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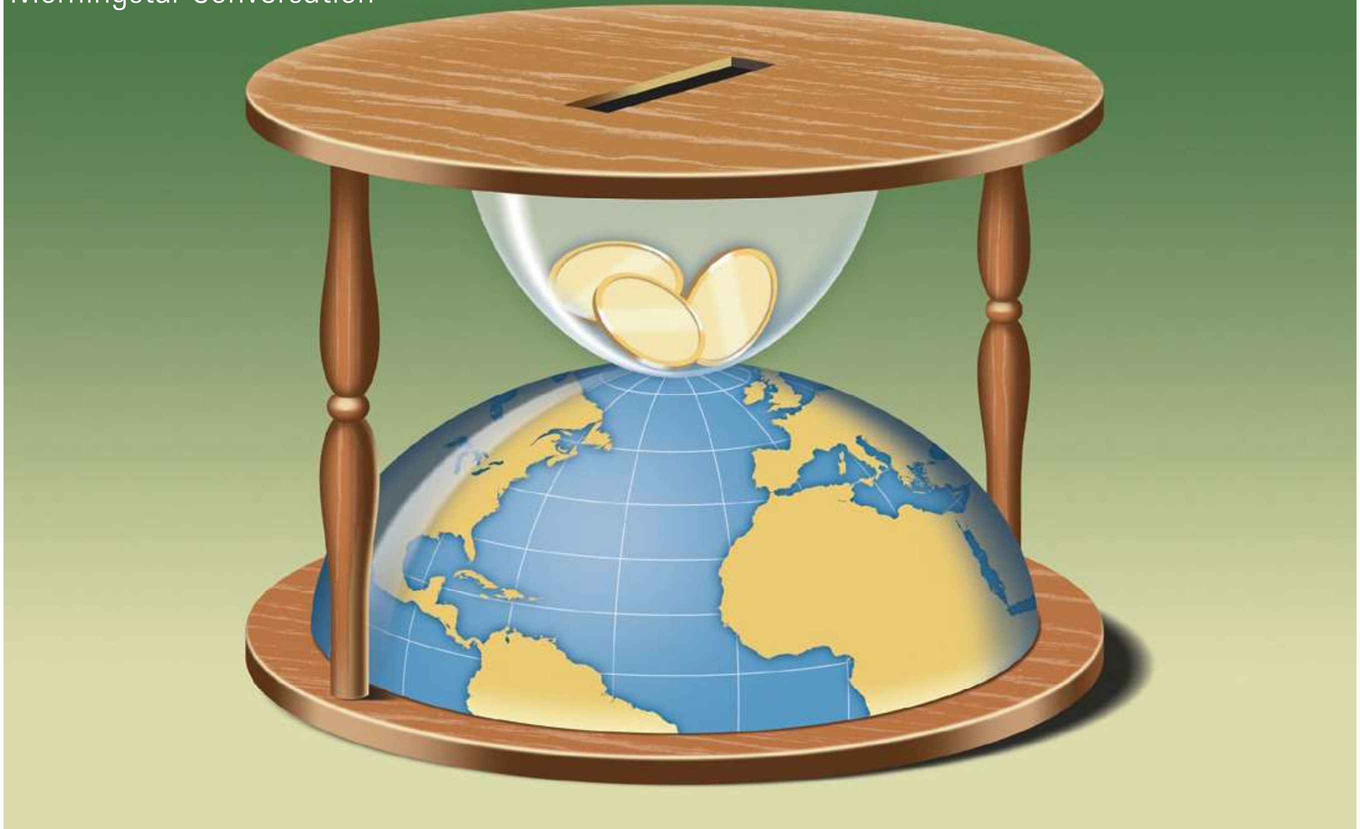

The World Is Getting Grayer

By Francisco Torralba

Globally, almost all populations are getting older. Europe's sovereign debt crisis provides a glimpse of the economic troubles this aging will cause, economist Edward Hugh says.

