Is the Aging of the Developed World

The developed-world populations are aging and shrinking, producing huge fiscal, economic, political, and social stresses given the unfunded liabilities of public entitlement programs. Does this phenomenon represent a global crisis? If a crisis looms, what kind of crisis is likely, when will it unfold, who faces the greatest risk, and what if anything can be done?

Twenty important experts offer their views.
A Ticking Time Bomb?
The aging of the population poses an enormous challenge for the developed countries. Businesses will have to cope with an aging and shrinking labor pool. Families will have to cope with a burgeoning number of frail elders. Most fateful, workers and taxpayers will have to foot the growing bill for today’s pay-as-you-go retirement programs.

Graying means paying. Today, the total public cost of public pensions and elder health benefits consumes an average of 12 percent of GDP in the developed countries. By 2040, this cost is on track to rise to 24 percent of GDP. The increase alone—12 percent of GDP—is three and one-half times more than everything the United States spends on national defense. This increase is also the equivalent of 30 percent of workers’ payroll on top of payroll tax rates that often exceed 30 percent already.

Global aging poses the greatest—and more immediate—threat to Europe and Japan, which is where we find the fastest-aging populations, the most generous benefit systems—and the most unsustainable projections. The United States, with its younger population and more dynamic economy, is better positioned to confront the challenge. But let there be no doubt. Global aging will wreak havoc on the economy of any nation that fails to prepare, even the United States.

By the mid-2020s, government borrowing to cover widening pension deficits is on track to consume all the savings of the G7 countries.

The late Herb Stein, the former chairman of the Council of Economic Advisers and sometimes humorist, was fond of saying that things that are unsustainable tend to stop. I’ve asked a dozen or so top experts about America’s twin deficits. Many believe that we run a serious risk of a hard landing—a plunging dollar, surging interest rates, and of course goodbye Dow 10,000. But even if we avoid a near-term train wreck, the river of foreign capital propping up the U.S. economy will eventually run dry. Why? Precisely because other developed nations are aging faster than we are and face even larger long-term deficits than we do. By the mid-2020s, government borrowing to cover widening pension deficits is on track to consume all the savings of the G7 countries.

Let me return to where I started. America’s relative youth and economic dynamism give it an advantage in confronting the age wave. But unless we dramatically improve our national balance sheet—and soon—we may find ourselves no better off than Europe and Japan.

The relevant realm here is more psychological than economic.

Since everything has some sort of downside, almost everything can be interpreted as a ticking time bomb. In the underdeveloped world, a rapidly growing population is viewed as a ticking time bomb—unemployment...
among youths, shrinking per capital income, etc. By parallel in the developed world, an aging population will be viewed as a ticking time bomb—especially if there are substantial and inflexible welfare programs.

In Europe and Japan, the very low birth rate and the prospectively shrinking population pose major problems. Japan’s population will both age and shrink—in the absence of immigration—and the Japanese economy will have lost the vibrancy that marked it for so many years. In Europe, the problem is slightly eased by the steady, if unwanted, immigration. Nonetheless, in Europe there is a sharp clash between the aging of its population and the ability to sustain its welfare system. It should be noted, however, that the problem is not confined to developed countries. China, with its one-child policy, will have an aging population, will need to devote more resources to caring for the elderly—and likely will lose its now-robust economic growth.

Still, the ticking time bomb may be more relevant in the realm of psychology than that of economics. An aging population is most concerned about security. A low birth rate and a limited youth population leas against risk and casualties. Such nations, especially when democratic, will tend toward timid rather than bold foreign policies. They will seek to avoid military action, push trouble off to the future, be intolerant of casualties, and likely underfund and undercut their own defense establishments. To the extent that this would temper what some see as an aggressive China would not be without some advantages. Nonetheless, it does raise some interesting long-term questions about the steadfastness of the Western democracies in the face of global terrorism. Now, there is a ticking time bomb.

The controversial question is the role of immigration.

Samuel Brittan, Commentator, Financial Times

Most of the world’s populations are aging. This partly reflects the very welcome increase in life expectancy as a result of higher living standards and the progress of medical science. But it also reflects in many countries a fall in the birth rate. In Europe the typical female reproduction rate is 1.5 as against 2.1 required to maintain the population without immigration. The baby

boom has been followed by a baby blip. Not only is the proportion of old people in the population rising; but the proportion of working age adults available to support them is declining.

The problem is much less spectacular in the United States where thanks to a higher birth rate and more liberal immigration policy, the total population is expected by the United Nations to rise from 285 million in 2000 to almost 400 million by 2050. By contrast, the population of the European Union is expected to have fallen from 377 million to 339 million. This population trend could reduce the underlying European growth rate so much that its share of world output will have fallen to 10 percent from 18 percent. The United States on the other hand is expected to increase its share of global output slightly from the present 23 percent.

