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Economic crunch of ageing

Rich countries are headed for financial strife if they don't address ageing, **David Uren** writes in the last of his series on the coming G20 talks in Melbourne

USTRALIA'S AAA rating will slip to a mere BBB over the next 25 years and its bonds will become too risky to be considered investment grade by 2040, unless there is a change in government policy.

It will not be alone. Among the world's largest economies, only Canada's debt will still be investment grade, according to a study conducted by Standard & Poor's.

There are many uncertainties and assumptions in the scenario painted by the credit rating agency, but in a report prepared for the G20 the International Monetary Fund says it is hard to escape Standard and Poor's conclusion that pension, health and long-term care costs are going to rise sharply as a share of GDP, placing stress on the world financial system.

Australia has led the introduction of the topic of ageing into international forums through the G20.

The G20 has commissioned a range of research into the effect of ageing on global finances, and placed it on the agenda of the summit meeting to be held in Melbourne in November.

The studies show that although the fears of financial meltdown as the baby boomers cash in their superannuation simultaneously are overstated, the effects will be more widespread than generally believed.

The existing payment imbalances between the United States and Asia could be up-ended.

There may be shifts in the relative attraction of bonds and equities, while housing markets may sustain prolonged weakness.

There will be much greater demands placed on financial markets for innovation.

It isn't just a preoccupation of the West. By 2050, there will be 500 million people in Asia aged over 65, up from 150 million today.

Indeed, the ageing process is much more rapid in Asia than in the West, because longevity is increasing quickly from a much lower base.

The theory that ageing will bring a financial catastrophe has been pushed by Wharton Business School professor Jeremy Siegel, who predicts a 50 per cent fall in asset values as the baby boomers try to unload their savings onto a smaller generation of buyers.

Analysis prepared for the G20 shows that the 40-64 age group does sway financial markets. If the group is particularly large, such as the baby boomers now, shares are likely to do better. However, as they age beyond 65, bonds will do better.

But research by IMF analyst Robin Brooks shows that in countries like Australia, where there is heavy public investment in shares, people keep accumulating wealth into their old age and do little to run it down in retirement. Far from melting down, financial asset prices may continue to rise as the population ages.

The population has, of course, been ageing for some time as the average span of life increases and fertility rates decline. Fertility rates in Western countries have dropped from 2.9 children per woman in 1950 to 1.6 now.

A British specialist on ageing, Professor Philip Davis from Brunel University, recently looked at how the world economy has responded to ageing over the past 40 years. When there is a large 40-64 age group, it encourages higher balance of payments surpluses, because it saves more and makes smaller claims on government. The generation aged over 65 saves less, and encourages deficits.

However, economic growth and investment will also slow as the population ages. Simulations using the OECD's global economic modelling show that over the next 20 years slower growth in the OECD nations and efforts by an ageing population to build their savings will be associated with rising balance of payments surpluses. This may include the US, although some academics believe its faster growth will keep it in deficit.

However, beyond 2025 declining public and private savings in the OECD would start to generate deficits in the balance of payments with emerging market economies.

The modelling suggests savings would fall by more than investment, resulting in an increase in world interest rates.

Although reasonable estimates can be made for the shape of population growth over the next 25 or so years, there is great uncertainty beyond that.

Some expect the average lifespan to settle at about 85 years, because there is no evolutionary advantage in living longer. Others note that more than half the mortality decline in developed countries over the last 50 years has occurred among people aged over 50, and expect this process to continue. Researchers looking at death rates among the very old over the last century suggest the average lifespan could reach 100 by 2060.

The uncertainty is a challenge for financial institutions trying to offer products to fund long retirements.

The best way to turn accumulated savings into a smooth income flow is an annuity, but take-up has been poor, not only here, but around the world.

Research conducted by University of NSW's Professor John Piggott for the G20 says the people most likely to take up an annuity are those who are in the pink of health and believe they will live for decades, creating a problem of "adverse selection".

Professor Piggott says the uncertainty about what will happen to the average lifespan makes annuities a high-risk product for the funds, so their pricing is not attractive.

He argues there is a role for governments in developed countries to develop partnerships with pension

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funds to improve managing the risk of an ageing population. He suggests it would be possible for global institutions such as the World Bank to provide support for ageing insurance markets, creating products such as "survivor bonds" that would allow annuity issuers to hedge their exposure to an increase in average lifespan.

Professor Piggott also expects to see rapid growth in products such as reverse mortgages, which allow people to use home equity for living costs.

Australia has been in the forefront of planning for the ageing of the population. The Intergenerational Report released five years ago was the first attempt in the world to incorporate demographic change into budget planning.

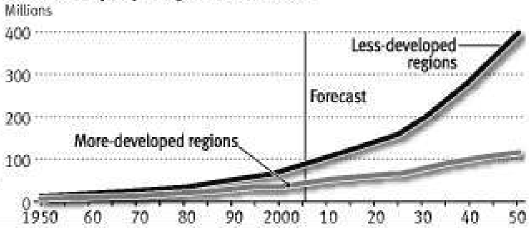
CHECKING OUT

How baby-boomer retirement could affect borrowing credit rating

	Australia	Canada	France	Germany	Italy	Japan	Korea	Spain	Sweden	UK	US
2005	**AAA**	AAA	AAA	AAA	AA	AA	A	AAA	AAA	AAA	AAA
2020	**AA**	AAA	A	AAA	A	Junk	A	AAA	AAA	AAA	BBB
2030	**BBB**	AAA	Junk	A	Junk	Junk	Junk	BBB	A	A	Junk
2040	**Junk**	AA	Junk	Junk	Junk	Junk	Junk	Junk	Junk	Junk	Junk

Junk = non-investment grade

Number of people aged 80 or above



Source: Standard & Poor's 2006; UN