Edward Hugh is a Catalan economist of British extraction who lives near Barcelona. As a macroeconomist, he specializes on demographic processes, migration flows, and growth and productivity theory. Although recently he has done a lot of work on the economic troubles of the eurozone (for obvious reasons), his curiosity has taken him far away from his home continent, and he has written about the economies of India, Eastern Europe, and Japan. Hugh is a regular contributor to a number of economics blogs, including "A Fistful of Euros," "Global Economy Matters," and "Demography Matters."

I spoke with Hugh on March 14 at the Morningstar Investment Conference in Vienna, where he delivered a presentation titled "What Do Aging Populations Have to Do With the Sovereign Debt Crisis?" We started our conversation with a discussion of the demographic problem of the developed world, but ended up visiting topics as diverse as how the United States' national identity has helped it through the financial crisis and how Italy might be the greatest threat to the eurozone's stability. Our conversation has been edited for clarity and length.

Francisco Torralba: You argue that the demographic situation in Western Europe, Japan, and the UK implies that sovereign finances are going to be in a very sticky

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situation within 10 to 20 years. The populations of these countries are aging rapidly and will need help funding their retirements. But fewer younger people are working and paying into the system. What will be the ramifications of these trends for sovereign finances?

Edward Hugh: What this means for sovereign finances in Europe is that there is increasing pressure on the level of sovereign debt and increasing pressure from markets on sovereign bonds simply because of political risk. It's going to be very difficult, as years go by, for the politicians to keep convincing voters that the necessary sacrifices have to be made to help an aging population. So, we're in a complex situation.

But if I can broaden this a bit, it's not simply a question of the demographic change in Europe, the United States, or Japan. What we're facing at the moment is a paradigm shift in the way markets, investors, economists, and everybody are thinking about economic processes, debts, and sovereign risk. Somebody told me about a recent pensions meeting where a presenter said, "It's the population, stupid."

This idea is very simple, and it's just surprising that it went out of people's heads for so long. In fact, traditionally, economists were always interested in population dynamics and demographic processes. But there were some famous studies in the 1970s and 1980s by the Nobel Economist Simon Kuznets, who found that *size* of population was not a factor in economic growth. That was the necessary catalyst that caused people to think, "Well, then, population doesn't matter." But Kuznets' research was very specific: the *size* of a population didn't matter. Iceland is no different from China in this sense.

Later, as we got into the 21st century, with the growth of emerging markets, people started discovering again that population structure does matter. It's not the size; it's the population structure, stupid.

So from the end of the 20th century, there was increasing interest among development economists in the way in which the drop in fertility rates in the emerging economies could help those economies get up to speed, if they made the necessary institutional reforms to accompany these changes.

The first warning signal came from countries like the Asian Tigers—Singapore, South Korea, Taiwan, and Hong Kong. Then, Goldman Sachs got the idea of BRICs, as China started to come online, and suddenly, we were talking about countries like Brazil, India, Indonesia, and the Philippines.

There's been a definite before and after to the global crisis, with the emerging markets assuming a far greater importance. The valuation of the outlook for both growth and sovereign risk in the developed economies has shifted into another gear, as has the perception of growth possibilities, and therefore, sovereign risk in the emerging markets.

That's why I call this a paradigm shift. Some of these debates which we have between Schumpeter and Keynes about how to handle the current crisis are out of date in light of that paradigm shift, I would argue.

Torralba: You argue that there's a ratio called the dependency ratio: the number of older, retired people relative to working-age people….

Hugh: If I can interrupt, actually, there are two dependency ratios. There's a child dependency ratio and an elderly dependency ratio. The problem with the super-underdeveloped economies is that they have a massive child dependency ratio, which means they have very little in the way of saving, because they have large numbers of children. My father was one of a family of 14 and started work at 12 in the Liverpool of the United Kingdom, which was the richest country on the planet at that time. As my father told me, having lots of children means poverty. Having a lot of old people, if we're not very careful, could also mean poverty, too.

