Demographic shifts accelerate

GLOBAL ECONOMY

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Once every few years the world gets concerned about demography. Last year, the United Nations announced that the world's 7 billionth human being had been born. This year the general election in the United States and the sovereign debt crisis in Europe are reminding us about the challenge of population ageing and its implications for the future viability of pension systems and healthcare insurance schemes. East Asia — especially Japan, South Korea, and China — are also facing difficult scenarios in the near term.

In our book, Global Turning Points, to be published in September, we point out that one needs not panic about demographic trends. But politicians and policymakers must pay attention to what is going on if we are to avoid difficult situations.

Fertility is dropping very quickly throughout the world. Still, higher-than-average births per woman in Africa, the Middle East, and South Asia will continue to generate relatively rapid demographic growth precisely in those regions of the world in which there are more natural resources, more failed states, and more political instability. The geopolitical challenges that we already face will no doubt be exacerbated by demographic growth in those areas.

From economic and financial points of view, however, population ageing is the most urgent challenge. We are living longer and having fewer children, two trends that make for an explosive mix. At the turn of the 21st century, only Germany and Italy had more people of age 60 and above than people below the age of 20. By 2010, Japan, Greece, Portugal, Spain, Austria, Bulgaria, Slovenia, Croatia, Finland, Switzerland, and Sweden were in the same situation. By 2015 South Korea will join them. By 2025, 46 countries or territories will be in that situation. China and Russia will join by 2030, the United States by 2035, Brazil by 2040, Mexico and Indonesia by 2050, and India by 2070.

While it is easy to explain why the population is ageing around the world, there's no agreement as to the implications.

From an economic point of view, labor scarcity in the developed world and labor abundance in the developing countries will spur migration. Some experts argue that population aging will further reduce economic growth in the developed countries because ageing dampens productivity due to more frequent health problems, outdated skills and cognitive decline. However, other experts point out that an older workforce can be more productive because it has more experience. Ageing will also affect consumption, altering the demand for both durable and non-durable goods. New services will be in high demand, especially those having to do with healthcare and leisure. Demand for financial services will also shift.

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The financial consequences of population ageing are unmistakable. Old people vote more assiduously than younger people, and they have distinct preferences regarding pension systems and healthcare insurance.

The financial pressure on government budgets is likely to increase, and one can easily predict rising inter-generational conflicts over taxes and spending. "Pay-as-you-go" pension and healthcare systems — those in which current expenditures are funded with current taxes — will become the center of much political debate and controversy.

Given the magnitude and the enormous implications of these demographic shifts, we see steady migration from high-fertility areas to low-fertility ones as a necessary part of the solution.

We also think that retirement ages will need to be raised, especially at a time when the average life expectancy at birth has risen above 75 years in many countries, and the average life expectancy after age 60 has broken through the 85-year barrier. We cannot afford massive numbers of people living for 25 years or more in retirement. But raising the minimum retirement age to obtain benefits can only go that far. We also need employers to redesign jobs and careers so that people in their sixties and seventies can continue to have long, productive working lives. The moment for both politicians and employers to begin acting is now.

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Are we about to face deflation?

KOREAN ECONOMY

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Korea's gross domestic product (GDP) in the second quarter grew only 2.4 percent on a year-on-year basis, hitting a record low since the third quarter of 2009. Private consumption, which accounts for more than half of GDP, has grown only 1.2 percent over the same period. Investment measured by total fixed capital formation is even worse. It shrunk by 2.9 percent last quarter.

Investment is not the only thing that has plummeted. Exports, which have been the growth engine of the Korean economy, fell by 8.8 percent in July, and what really alarms us is that exports to EU have taken a nosedive, decreasing by more than 15 percent this year. According to recent forecasts by Korea Economic Research Institute, GDP will only rise 2.6 percent in 2012. Korea's recovery from the effect of the European crisis seems to be in the very distant future.

What really makes us concerned is that the risk of deflation is higher than usual. Deflation, by definition, is a continuous decrease in the general price level of goods and services. During deflation, lending and investments may be shelved because cash holdings are seen as more attractive. In a worst-case scenario, deflation reduces production, which in turn lowers wages and demand for goods and services, leading to further deflation.

A vicious circle we call the deflationary circle can happen. Fortunately, the growth rate of the Consumer Price Index (CPI) has never been below zero, and deflation has not officially occurred in our territory.

However, the deflationary circle may indeed happen even when the CPI does not fall. In the event that the general price level grows at a much lower rate than everyone expects, we will be in trouble. For example, consider a scenario in which real estate prices fall even when the CPI grows mildly. People may take out a loan at a high interest rate to finance a real estate purchase because they believe real estate prices will skyrocket which can give them large capital gains. What would happen if real estate prices stay much lower than expected?