The burden of supporting the older population will however be rising everywhere. According to the UN estimates, the median age in the European Union’s present fifteen members will rise from 38 now to 49 by 2050. Even in the United States, the median age is expected to rise from 35 to 39.

The first part of any policy to alleviate the problem must be to index the pension age to life expectancy. It is totally absurd that the advance of medical science should go to waste in increasing and often involuntary idleness. It is important to have an automatic indexation formula. A staged rise to another fixed age, say 70, advocated by some European “reformers” does not meet the bill. Nor is doing away with compulsory retirement ages, U.S.-style, sufficient. Some notional retirement age has to be written in to the finances of any government social security scheme. And even pension funds and insurance companies make explicit or implicit assumptions on the matter. Obviously higher retirement has to be coupled with changes in work practices to make it easier for older workers to work shorter hours in a less arduous way, perhaps for lower pay.

The controversial question is what role immigration can play in improving the denominator of the dependency ratio (that is the ratio of old people to those of working age). Even if immigrants ultimately succumb to the forces making for lower birth rates among the native population, this will take many decades and in the meantime the working age population is replenished.

There is very little case however for so-called selective immigration permits for workers deemed in short supply. Labor shortages and surpluses depend overwhelmingly on pay and conditions offered. Advanced western countries could certainly recruit more native-born nurses, IT technicians, and kitchen cleaners if they offered better wages and working conditions.

Ultimately, attitudes toward immigration depend on how far present populations value the cultural mix that immigration brings and how far they are prepared to share...
their opportunities with both refugees and other people seeking a better life.

One counter-argument could be the pressure on limited land and the resulting congestion and urbanization. Here the United States and Ireland are much better placed than the rest of western Europe, while Australia is virtually empty. But even the Netherlands, which has one of the highest population densities, manages a quite reasonable quality of life.

A final consideration is that immigration controls, like controls on drugs, are obviously an incitement to crime on the part of unscrupulous entrepreneurs prepared to take risks. As one way or another immigrants are going to come, then why not enjoy the process and in the meantime give ourselves a breathing space in dealing with rising dependency ratios?

The United States is much better situated than Europe and Japan.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

A population can age either from increased longevity or from reduced natality. The United States is aging mainly from increased longevity. Russia is aging mainly from reduced birth rates. Europe and Japan are experiencing both, and face both aging and population decline in the coming decades.

Aging creates demand for activities that cater to “senior citizens”—health care, retirement homes, and recreation such as cruises and golf. It also reduces demand for schools and new housing.

Retirees draw public pensions and get publicly supported health care in all rich countries, although the generosity of these arrangements varies greatly. A rising fraction of aged stresses fiscal systems as those receiving benefits rise relative to those contributing taxes. Italy stands out, with relatively early retirement and women of child-bearing age averaging only 1.2 children (it takes just over 2 to maintain a stable population). Japan and Spain are not far behind, followed by Germany and other European countries. The “social contract” of the 1950s and 1960s, which provided a generous social safety net in exchange for political peace and increased flexibility of organized labor in the workplace, thereby permitting rapid growth, will have to be re-written, since the commitments have become fiscally unsustainable. This painful process will dominate domestic politics in several countries for the next decade.

Moreover, year-after-year declines in the number of young adults will reduce flexibility in the labor force, because younger people are recently trained and more open to new careers than are older people. Europe and Japan thus will experience lower growth not only because of declines in the labor force, but also because of reductions in the most flexible component of the labor force. We have no experience in managing a modern economy undergoing a secular decline in population.

The United States is much better situated than Europe and Japan. Natality has not dropped so dramatically, and the retirement age has already been extended to 67 starting in 2008 (and doubtless will be extended further within the next two decades).

Furthermore, the United States is much more receptive to immigration than Europe or Japan, and does a better job of integrating immigrants and especially their children into mainstream society. The United States could keep its “dependency ratio” unchanged by ramping up immigration from current (legal plus illegal) levels of about 1.2 million per year to 2.4 million per year by 2025—something that sounds radical, but is eminently doable in the context of declining growth of the native population.

These changes would greatly mitigate fiscal pressures from increased longevity in the United States. The real problem here is not pensions but Medicare. Technically fantastic but expensive advances in medical science combined with greater longevity create high fiscal exposure. Death becomes an option; we badly need a painful discussion about death, and who pays for avoiding it.

The aging of developed world populations will raise equity risk premiums.

BERNARD CONNOLLY
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Demographics are a huge problem for Europe. It needs immigrants, but the most obvious sources of migration are Islamic countries, a problem in the current regrettable climate. Worse, the destruction of a
Demographics are a huge problem for Europe, but the most obvious sources of migration are Islamic countries.