We're making an inversion from having too many children in proportion to the rest of the population to having too many old people. For developing economies, the news that fertility is dropping is good. In developed societies where the key ratio to watch is the elderly dependency ratio, then a continuing fall can become a major issue. Having let the developed world population pyramid get to the stage it's now in, trying to address the problem is going to be difficult. Giving more facilities to working mothers who want to have children, for example, or some kind of family support system, or paying to subsidize school textbooks so that having a child is not such a direct economic burden on a family—all these are going to be very, very difficult in a situation where resources are so strained, because of the demands on the pension and health systems due to the large proportions of elderly people.

Torralba: The problem is that we used to have a demographic dividend, where we always had an adequate ratio of retired people to working people. It's what we call a pay-as-you-go system. Each year's taxes are used to pay the pensions for that year. That model will be inadequate for the next two or three decades. How are we going to transition to a new form of financing retirement?

Hugh: Well, the transition will be turbulent. That's the only clear thing we can say. Our societies just aren't prepared for this transition. People in many countries—and it's not just Southern Europe, because I think the United Kingdom could soon be in the same situation—don't understand that you need to make systematic cuts—in health systems, for example. One of the reasons why the proportions of elderly dependents are rising is simply because of advances in medical technology. It's getting easier to extend people's lives, but we achieve this end by using more and more expensive medication and technology for increasingly lower additions to quality of life. It's a very expensive process, but it's going to be very hard to explain to people that that's the case.

What do I see in the future? In the first place, I see a lot of turbulence in the political systems. Second place, I see a process of realignment in the global markets. Every company needs growth. Companies need markets to grow for their products to justify the next generations of investment. For corporations, the expansion in emerging markets is a godsend. Even though the majority of the population can't buy Italian luxury products or expensive German cars, the volume of the population is so large that even with only a small percentage of that population being rather rich, you've got quite a big market.

So, at the moment, the corporate sector is reorienting and reinventing itself. This is being reflected in the U.S. equity markets; companies are reorienting production toward these new, growing areas. But it's going to be quite difficult for the populations in the developed countries to come to terms with the fact that their status in the world is changing.

What Can We Learn From Japan?

Torralba: Japan is a little bit further along in the demographic transition than Western Europe. Is there anything we can learn from Japan's situation that is applicable to Western Europe?

Hugh: The thing that's distinguished Japan the most has been its ongoing deflation. Up to now, no other countries have had this kind of deflation. So, at the moment, this is a unique Japanese feature. We need more time to see whether it's going to typify other countries or not.

What we can say, though, is that Germany, which has a similar aging profile as Japan's, has had a very strong disinflationary tendency over the past few years. The Germans have patted themselves on the back about this and said how good they've been in comparison with their European peers. But to some extent, this could simply be a product of the internal demand dynamic. Because I think the lesson that we can get from Japan is that with populations aging beyond certain thresholds, the structure of production changes. Investment oriented toward domestic consumption, and domestic consumption itself, tends to become more and more lackluster, while the country comes to depend increasingly on having a super-efficient tradable sector and ramping up the level of export production.

We do see a rather similar pattern in Germany. Why is it the case that domestic demand starts to weaken? Because most of the actual economic growth that we get comes from taking demand from the future in terms of credit. In this sense, rather than a credit cycle, what we see is a structural shift in the role of credit. Where we do get strong consumer demand growth in countries like Spain or Ireland or the United Kingdom during the first decade of the century, the driving force was a very large increase in private domestic credit. Once that comes to an end, you seem to notice that consumer demand doesn't have anything like the same dynamic, because a higher proportion of the population is just buying out of current earnings and current income.

There is a certain age profile associated with patterns of spending and borrowing. Nobel economist Franco Modigliani noticed this in formulating his lifecyle model. It was indeed a pattern that had already been identified by the British social philanthropist Joseph Rowntree at the start of the 20th century. There are different stages in life. And these stages are successively either ones of increasing borrowing or ones of increasing saving for the future.

When we extend these stages to a whole population, we can see that the domestic demand dynamic isn't what it was as countries get older. So, that's one of the points that we can get from Japan.

