Global Demographics: An Economic and Geopolitical Time Bomb

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Overview

Changing population trends will have dramatic effects on the global economic and geopolitical landscape over the next few decades. Working-age populations in most major industrialized countries will shrink; populations in the developed world will continue to age; and populations in the developing world will mushroom. Pension funds will continue to grow over the next ten years as baby boomers save for retirement, but net outflows will eventually exceed net inflows as retirees draw down their savings. Instead of getting their fiscal houses in order in preparation for these changes, many countries are running large deficits and generating high ratios of debt in relation to gross domestic product. Massive tax increases and cuts in discretionary spending will ultimately be needed in most countries to support the elderly and to prevent explosive increases in debt. Rising birthrates in some of the world's poorest, most unstable countries will spawn burgeoning populations of young people with limited economic prospects, pointing to growing geopolitical risks. Demographic dynamics will also affect asset prices in the years ahead.

Global population shifts over the next 50 years will profoundly affect the world's economic and geopolitical landscape. Three trends in particular have strategic implications for the long-term economic and geopolitical outlook:

- Working-age populations will shrink in most major
- Populations throughout the developed world are rapidly aging.
- Populations throughout the developing world are rapidly growing, especially in Islamic countries.

The U.S. population will continue to grow in the coming decades, whereas the populations of Europe and Japan will shrink, indicating that the United States will become an increasingly dominant global economic and political power. At the same time, rising birthrates in some of the world's poorest, most unstable countries will spawn burgeoning populations of young people with limited economic prospects, pointing to growing geopolitical risks.

Population Trends and Industrialized Economies

Population trends have significant implications for relative economic performance. In the United States, potential growth in the gross domestic product (GDP) is expected to slow slightly along with the decline in the working-age population, but the birthrate is projected to remain close to replacement levels and the country will continue to benefit from a relatively high immigration rate. Because of these factors, the United States is in the best position of all the major economies, but it too faces a rising fiscal burden.

The failure of most governments to get their fiscal houses in order bodes ill for the future. Ideally, governments would currently be running large surpluses to prepare for the sharp financial deterioration expected early in the next decade. Most countries, however, are running large deficits and thus are generating rising debt–to-GDP ratios. Massive tax increases and cuts in discretionary spending will ultimately be needed in most countries to support the elderly and to prevent an explosive rise in debt.

Demographics and Geopolitics

The world's population will grow by 47 percent between 2000 and 2050, according to United Nations (UN) estimates. Within this average, the population of developed countries will grow by 2 percent, whereas the population of the developing world will grow by 58 percent. As a result, the developed countries' share of world population is expected to drop from 20 percent to 14 percent during the next 50 years. In ten Islamic countries—Afghanistan, Algeria, Indonesia, Iran, Iraq, Pakistan, Saudi Arabia, Sudan, Somalia and Yemen—the population was less than half that of the developed world in 2000 but will almost match that of the industrialized world by 2050.

These demographic trends are very much on the radar screen of strategic thinkers in the United States and may have influenced current administration policies regarding Iraq. A 2001 report released by the U.S. Central Intelligence Agency indicates its authors believe worldwide population trends may pose serious threats to global stability. The report, Long-Term Global Demographic Trends: Reshaping the Geopolitical Landscape, claims that "failure to adequately integrate large youth populations in the Middle East and Sub-Saharan Africa is likely to perpetuate the cycle of political instability, ethnic wars, revolutions and anti-regime activities that already affect many of these countries. Unemployed youth provide exceptional fodder for radical movements and terrorist organizations, particularly in the Middle East."

Other Key Implications of Demographic Trends

In addition to potential geopolitical instability, other likely results of the UN-projected population trends include:

- Diminishing aggregate demand for consumer products and real estate as working-age populations in Europe and

Japan shrink;
- Full employment and labor shortages in industrialized economies (this will benefit per capita incomes but not profit margins);
- Steady growth in demand for consumer products in emerging countries, particularly in Asia;
- Continued transfer of manufacturing and service jobs to Asia;
- Declining public-sector services in developed countries (the retirement age will almost inevitably rise in advanced economies, real benefits may be cut, and aging populations will put immense pressure on state-funded health care systems);
- Uncertain sustainability of the euro; and
- Emergence of western economic problems in China.

Additional related issues include the implications of increased urbanization in unstable countries, the global spread of infectious diseases, and the environmental consequences of rapid population growth in the developing world.

Implications for Financial Markets

Demographic dynamics will affect asset prices in the years ahead. The performance of stocks and bonds is largely determined by trends in economic activity, corporate profits and inflation. The long-term picture for Europe and Japan looks relatively bleak because a deteriorating fiscal situation will be bearish for bonds, and weak aggregate demand will be bearish for stocks. The U.S. picture is slightly better because potential GDP growth is expected to hold up reasonably well for the next 20 years or so, and fiscal deterioration will be less severe than in Europe and Japan.

Still, throughout the developed world, aging has big implications for capital flows in and out of private retirement funds. In the next ten years or so, pension funds will continue to grow as baby boomers save for retirement. Between 2015 and 2020, however, net outflows will replace net inflows as retirees draw down their savings. These trends have bearish implications for financial markets.

Because the impact of global demographic trends will not be felt right away, cyclical factors will continue to dominate economic and market conditions in the short term. Nevertheless, the long-term picture suggests that U.S. equities will offer better opportunities than those of Japan and Europe.

If governments respond to the looming demographic crisis with policies that will boost productivity and growth, this approach would tend to favor stocks over bonds. In contrast, a less pro-active government response could lead to "stagflation," in which case the only asset class that would perform well would be inflation-indexed government bonds.

About the Author

Martin Barnes is managing editor of* The Bank Credit Analyst*, a monthy publication that provides analyses and forecasts of U.S. financial markets and economic conditions. Recently he has written extensively about new technologies and long-wave cycles, implications of low inflation and trends in corporate profitability. Before joining the Bank Credit Analyst Research Group in 1988, Mr. Barnes spent ten years as chief international economist with a major U.K. stockbroker, and from 1973 to 1977 he was an economist with British Petroleum in London.