RUDOLPH G. PENNER
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Western democracies face grave difficulties in dealing with elderly voters.

For the first time in the modern industrial age, some developed countries will experience declining labor forces. In many others, including the United States, labor forces will grow very slowly and would be declining without immigration. At the same time, elderly populations will be soaring, largely because of increased life expectancy. Fewer and fewer workers will be asked to support more and more retirees.

The fiscal strain imposed on different countries will grow at significantly different rates and this could cause tensions within the Euro area if Maastricht restraints on deficits and debt are continued. The U.S. civilian budget is dominated by the elderly with almost half of non-interest spending going to people 65 and over. Without cost saving reforms or huge tax increases, a budget crisis is inevitable. The only reform now being considered—a Medicare prescription drug program—will worsen the outlook considerably. During the previous fifty years, the inexorable growth in public support for the elderly was financed by a secular decline in defense spending. With defense now down to 4 percent of GDP, the trend cannot continue much longer.

How and when will a U.S. budget crisis emerge? At what deficit- or debt-to-GDP ratio will financial markets lose their nerve? That is difficult to predict because demographically related fiscal pressures will grow slowly and financial markets are notoriously fickle in their attitude toward deficits. They punished Jimmy Carter for a $16 billion proposed deficit in 1980 and shortly thereafter accepted Ronald Reagan’s $208 billion 1983 deficit with equanimity. But the deterioration of the fiscal situation accelerates rapidly in the 2020s and it is my guess that the day of reckoning is very likely to occur in that decade.

Experience in Western democracies suggests that politicians face grave difficulties in dealing with elderly voters. It appears that budget problems related to aging cannot be confronted unless there is an economic or fiscal crisis. The United Kingdom, Sweden, and Italy have managed substantial social security reforms because of economic and budget pressures and it is probable that the United States will also need to be confronted by a severe problem...
Neither the supply nor demand side of the world economy is prepared for a smooth response to demographic aging.

GARY CLYDE HUFBAUER
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The fiscal cost of aging ranks among the most authoritatively forecast disasters since Adam bit the apple. Authoritative forecasts, however, give no assurance of political action. Timely action would, in the first place, require substantial federal surpluses (say 2 percent of GDP) and a big leap in the household savings rate (from under 4 percent to over 7 percent of personal income). It would also require safe and profitable places to invest. Over a horizon of two decades, the most plausible investment destinations would seem to be emerging markets. With few exceptions, however, emerging markets have not been particularly safe, even if some have been transiently profitable.

In other words, neither the supply side nor the demand side of the world economy currently provides the sort of giant bellows required for a smooth response to demographic aging. The ideal response would entail a savings surge and huge capital outflows from industrial countries to emerging markets over the next two decades, followed by huge inflows of capital from China, India, and Brazil to finance the household outlays of aging industrial societies in the period 2020 to 2050. Prospects seem remote that Europe and the United States will soon rediscover the virtues of thrift, or that emerging countries will gladden Hernando de Soto’s heart by embracing robust property rights.

Turning from prescription to forecast, my guess is that, starting with the U.S. president elected in 2008, the federal government will cope with the looming crisis by gradually adding at least 10 percentage points of GDP to the tax load, as the claims of the elderly come to dominate the political agenda. What kind of taxes? Broad-based consumption taxes would be least undesirable, but stiff energy taxes will probably come first. In the shootout between Social Security and SUVs, Social Security will win.

Aging is a secondary issue.
The main protagonist: globalization of production.

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Excess borrowing and consumption are leading the United States into a dollar crisis, which over the long term could see the downfall of the dollar as a key currency. Aging and shrinking of the population may have a bit part to play in the unfolding of this scenario, but the main protagonist is the globalization of production.

Globalized production is most profitable when it combines technology from rich industrialized countries with cheap labor in developing nations such as China. For the industrialized world this business model yields plentiful supplies of cheap manufactured goods, thereby boosting consumption, but at the same time reducing employment. It encourages rich nations as a whole to become over-weight consumers—to consume more and work less.

The aging and shrinking of populations in the industrialized world reinforces this paradoxical trend, because old people carry on consuming after they retire. At the same time, as a population ages the weight of consumption rises relative to saving, and the consequent fall in the savings ratio contributes to balance of payments weakness.

But the original cause of the weakening balance of payments positions of industrialized nations is insufficient wealth-creation by their manufacturing industries. The extent to which America in particular has got into the habit of consuming too much relative to its wealth creation is reflected in the expansion of its current account deficit.