The other point is this increasing dependency on exports and external saving. One way of making the situation easier was always the idea that during the good years, when you are having higher levels of economic growth, savings could be diverted out of the country into overseas investments—and to some extent, the population can live off of these overseas investments.

Indeed, this is what we're seeing in Japan at the moment, because Japan's got a 50% of GDP net national investment position, which helps the current account, but the country can't live forever off this. Little by little, we can see the surplus weaken as people draw down on their savings. So, there's then a big

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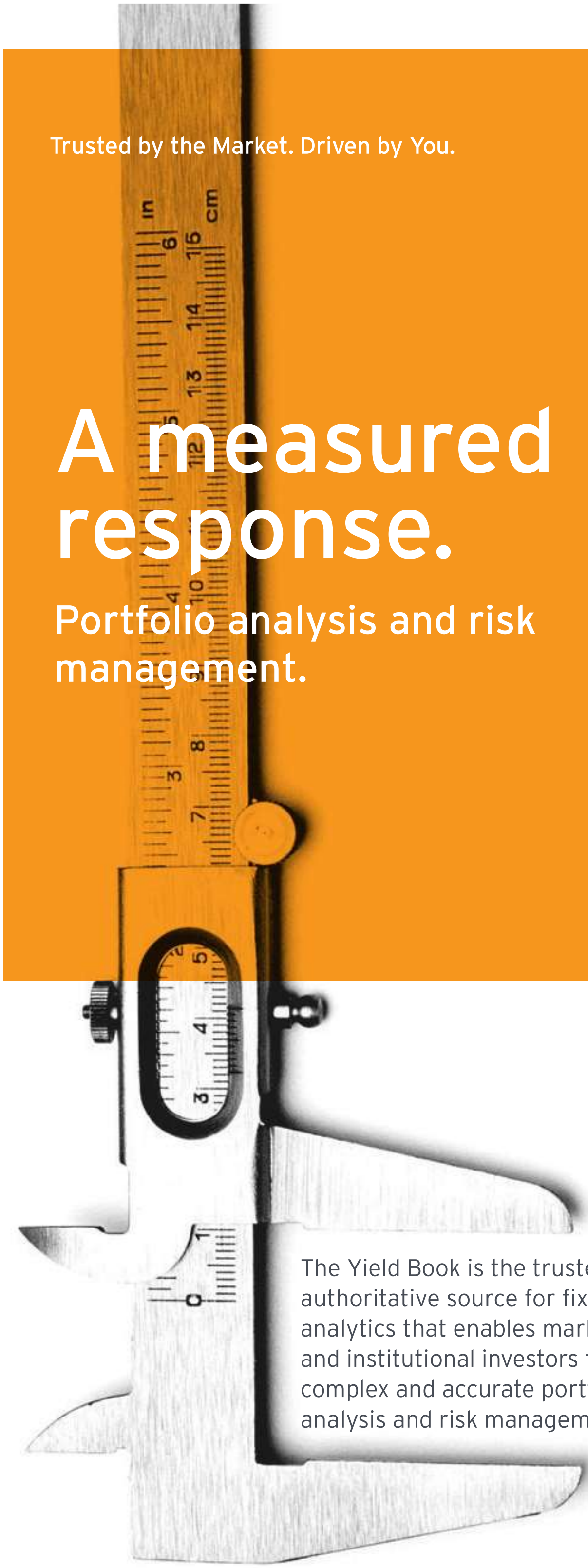

