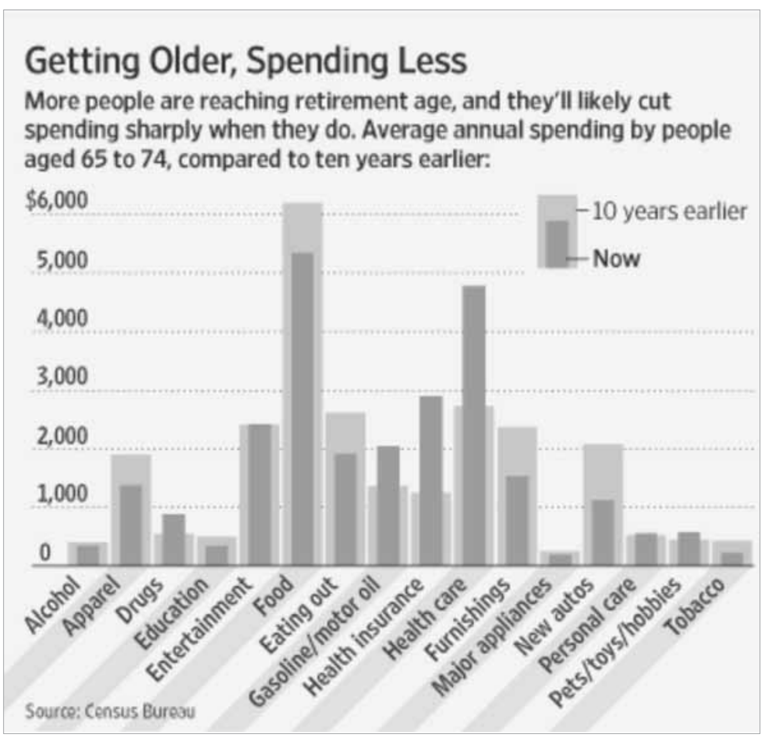






CONTINUED ON **PAGE 12**





We will witness a major shift in the global age breakdowns over the next several generations, and this is not what has naturally occurred in history (of course subject to various diseases, war, and other calamities which sometimes has impacted one age group or gender disproportionately to another.)[3] (See chart, top, left)

Spending is certainly impacted as one becomes older. The expectation is that on a total spending basis, the average overall amount spent will be lower, especially after retirement. (See chart, bottom, left)

INVESTING

Negative demographics also mean we have to be more selective in what we invest in. Before, a chewing gum or toothpaste company could reasonably expect to sell more of its product with little product enhancement. The company could grow by almost standing still, since the population was growing. Now with the prospect of declining population, such a company will need to find ways to cut costs or produce its product more effectively and also to take market share, simply to stay in the same place in terms of revenue or profitability.

As we may have seen with certain companies and industries (e.g., manufacturing, auto industry, airlines), those that cut back on health and pension benefits for their employees, would often have the best prospect for earnings growth and expansion. These companies would be better able to attract shareholder and institutional investor interest. The same viewpoint could eventually be adopted regarding countries. Those countries providing less costly social programs for its workforce and that maintain a lesser tax burden could become more appealing.

CENTRAL BANK AND LENDING POLICY

Central banks have adopted the view for the past century, that lowering interest rates will increase the demand for credit and increase spending. Now such a policy may only keep demand at the same level. Also the absolute level of interest rates may need to be lower than in previous generations due to the

> CURRENT DEMOGRAPHICS HAVE NEGATIVE IMPLICATIONS FOR ECONOMIC GROWTH. WE MAY NOT FULLY UNDERSTAND ITS EXACT IMPLICATIONS, FOR IN RECENT MEMORY WE HAVE NOT EXPERIENCED IT ON SUCH A SCALE BEFORE.

declining population trend. Central banks have also used much of their interest rate firepower already, by taking their rates to very low levels (often near zero).