True, the overseas shift in production is boosting U.S. income from direct investment, but not by enough to offset the ballooning trade deficit. Moreover, if the U.S. current account deficit continues to grow, ownership of U.S. multinationals will fall increasingly into the hands of foreign shareholders, so that progressively less investment income will be repatriated to the United States.

Continued expansion of the U.S. current account deficit will have far more serious implications for the dollar now than was the case during the 1980s. At that time America was borrowing in order to invest in its own capacity for wealth creation. The present expansion of the current account deficit is a corollary of American creation of wealth abroad. That is why, unless action is taken to reduce the deficit, foreign dollar-holders—central banks...
and private investors—will sell their dollar assets, and the dollar will gradually lose its status as a key currency.

To avoid a dollar crisis and accompanying higher interest rates, Americans first need to accept a lower living standard and to import less. Second, the core creators of America’s wealth, its multinational manufacturers, need to be given more incentive—for example, by continuous appreciation of the renminbi—to locate production at home rather than in China.

The experience of Japan, where demographic worries have long been in the news, suggests that aging is such a slow-moving behemoth that it does not tend to disturb the markets. What does trouble the markets is the expansion of the U.S. current account deficit, whose primary cause is globalized production. Aging is a secondary issue.

The difference between the United States and the rest of the developed world is devastating.

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The current concerns over “aging” remind me of the dire 1960s predictions that “famine” and “under-nourishment” would strike the United States “within twenty years.” We got “obesity” instead. Current demographic trends suggest that if a “challenge” were to arise from improved longevities and better managed birth rates, it would be a concrete challenge of governance beckoning the world to imitate the American model, rather than an abstract “demographic challenge.”

By 2050, the U.S. population will nearly double to 552 million from the present level of 292 million, and the median U.S. age will be 35; the EU-15 population will decline to 340 million from the present 380 million, and the median EU age will be 52. Japan’s population will decline to 99 million from the present 127 million, and the Japanese median age will be 55.

Clearly, the demographics of today’s developed economies (United States, European Union, and Japan) will consist of two unrecognizably different halves: A huge, youthful, and growing U.S. population, and a smaller, elderly, and shrinking Japanese and EU population, with the U.S. outnumbering the combined EU and Japan population by over 70 million.

This devastating difference between the United States and the rest of the “developed economies” is the result of two factors: (1) American cultural optimism resulting in higher natural birth rates vs. European and Japanese cultural pessimism resulting in birth rates below replacement levels; and (2) American eagerness to welcome and assimilate immigrants vs. European and Japanese xenophobia. As present, the United States, the par excellence immigrant nation, is undergoing its golden age of immigration, receiving and assimilating greater numbers of immigrants than ever before it its history. The European Union and Japan continue to shun immigrants.

Outside of the “developed economies,” population increases in Latin America, Asia, the Middle East, and Africa are producing larger and more youthful societies.

The implication of this for global capital flows over the next half century is obvious. The European Union and Japan will need growing amounts of investment income from the rest of the world in order to feed their waning populations. They will therefore continue and increase their massive capital inflows to the United States, imposing on the U.S. financial industry the role of reallocating and diversifying the world’s investable resources on a far greater scale than in the fabulous 1990s. Meanwhile, over the next fifty years, the “developing economies” will depend more on the United States to supply their youthful, growing populations with investible funds.

The big problem will be the political difficulty of adopting reforms.

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The demographic transition will pose serious challenges, but no ticking time bomb need explode. The aging is a combination of the retirement of the baby boom generation, rising life expectancy of the elderly, and plunging fertility rates to far below replacement in most of the developed world (other than the United States). This is creating societies where the most rapidly growing part of the population will be over 85, in which it will be common for families to have four generations alive simultaneously, and whose population, barring massive immigration, will begin to shrink for the first time in human history for reasons other than war, famine, or disease.

The ramifications of this aging are far more ubiquitous and profound than just the obsessive, albeit important, focus on the budgetary costs of entitlement programs. Rates of saving and economic growth, global patterns of
trade and capital flows, spatial patterns of work and living, job promotion, age-earnings, retirement and education patterns, saving and insurance vehicles, medical research and practice, strains on intrafamily relations and budgets, and decreased willingness to bear economic, financial, social, and political risks are likely to be as profoundly affected as public budgets by the aging population.

The United States is in far better shape to deal with these issues than the bulk of the developed world. Our fertility rate is near replacement and we are less hostile to immigration than Europe or Japan. We will have two workers per retiree (down from the current three), whereas much of Europe will have only one, and a much higher median age. Europe and Japan start from a considerably lower per capita income, a far less flexible and dynamic economy, and (in Europe) much more bloated welfare states in which a majority of the voters may soon be net income recipients from the government rather than net taxpayers. That will make the political difficulty of reforming the structure and budget impact of public retirement and health programs even more difficult than historically has been the case in the United States. Several sensible reforms to these programs, phased in gradually after a grace period, are readily available. The big problem is the political difficulty of adopting reforms in advance of a short-run crisis (as occurred prior to the 1983 Social Security amendments). Waiting for that to happen would decrease options and make the economic adjustment far more wrenching.