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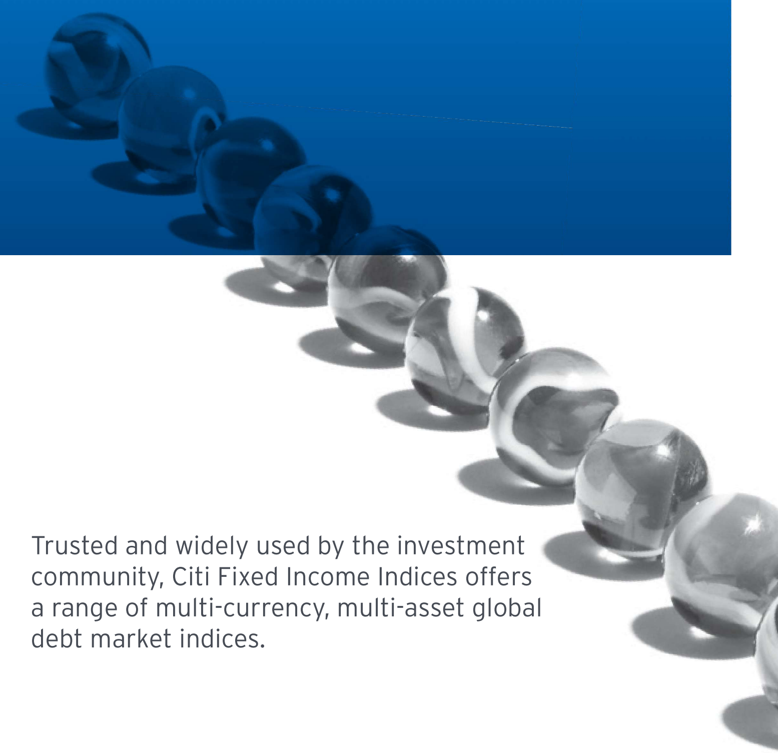

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theoretical argument among economists about how long this will last. But if we look at not only Southern Europe but also Eastern Europe—these are all countries that are about to enter this important aging period, and they've got strong negative external investment positions. This is a great concern. How are they going to manage the aging process? They haven't got the external savings to draw down, and they have external debts to pay.

Torralba: Exactly. Not only do they have current account deficits, but on top of that, they owe money to the external sector.

Hugh: Every month, just to cover the current outflows on the equities and on the debt obligations these countries have, they have to do an extra dose of exporting to be able to earn the money to pay it down. That exporting doesn't help compensate for deficient internal demand. So, it's going to become an increasing headache.

Labor Mobility

Torralba: I'd like to discuss the relationship between migration and fiscal policy. In an economic area like the eurozone, where in theory you have a free labor market—people are free to work and live wherever they choose—you have the possibility that people will move from the least-productive, lowest-wage parts of the eurozone to the most-productive, highest-wage areas. That leaves behind retirees, or people with very low earnings, who make small fiscal contributions to the state. What does the free labor market in the eurozone imply for fiscal solidarity in the eurozone?

Hugh: This is a very important point. The euro was set up with major institutional deficiencies. Some of these had to do with the fiscal coordination and product market integration, services integration, or whatever. One of the deficiencies was the absence of widespread labor mobility. For some reason or another, people were not moving from one country to another. Or even within countries. Take the example of Spain; even when the economy was growing at 4% a year and 750,000 migrants were entering the country every year, there was double-digit unemployment in the southern parts of Spain. There was no movement from these areas towards richer regions like Madrid, Valencia, or Barcelona, where the economies were booming, and there was plenty of opportunity for work.

Spain is quite a nice microcosm of the problems that the euro area has as a whole. If this mobility wasn't evident, or wasn't evident in Italy from the south to the north in the first decade of this century, how much less wasn't it there in the euro area as a whole. I mean, there was a migration from Eastern Europe into the euro area, but not from one eurozone country to another, except at the most highly qualified level.

What we are seeing now is something new, and something that in principle is very welcome—people are moving from countries which are stuck in deep recession to areas where there is economic growth, where there is demand for labor.

But, as you're suggesting, this basically good news also presents us with a problem, as it highlights yet another institutional deficiency in the design of the euro area. Basically, those who are moving have been brought up, educated, and prepared for life by one society but they then go and work in another one. Instead of paying contributions through the pay-go system of their own country, they contribute to the pay-go system of another one, and there's no evident mechanism whereby any of this money gets recycled back to meet the old-age needs of the parents who raised them.

The issue then is, is the euro area going to set up some kind of equivalent arrangement to the one that's been set up in the Federal Republic of Germany, or the autonomous communities of Spain, and make some kind of allowance for the sharing of the benefits of this migration? Because if it isn't, then what you are left with is what the old East Germany would be like, if it wasn't part of the Federal Republic, a country with a very large number of old people, quite a high unemployment rate, and insufficient growth to support the basic welfare system.