As the actual burden of repayment increases, people who don't have sufficient capability to repay their loans start selling real estates, which would end up leading to a further decrease in real estate prices. A problem exacerbates its own cause, and the vicious circle starts. This is the type of debt deflation emphasized by Hyman Minsky in the 1980s.

Now consider where we stand. Korea's household debt has soared to higher than 900 trillion won, and the mortgage late payment rate, which was 0.62 percent in May last year, rose to 0.85 percent this May.

To make things even worse, the price of large-size apartment in the Seoul metropolitan area has dropped by about 13 percent on average since the year 2008, and by more than 40 percent in some areas even during the period when the general price level was rising mildly. We may find signs of deflation elsewhere. The M2 money multiplier has dropped to 22, reaching the lowest level since January 2000. The bank deposit circulation rate is decreasing recently, and long term interest rates are lower than CD rates since April 2012, reflecting gloomy economic forecasts. Furthermore, the IMF deflation vulnerability index, which shows the probability of deflation, has increased from a 'minimal' to a 'moderate' level since the second quarter of 2011. We might be really facing deflation.

Some argue that the chance of deflation is slim because we expect price increases in some manufacturing goods, electricity and some public services. However, remember that when an economy is in recession and prices go up because of supply shortages and cost hikes, there is a higher chance of stagflation, not a lower risk of deflation.

Stability in the real estate market is a necessity for boosting domestic demand. Household debt must be not only downsized but also must become compositionally healthy. Now it's time to take a closer look at the domestic markets.

Issue Focus

Saving France, saving Europe

By Michel Rocard

The face of French politics changed dramatically in May and June. First, after 17 years of center-right presidents, Francois Hollande, a Socialist, was elected. Then, a month later, a center-left majority took control of the National Assembly, too, after ten years of right-wing domination.

Meanwhile, the Senate, the French parliament's upper house, a conservative bastion between the two world wars and ever since, swung to a Socialist majority for the first time in history at the end of 2011. The Socialists also control 20 of France's 22 regional governments, a majority of the presidencies of the Departments, and most cities with more than 30,000 inhabitants. In short, we are now witnessing a stunning concentration of power that is unprecedented in French republican history.

All of this occurred very peacefully, with no wave of triumphalism, or even much enthusiasm. Indeed, the abstention rate for a presidential election had never been higher before the contest between Hollande and Nicolas Sarkozy. France's profound political shift reflects the persistence of the economic crisis that began in 2008. French electors did not vote for a dream. The Socialist Party's program and its presidential candidate's campaign promises were considerably less ambitious than they were in 1981, when Francois Mitterand was elected.

As a result, the campaign was quiet, almost cautious. Indeed, most candidates, notably Sarkozy and Hollande, might have been too cautious: the current crisis and possible future threats received little emphasis, which means that it may be difficult for Hollande to claim a mandate for any painful reforms that he will have to propose.

And now there is no escape from the difficult reality that the budget deficit remains massive, at more than 4 percent of GDP in 2011. Except for creating 60,000 new jobs in education (following controversial cuts last year) and restoring the right (rescinded under Sarkozy) to retire at 60 for roughly 200,000 individuals, Hollande's administration has barely any room to maneuver, and severe economic measures will have to be introduced in the 2013 budget.

Moreover, France's rapidly worsening foreign-trade deficit is boosting already-excessive debt levels, while output is falling and unemployment is rising. Unfit for modern markets, France's tax system actually stifles the country's businesses, reflected in a disturbing increase in bankruptcies among small and medium-size companies.

In such conditions, France urgently needs to restore and maintain economic growth, and should seek to coordinate its policies with those of other eurozone member countries. After all, because most of the eurozone's 17 member states suffer from heavy debt burdens, they are all anxious to find fiscally responsible ways to promote growth.

Unfortunately, the eurozone's institutions lack the powers needed to defend the monetary union effectively. Greek debt amounts to less than 2 percent of European GDP. Had the European Central Bank been entitled to deploy enough firepower when the Greek crisis first erupted, the threat would have lasted only two hours. Instead, it took three weeks to grant the ECB only partial authorization to act, causing speculation to take hold and spread to Portuguese, Spanish, and Italian debt, thereby jeopardizing the euro's survival.

Removing the risk of a euro implosion — which, given massive global imbalances, derivatives markets run amok, and the colossal scale of America's budget deficit, could catalyze a major international crash and presupposes two fundamental changes in Europe. The first is political and involves sovereignty: Full European solidarity can be achieved only through stronger fiscal and monetary federalism, which would enable the eurozone to act, despite minority dissent. Europe has succeeded in missing this goal for a half-century; now it has no choice but to shoot straight.

The second change involves economic doctrine. If markets self-correct, they do so only when defaults are registered and punished. But countries and their public services cannot default without inflicting severe pain on entire populations.

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