Thus, it will be essential to preserve our economic flexibility and dynamism to maximize noninflationary growth. That will require the lowest possible tax rates, spending control, regulatory and litigation reform, trade liberalization, and sound monetary policy, as well as sensible entitlement reform. That is no small task, as recent spending and trade setbacks demonstrate, but far from unachievable, let alone impossible.

Most national pension systems use taxes from current workers to pay the benefits of current retirees. This approach guarantees severe future fiscal problems. The answer is to allow workers to have private investment accounts. Capital would thereby be created to develop bigger, stronger economies; wealthier economies can better support pensioners than weaker ones. Workers would have a meaningful pool of capital at retirement as well as bigger pensions. Borrowing money to help pay current beneficiaries is sound if a privatization plan is in place. A relatively small portion of payroll taxes would be able to service this debt and eventually retire it as you would a mortgage.

The same principle applies to healthcare. The problem here is the disconnect between providers and patients. Almost everything is paid for by third parties. There is little or no positive incentive for patients to get the best value for their healthcare dollars—because the dollars don’t belong to them—or for providers to find new, better, less-costly ways to deliver their services. The United States’ new Medicare prescription drug bill allows for health savings accounts, whereby employees and employers can put tax-free money in IRA-like vehicles. These monies can be used for routine medical expenses. Catastrophic health insurance thus becomes more affordable because of the high deductibles. We at Forbes have used this approach for years. Our medical expenses for 2004 increased by single digits while most companies face increases of 12–20 percent.

And, of course, pro-growth, supply-side tax cuts would also generate wealth to generously help those who cannot help themselves as well as to honor the obligations we have to current or about-to-be beneficiaries.

Demographic trends are clear and powerful. Over the course of the 21st century, the rapidly aging societies of Russia and Japan are likely to lose a significant fraction of their populations. Other developed nations—notably Germany, France, and Italy—are expected to follow similar, albeit not quite as dramatic, negative trends.
Nations with younger and growing populations—especially on the Asian mainland who are achieving rapid economic growth—will benefit from the resultant shift in economic and political power. When current demographic trends are fully played out, the array of dominant nations on the globe may look rather different than today. Because of its restraint on family size, China will soon forfeit “first place” in absolute population to India. Nevertheless, both nations seem destined to become major economic players in the course of the 21st century.

Crisis is not inevitable in the years ahead. For example, the United States will be facing an aging, although not a declining, population. Numerous policy responses have been proposed to the financial pressures that will be accelerating. Because Americans are living longer, postponing social security payments until perhaps age 70 would be a reasonable change. So would modifying the customary annual “cost of living” increase. Private insurance policies rarely contain such inflation protection. Also, partial privatization could be a means of reducing the financing gap.

The demographic challenge for the United States will be far less than for Japan or Europe. A potential offset is adopting a more liberal attitude toward immigrants, not only in admitting them but in integrating them into the national society. The United States is a positive example of attracting millions of immigrants and—with a generation or two—their becoming not only citizens but accepted as fellow Americans. In many other countries, even after several generations the descendants of immigrants are treated as outsiders. Just think what the United States would look like today if the original English and Scotch-Irish European settlers had adopted such an insular attitude.

Not all demographic expansions will be benign. Many countries in Asia and Africa are facing a painful combination of a stagnant economy and a young, rapidly growing population. They will experience great instability as unemployment rises. Their future will be a race between chaos and economic development coupled with the creation of viable institutions.

There are two relevant facts to consider, neither of which is the slightest bit controversial. First, current promises to retirees have committed developed nations to explosive growth in government spending over the next 75 years. Second, countries with a high share of government spending in their GDP generally grow significantly slower than countries with smaller governments.

In the United States, for example, the Congressional Budget Office has estimated that the share of government spending to GDP will approximately double. In terms of economic growth and the size of government, the United States is on the road to France. It probably will not catch up with France, though. France is on the road to the former Soviet Union. Absent significant policy changes, it is safe to conclude that economic growth will decline sharply throughout the developed world.

There is reason, however, for at least a little bit of optimism. As economies grow over time, reductions in pension benefits may become more politically feasible precisely because retirees are already so wealthy. If GDP grows at a relatively modest annual rate of 2 percentage points for the next seventy-five years, it will be about four times larger than it is today. We would reject out of hand a policy that required a doubling of taxes in order to finance generous benefits for the rich. In a few decades, the median earner will have an income so high that he would be considered rich today. So shouldn’t we just as readily reject the current baseline growth of benefits? Perhaps a political consensus to hold back the growth of entitlements—either by indexing to inflation rather than growth, or by privatizing—is possible.