Torralba: From a political point of view, it's going to be extremely complicated. It creates tensions between regions, and it creates resentment. In Spain, people in Catalonia think they're paying too much to Madrid. How is that going to work in Europe when Germany is told that they're going to have to send checks every month to pay for the Spanish retirees? I don't see that going down very well.

Hugh: No, and I don't think that's going to happen, either. Japan has these problems, not at the regional level, but the problem simply of sustaining the health and pension system, given the lackluster nature of the economy and now the declining workforce and problems of productivity that they're having, associated with its aging. How Japan is handling this is just by boosting debt. Japan's gross sovereign debt last year was around 235% of GDP, and they were running a fiscal deficit of around 10%. The prime minister, Shinzo Abe, is talking about doing even more of the same this year, so we can imagine they could go up through the 250% of GDP and onwards to upwards to more than 300% over the next few years.

These are unheard of proportions in any modern society. We don't know where this leads. But I would suggest that the most likely tendency that we can see in Europe at the moment is a tendency for some kind of mechanism to be devised, yet to be specified, which allows these countries to continue spending without all the weight of this falling on Germany.

Torralba: We've been talking about the implications of demographics for fiscal solidarity. Another implication that we read about is that having a single financial system eventually leads to some sort of

The whole idea of a working European Union, and especially the euro, depends on everybody feeling part of the same entity. They obviously don't. Therefore, it's dysfunctional.

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burden-shedding in the end, because eventually, the state is the guarantor of the financial system's liabilities.

You wrote recently that what Ireland did may be a peek into the future of the eurozone. First, the Irish Central Bank bought promissory notes that were meant to recapitalize the financial system, and then those promissory notes were actually later swapped for Irish government debt. In the end, what this means basically is that the Irish Central Bank is financing the deficit, even though it completely goes against the European Union Treaty—that the central banks are not supposed to finance deficits. The European Central Bank is against it, the Bundesbank is against it, and nonetheless, it seems to be happening in Ireland. Is this where we're headed in Europe?

Hugh: Something is going to have to happen, isn't it? The market's assuming as well that something is going to happen, because otherwise, you can't make sense of the pricing of European sovereign bonds at the moment, unless you think that's the case.

The premise would be what you said in the earlier question, and that is that it's going to be very, very difficult for the Europeans collectively to agree to have the kind of fiscal arrangement they have in the United States, where there are automatic stabilizers from one state to another, which operate immediately. If there is some kind of economic slowdown in one part, that doesn't affect another. People can go and live in Florida and have pensions paid, just the same as if they were living at home.

It's going to be very difficult to convince German voters to accept that, so some other way has to be found. What's concentrated everybody's mind recently is the outcome of the Italian election, because it's clear in Italy that people are not voting at the moment and are unlikely to vote in the foreseeable future for a government that is strongly committed to the kind of reforms that will be needed in order to apply to Mario Draghi to implement an Outright Monetary Transactions bond-buying program. Yet, the whole market current position is based on the idea that ultimately these countries, Italy and Spain in particular, will, if need be, apply to Mario Draghi.

So, everyone is skating on thin ice at the moment. What happened in Italy could easily happen in Greece in the next elections. You could get another party which is not favorable to continuing with the Troika programs, with a majority, because Greece has this first-past-the-post party system, winner takes nearly all. So, if it was Syriza instead of New Democracy that came first by a short head in the next elections, this would cause all kinds of problems. Portugal is going to have elections one day or another and has a similar situation pending. You don't have to be a genius to see that there's a limited lifespan to the unpopular austerity measures, necessary as many of them may be.