Inflation should be of lesser importance overall, even though it could be a factor for various commodities (e.g., oil) where the supply may be dwindling faster than any decline of demand. Perhaps the biggest risk to inflation is the fact that some countries have gotten so deep into debt (as has been the fear for some countries in Europe), that it appears that the younger generation cannot pay it, leading to future defaults, devaluation and thereby localized inflation. Some research has cited that it is not likely that all countries will be successful in unwinding their debt bubble.

Lending has been an important component for corporate expansion. As companies grew, they would borrow to expand facilities. This was an overall trend in the developed world. With a declining population, there likely will be fewer companies able to expand, and many will actually be shrinking or going out of business. Lending will still take place to modernize a facility or to expand in a certain region, but this may occur in fewer cases. So the overall demand for corporate borrowing will also decline. Unlike the past where we had upward pressure on interest rates due to borrowing demand, we may now see downward pressure on rates as demand wanes over time.

It is not often clear whether central banks truly understand demographics. Addressing changes in demographics does involve long-term thinking while monetary policy is more short-term. It therefore may not always be clear when monetary policy will stop working the old way. It will actually require modifications over time to address population shifts.

REAL ESTATE

Real estate investing will also be a challenge and one will need to be more selective. Some cities can still grow if population shifts to that area, while many can decline. It may also depend on whether more population shifts from rural to urban centers, in which case many cities may maintain their size while many rural areas including towns could virtually disappear. We will also find more residential housing entering the marketplace, as older residents pass-on or enter nursing homes.

THE FREE LUNCH THAT GOT EXPENSIVE

Positive or stable demographics did give us the prospect of a "free lunch." Social programs including those providing retirement benefits allowed governments the credit of giving their constituents benefits which did not truly cost the government anything, since the next generation was going to pay for them (the pay-as-you-go funding approach). This revolving door philosophy worked well when overall demographics were moving in the government's favor. Now with burgeoning government debt burdens and the realization that the next generation may not be able to afford it, there has been some push to rollback various benefit promises before the crisis could become very real. We have seen those moves in countries such as France and Greece, but those actions were met with strikes and protests. We will see more attempts in other countries to rollback benefits, since even though such moves are not popular, they will be increasingly necessary to balance budgets and to match with revenue from taxes.

Government debt becomes less of an issue when the overall population increases, as the per capita expenditure is less of a burden. Countries could grow themselves out of problems. With a declining population however, we need to see government debts reduced. Otherwise we have a generation that cannot afford to pay for its own benefits plus that of its parents', while also trying to survive on its day-to-day living costs.

SUMMARY

Current demographics have negative implications for economic growth. We may not fully understand its exact implications, for in recent memory we have not experienced it on such a scale before. We may get clues from looking at the experience in Japan, but the insights are not very encouraging.

CONTINUED ON **PAGE 14**

An increasing domestic and world population solved many problems in terms of being able to support social programs, spending programs and corporate expansion. Now the world may face economic declines in many areas partly caused by a declining population, at a time when government debt levels are high and when promises to older generations have become expensive.

The world has to unwind the excesses created in the past number of decades without causing major disruption. This will not be easy. It can also mean that profitability for companies, and the wealth for the country and individual consumer may not be as high as in the past. Investment will have to be more selective with a less optimistic view of financial performance.

END NOTES

[1] Hokenson, Richard F., Global Demographics and the Impact on Investment Opportunities (luncheon seminar sponsored by Toronto CFA Society), April 14, 2009.

[2] "Global Demographic Trends." Finance & Development Magazine, International Monetary Fund. <http://www.imf.org/external/> [path: http://www.imf.org/external/pubs/ft/fandd/2006/09/picture.htm] September 2006, Volume 43, Number 3. *Based on United Nations, World Population Prospects 2004.* Prepared by Larry Rosenberg and David Bloom (Harvard University).

[3] "Demography Graphs." Foreign Affairs and International Trade Canada. <http://www.international.gc.ca/international/index.aspx?lang=eng> [path: http://www.international.gc.ca/cip-pic/discussions/geopolitics-geopolitique/graphs-graphiques.aspx?lang=eng]

Nino Boezio, FSA, FCIA, is responsible for Managed Products Business Development at TD Bank Financial Group. He can be contacted at nino.boezio@td.com.