The risk, however, is significant. For example, the “Greedy Old Geezers” are so politically powerful in America that even the Republicans have expanded entitlement spending. Their ill-conceived prescription drug benefit may cost more over time than the entire Social Security program.

If politicians cannot agree to address the long-run challenge now, what will they do when the baby boomers retire and more voters become seniors? Who knows, by then they may just decide to assign a young caretaker to every retiree.
Predicting the future—even the demographic future—can be a nasty business.

JEFF GEDMIN
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Predicting the future can be a messy business. At the end of the Cold War came the news that the “peace dividend” had arrived. No one imagined that within a couple years we would send thousands of American troops to the Balkans, or go to war to eject Iraq from Kuwait.

A week after the war to oust Saddam Hussein began last spring, there was schadenfreude among the war’s opponents. The war looked to go badly. After the stunning military victory, there was schadenfreude among the war’s advocates. Today, with security problems in Iraq, the tables have turned again.

Long-term or short, this figuring out what will happen next has never been easy. A century ago the best and the brightest forecast an end to war (men had discovered trade, it was said). Germany was destined to be a force for peace in the world, some thought. It was one hundred years ago that the Wright brothers launched their first flight from Kitty Hawk, North Carolina. There were ideas at the time about submarines traveling at high speeds from America to Europe, but no one guessed how aviation would transform global commerce—or the way we fight wars.

The science of demography is different. It is destiny, as a French philosopher once put it. So it was in the 1970s that the best and the brightest forecast massive world hunger due to the population explosion. It was simply a fact, “as certain as two plus two equals four,” pronounced one political analyst at the time.

Thirty years later all agree that exactly the opposite is the case. Expect a smaller world after all. The impact on economics and geopolitics will be profound. Multiple crises are in the offing. There are no exemptions for the transatlantic relationship either.

The Economist magazine expects a half billion Americans in the decades ahead, while Europe keeps getting older and smaller. Ben Wattenberg of the American Enterprise Institute argues that weaker allies will mean more U.S. unilateralism: “not because we want to, but because we have to.”

The challenge is a serious one, to be sure. Like two plus two equals four?

Without reform, Europe is heading Japan’s way.

JIM O’NEILL
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Greatly due to changing demographic trends, by 2050 the world economy will look very different. We showed in a recent paper “Dreaming With BRICs: The Path to 2050” that two of the four biggest economies in the world by then will be China and India. China will become bigger than the United States by 2041, India will become bigger than Japan by 2032. The combined GDP of the BRICs—Brazil, Russia, India and China—will become bigger than the G6 (G7 minus Canada) by 2040.

This changing pattern of world growth will have profound consequences in terms of economic trends, including patterns of consumption and the use of commodities.

Will there be devastating consequences for the developed economies from these trends or will they simply become smaller on a relative basis? It depends upon policy, especially with respect to migration and measures to stimulate productivity. Without an active and successful immigration strategy or a large boost to productivity, within a decade, Japan’s trend growth rate will have slowed to zero. Japan’s public-sector debt problem will have ballooned even more, and unless inflation rises sharply, no revenues will be available to support public services. There are incipient signs that Japan is starting down the path to deal with these challenges, but they are very tentative.

In the Eurozone, monetary union theoretically raises the possibility for rapid productivity gains as a result of the competitive forces that could be unveiled. Europe’s policymakers so far seem reluctant to allow these necessary processes to unfold. The expansion of the European Union in 2004 to include fifteen new members theoretically offers Europe another chance in terms of improved labor mobility and flexibility. However, economic policy needs to be adapted considerably to allow benefits to accrue. Without these and other policies to boost immigration, Europe is heading Japan’s way.

For the United States, the outlook appears less threatening especially in the near future, as demographics are more favorable. Of course, if the well-known challenges in terms of economic imbalances unhinge the economy in the next couple of years, and unemployment were to grow sharply, U.S. policies could shift away from the
model that has stimulated the youthful growth of the U.S. labor force. There may be some risks to the United States also from the failure to find a more optimal response to both the terrorist threat and the measures to combat the resulting human and social consequences.

No ready solutions are at hand.