Strength of the U.S. Federal System

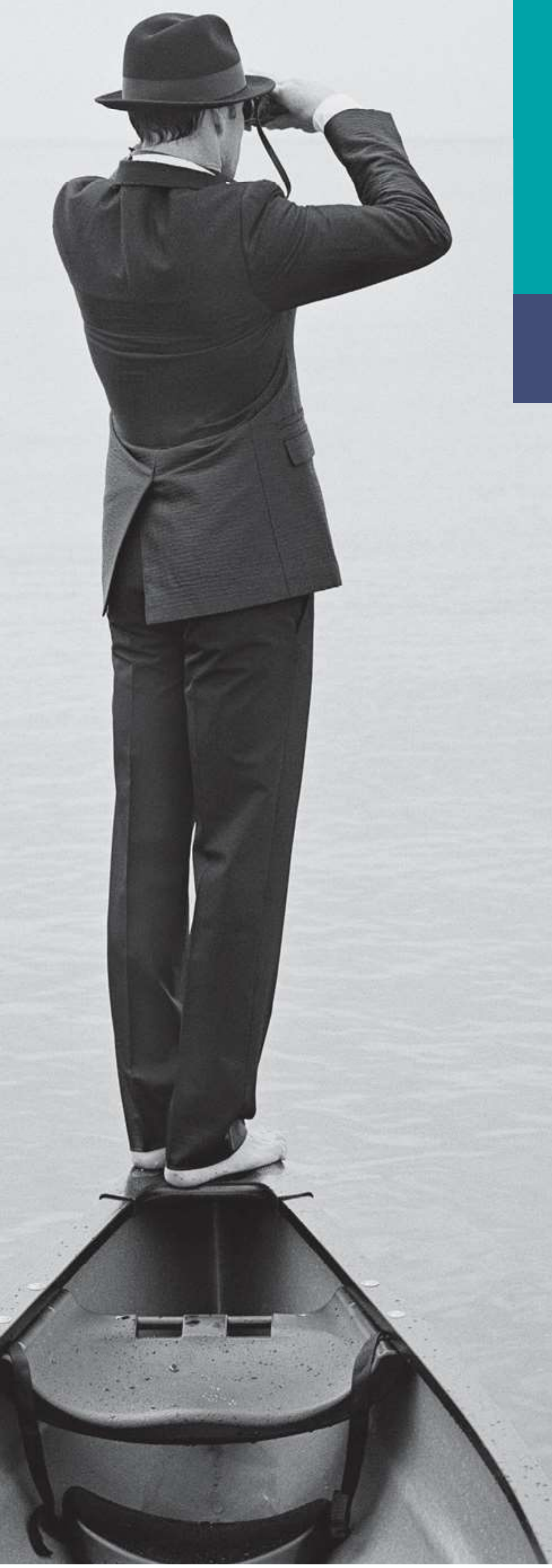
Torralba: This reminds us that monetary policy and fiscal policy are not independent. They're kind of two sides of the same coin. In Europe, it's difficult within the short time horizons to have responsible fiscal policies, so we're going to resort to monetary policy to finance deficits. In the United States, you don't have that fiscal constraint. Why has the U.S. embarked on this monetary expansion policy that seems to be turning into "QE infinity"?

Hugh: I think there are two questions here. One is, why has the United States gone for quantitative easing? And the other one is, why is it possible for the United States to do certain things where they don't mind who's paying—whether it's somebody in Alabama who's paying or in California?

Most people I talk to from the United States say that the United States can have this federal system—where people maybe moan a little bit, but nobody really seriously takes issue with who's paying for what. They had a Civil War, and the Civil War settled this question.

Now, that's not an argument for having a civil war in Europe, but we've never settled the question, despite all these wars we've had. It's quite interesting that the whole idea of the European Union, the traditional argument for it, is that because we were always at war. But in fact, war didn't settle this issue, because we are still a continent of bigger and smaller nations, where the national identity is something that's important to us.

Yet, the whole idea of a working European Union, and especially the euro, depends on everybody feeling part of the same entity. They obviously don't. Therefore, it's dysfunctional. That's why the United States can do something



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that Europe can't, and I don't see any short-term or easy solution to this question.

Why do they keep doing QE even when there's no evidence it works? Again, we can go back to Japan. It's curious that people say that the Bank of Japan hasn't ramped up its balance sheet as much as anybody else. In fact, it did ramp up its balance sheet quite a lot before the crisis started, so the baseline is a bit different there.

But it was quite obvious that in fact QE didn't work the first time it was tried in Japan. There was this critical moment in 2005 when the G20 had decided that everybody was going to go back home and try to start raising interest rates, because the environment was perceived as being excessivley risky with people extending too much credit, etc. People were anticipating, a little bit, the crisis.

Japan got as far as putting the rate up a quarter percentage point and then stopped the whole tightening cycle, because it couldn't go any further without imploding the economy.

So, on the one hand, it wasn't working, but on the other hand, Japan wasn't able to apply a more hawkish monetary policy without really putting the economy itself at risk.

This is the whole point. It's working in that it's boosting the equity markets and boosting carry trades across the planet, but this way may be indirectly creating a little bit of inflation. But it's not meeting its primary objectives of restarting credit flows and generating a slightly higher inflation rate to aid deleveraging. Fine, but what would?

So, if you haven't got an answer to "what would?" then you stay where you are. I think that's why we are where we are. There are people in the United States who would argue that QE is doing certain things, achieving some of its objectives. That's a huge debate that I don't really want to go into because it isn't really within the bounds of my expertise.

But we are locked into these kinds of situations because nobody's come up with a better idea. The alternative to this is not to raise interest rates. So, what do we do?

Torralba: Speaking about inflation, a prediction that you hear about sometime is that the monetization of government debt in the long run will imply much higher rates of inflation. In fact, this is one way how governments are going to deal with their fiscal problems: just wipe away the real value of their debt by letting inflation run higher.

Do you think this eventually is an outcome that we should be worried about?

Hugh: Well, it's not a concern that I have at the moment, because there seems to be a structural deficiency in domestic demand in many of the economies where they're applying this technique. So, it's hard to see how you can get domestically driven inflation. How you could get troubling inflation is if you provoke a collapse in the currency. This is a risk Japan is running, as George Soros is pointing out.

So, in the long run, you could have hyperinflation, let's say, in Japan, if the yen really collapsed—not if it went from JPY80 to JPY100 to JPY120, but went from JPY120 to JPY300. If there was a dramatic collapse in the yen, because there was a dramatic flight of funds out of Japan at some moment, because people anticipating continuing falls in the yen started really panicking, then, this could precipitate a very strong inflationary dynamic.

This creates a peculiar position, then, for the countries in Southern Europe, because the only way you can avoid breakup risk coming back again is to let some economies spend more money. The advantage of doing it through the national central banks is that it doesn't all fall back onto Target2 balances and generate additional liabilities for the Germans. If this is shown to be the case, then maybe the Germans will become more relaxed about the situation.

But the interesting thing is that these countries with large net-negative external investment positions and high levels of sovereign debt normally would experience a big run on their currency. What the euro does is stop the big run on the currency, because they're in a common currency—although it isn't a national level currency.

But what Willem Buiter, the chief Citigroup economist, has spoken about over the past months, and it's becoming increasingly relevant, is the possible ruble-ization of the euro, making a comparison with the old USSR, when the ruble was retained as a common currency for a number of increasingly independent states. In fact, 5 euros in Germany may already effectively have a different value, even though we're talking about the same banknote, to 5 euros in Greece.

Torralba: Just to make sure I understand what you're saying. Right now, the value of the euro is in a sense anchored by Germany. Germany is seen as a responsible country with a current account surplus.

Hugh: Yes, and as a result of that perception Germans get all kinds of financial perks, like cheaper interest rates when they want credit. But it's interesting, the Germans and the French are increasingly arguing now about this point that you've drawn attention to. It was interesting to hear Jens Weidmann, the president of the German central bank, recently raising doubts about the French will to implement major structural reforms and to bring the fiscal deficits under control. If the tensions grow on the German/French axis, we're going to be in even more trouble. But, yes, Germany is seen at the moment as the heart. M

Francisco Torralba, Ph.D., is an economist with the Morningstar Investment Management division.