NORBERT WALTER
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The “principle of responsibility” put forward by Hans Jonas was probably misconstrued when the 1968 generation decided—under the auspices of the Club of Rome’s “Limits to Growth”—to forget about breeding. It is not the increase in life expectancy that is threatening mankind: it is the lack of children in the developed world. Nobody is as good at neglecting the future as the former Communist world. Net reproduction rates there have fallen below one in many cases. Part of old Europe is second in the low fertility ranking: Italy, Spain, Denmark, and Germany are set to reduce their next generation by one-third. Such radical social engineering will lead into an unknown abyss: a lack of joy, lack of demand, lack of investment, lack of entrepreneurship, and a decline in prices of all local assets.

No ready solutions are at hand. An upturn in fertility—besides being improbable for a long time anyhow, owing to excessive individualism—would not help against most problems before 2020. Immigration, while helpful and welcome if it is selective and increases the labor force rather than the welfare system, is more probable in regions where the demographic strains are less severe (United States) than elsewhere (Japan, the European continent), considering the existing xenophobia. In addition, immigration on any scale can only come from places with a rather different ethnic, religious, or cultural background, which would make the costs of social integration quite high. In a world of ever-faster technological change, an aging labor force and a lack of entrepreneurs means that productivity will increase less; the capital stock will be aging as well. Dynamism will emigrate to the vibrant parts of the world. Asia (ex Japan) will be the game to play. The United States will be the least graying country of the old world. In 2005 few will really believe this; by 2015 everybody will know it. Multinational companies and financial investors will be the trend scouts of this process, probably already during this first decade of the new century.

In the United States the debate about aging is focusing on the implications for asset prices, especially for real estate and shares. There is a serious threat of a meltdown of these prices in the period when the post-war baby boomers retire. Such dramatic changes in asset prices can, however, also be triggered by other factors, such as an end to low interest rates (which may already be the case by 2005 in the United States).

The true downside of aging may be a fate like that of Italy’s Mezzogiorno region: the exodus of the mobile factors of production, the end of modernization, a brain drain, a loss of confidence. While asset prices can recover, a deserted country may not blossom again.

Asia (ex Japan) will be the game to play.

HORST SIEBERT
Steven Muller Professor, Johns Hopkins University, Bologna, Italy, and President-Emeritus of the Kiel Institute for World Economics

Europe will be affected more intensively by the aging of the population. Take Germany as an example. According to the tenth official population forecast, the German population will shrink from 82 million to 67 million in the year 2050 assuming an increase in life expectancy by about five years and an annual net immigration of 100,000. This will mean quite a different German economy. The labor supply will shrink, having a negative impact on the GDP growth rate. The existing capital stock will be too large for the smaller number of people and will have to be melted down. Investment opportunities will generally be less abundant in aging societies. An older society may be more risk averse so that there is less technological progress. Moreover, older people will have different preferences so that the political process itself will change. In sum, there will be less economic dynamism, especially in continental Europe where Italy is forecasted to experience a similar aging as Germany and where France will be affected somewhat less.
Due to these changes and due to a preference of older people for leisure products, we can expect a current account deficit to arise. At the same time, the financing constraints of the pay-as-you-go systems of social security will become even more apparent than they are today.

The implicit debt of Germany’s social security system is estimated at 270 percent of GDP. This shows how unsustainable the situation is. If this debt becomes explicit, the euro is likely to devalue. Even today, the social security system can no longer be financed.

And even today, one can see some of the future problems beginning to show. This applies to Germany’s low GDP growth rate since 1995, at least in large part the result of the financing problems of social security. And this applies to the reneging on the stability pact in Europe’s monetary union by the finance ministers who apparently need new debt to keep the system going. This scenario of lower growth in continental Europe, a current account deficit, and a weakening euro will have repercussions for other countries of the world.

**Government should shift to a system of personal retirement accounts based on mandatory private saving.**

**DANIEL J. MITCHELL**  
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Politicians from industrial democracies are caught between the proverbial rock and a hard place. On the one hand, they have aging populations and concomitant political pressures to boost the level of income redistribution from workers to retirees. But on the other hand, the global economy exacts a steep price on lawmakers that follow this route. Simply stated, it is now much easier for jobs and capital to migrate away from nations that have burdensome public sectors.

But even in the absence of jurisdictional competition, governments would have a hard time increasing income transfers to the elderly because of demographic shifts. Thanks to longer life spans and lower birth rates, the share of the population over age 65 in many nations is going to increase dramatically. By 2030, for instance, the U.S. population will mirror the age distribution in Florida today. And for many European nations, the problem will be even more acute because their birth rates are so low that populations will be shrinking. This will make it difficult for these countries to fulfill existing promises to senior citizens, and expanding entitlements will be even more difficult (though Republicans managed this “accomplishment” in America by deciding that the 2004 election trumped all other considerations).

For all intents and purposes, it is almost impossible to provide generous income transfers to the elderly when there are only two or three people in the workforce for every retiree. The tax burdens necessary to maintain such a system would be so onerous as to cripple economic activity. Indeed, France and Germany may already have reached this stage.

Fortunately, there is a way for governments to avoid this fate—shifting to a system of personal accounts based on mandatory private saving. About two dozen nations have implemented “funded” pension systems. Latin American and Eastern European nations have led the way, but fully or partially “privatized” systems also have been enacted in Australia, Hong Kong, Sweden, the United Kingdom, and the Cayman Islands.

These reforms often are not easy, in part because of transition expenses (the cost of providing benefits for existing retirees while simultaneously allowing younger workers to divert payroll taxes into private accounts). But the long-term savings of reform are much bigger than these one-time transition costs, making reform a win-win situation.

**Demographics alone represent no fundamental problem for free and open economies.**

**ALAN REYNOLDS**  
*Senior Fellow, Cato Institute*

In some parts of the world, such as China, India, and Mexico, labor will be relatively abundant and capital scarce. In other parts of the world, such as Japan, Europe, and the United States, capital will be relatively abundant—at least in comparison with an increasingly scarce supply of willing and able workers. How willing and able those workers will be, however, is more a matter of incentives than demographics.

Demographics alone present no fundamental economic problems for free and open economies. Nations relatively short of labor can either import workers through open immigration policies or they can import labor-intensive goods and services through open trade, including
electronic imports of services. Nations relatively short of capital can either import financial capital by providing secure property rights and competitive taxation or they can import capital-intensive goods and knowledge-intensive skills through open trade.

Any nation that attempts to block mobility of both labor and capital leaves itself with no remaining option but economic stagnation. If a labor-short country blocks both immigration and imports of labor-intensive goods, for example, domestically produced labor-intensive goods will become increasingly expensive, reducing real incomes. If a capital-short country blocks both foreign investment and imports of foreign equipment and know-how, then real output and income per worker will remain depressed.

Taxes and transfers complicate the picture. Aging populations of industrial countries could provide a more skilled and stable work force, but not if taxes on work and subsidies for retirement virtually compel premature retirement. Japan, Europe, and the United States are going to have to take work incentives more seriously. In the United States, for example, those foolish enough to keep working after age 65 continue paying taxes for Social Security and Medicare without receiving any added benefits. No private retirement or health program would dare try charging such a high fee for nothing.

Taking the politics out of retirement planning and giving people much more freedom to take care of their own futures could do a lot to solve what politicians wrongly perceive as a demographic problem. Any remaining demographic difficulties can easily be managed through free trade in goods, services, and capital. Nations with free and open economies, frugal governments, and predictable regulatory regimes will prosper regardless of demographics.

**Paul S. Hewitt**

*Deputy Commissioner for Policy, Social Security Administration*

Global aging will be both very good and very bad for the global economy. Whether the bad defeats the good, and plunges international markets into chaos, or the good triumphs, and ushers in a new era of global prosperity, depends to a large extent on policies adopted in the next few years.

First, the bad news. With the exception of the United States, the world’s richest countries are also the most aged—a distinction achieved through decades of below-replacement birthrates. Looking ahead, the ensuing depopulation will adversely effect growth rates, fiscal balances, and probably asset prices. GDP is merely the number of workers times average output per worker. After 2010, Japan and most European countries expect their labor forces to decline by an average of 1 percent per year or more.

In other words, at current productivity rates, GDP growth will barely hover above zero. Meanwhile, both regions face stagnant or shrinking numbers of consumers, who of course are getting older and thriftier. The prospect of perpetually flat or declining demand signals an era of over-capacity in key industries, and hence diminished pricing power, profits, and corporate tax revenues, as well as falling tangible asset prices.

Last, but not least, every rich country is plagued by plunging ratios of workers to retirees that will undermine their pay-as-you-go retirement finances. Maintaining generous pension and health care promises will require growth-sapping tax increases—or worse, destabilizing budget deficits. Pension shortfalls alone could soak up all of the developed world’s savings by 2030.

The good news is that, due to falling fertility, many developing countries also are aging. Smaller family sizes are allowing countries like China, Indonesia, India, and Brazil to reap a “demographic dividend” of rising per capita incomes, increased female labor force participation, and higher expenditures on education and health care. While advanced aging is undermining capital productivity in the developed countries, in its incipient stage, it is expanding it in the emerging markets.

In the best-case scenario, rich country retirement savings increasingly will be invested in the emerging markets, where infusions of cash and know-how will generate a combination of robust financial returns and rapid social development. Whether such a “win-win” outcome is probable is another matter. In order to avert financial crisis, the rich countries must embrace meaningful benefit and labor law reforms that, alas, are proving too controversial to enact.

**Pension shortfalls alone could soak up all of the developed world’s savings by 2030.**