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Do demographic changes matter? A cross-country perspective

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ABSTRACT

We explore the inflation-adjusted yields on benchmark 10-year government bonds in seven developed countries to see if both demographic and non-demographic variables can explain why real bond yields are so low.

We find that over the last 60 years there has been a regime shift in the late-1980s that radically altered output growth in major economies as dependency ratios declined. Because of this change we used two time periods for our models: low-frequency annual data from 1950 to 2012 and quarterly data from 1990 to 2013. We show that population age ratios are important as a determinant in the demand for financial assets. In this paper we also introduce a global proxy for quantitative easing (QE). We find that in developed markets in Europe and North America the QE has lowered bond yields by approximately 50–100 bps since the global credit crisis began.

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1. Introduction

The recent quest for finding a solution to an ageing population primarily in the developed countries has been initiated by the evaluation of asset values for the retiring baby boom generation in the US. Following the end of World War II the prosperous economic environment in the US, which doubled the industrial output over the previous several years and then was further supported by rebuilding

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endeavours, primarily in war torn Western Europe led to the assertion of the US as a global power. An increase in birth rates reflected the benefits of these growth rates that could be only realised through unexpected interruptions in human development. Another impetus for excessive growth was the drive for globalisation and deregulation in the 1980s, followed by a demise of the communist world at the beginning of the 1990s. Even if sweeping political changes did not manage to reach all countries with similar force, the changes in the economic environment were rather unambiguous. To rebuild a country on new entrepreneurial foundations or to risk being exposed to another period of isolation, the consequences of which were quite evident throughout 20th century, were options faced by some Asian countries.

Previous studies until Davis and Li (2003) mainly referred to demographic variables and linked them to effects on returns in stock markets and bonds. Based on findings and suggestions enclosed in this and some other seminal papers such as Poterba (2001, 2004) there were multiple attempts to compare various countries and variables in order to examine if there is a relationship with population variables. However, when countries were included in studies they were either analysed to confirm or refute the claims about a single country in a study or the countries were observed together in an attempt to find lasting policy recommendations. In this paper we have tried to include countries that may face the problem of ageing population, but at the same time offer intriguing specificities in dealing with the problem. US, Canada, Australia and New Zealand are historically attractive immigration countries, but there are striking differences among them. Immigration policies have a different impact on the number of immigrants (calculated as the ratio to the total population) in respective countries. While US and Canada, as part of NAFTA and NATO pact maintain strong links to Europe and Central and South America, Australia and New Zealand in spite of their dominant European heritage are increasingly more oriented towards the Pacific Rim and Asia, in particular. Finally, New Zealand faces a potential population loss to Australia, even though there has been a net gain in population (Bedford et al., 2010). Personal disposable income in New Zealand represents only 52% of that in Australia and it seems to be a strong reason for emigration to the Commonwealth of Australia (EIU ViewsWire, 2010). More importantly, Australia and Canada have made a move to funded pension schemes and the global ramifications of this change will become more evident quite soon. Studies refer to prices of publicly traded stocks and fixed income securities and neglect the fact that many of these superfunds are larger than company pension funds and their diversification policies are not necessarily based on CAPM postulates. Multiple divisions are requested to increase exposures to specific industries, but the funds themselves due to their gigantic structures are diversified. Another obvious consequence is that these aggressively growing funds avoid publicly traded assets in order to shun accusations of manipulating the market and most probable liquidity and marketability issues. They invest in alternative assets which market values are difficult to quantify. When these pension funds decide to sell assets in financial markets the impact will be significant and unless they face similar giant buyers from other countries there may be challenges that cannot be accurately predicted at this stage. Siegel's (1998) concern about the problem of transferring trillions of dollars of baby boomers assets could be applied to a multitude of countries that will face similar challenges. Chamon and Prasad (2008) examined the age profile of savings in China in 2005 by age of head of household and the results were striking in that the highest rate at 30% belonged to the age-25 group, almost double the age-45 cohort. Clearly demographics are important as well as productivity (income) growth in determining savings rates. This early-20s cohort is likely a reflection of the once-child policy adopted in 1979.

Global real interest rates fell from a peak of 5% in the mid-1980s to a natural rate of about 2% prior to the onset of the global credit crisis, and have been approximately 0% since 2012 (Blanchard et al., 2014). The authors also suggest that the world is poised for a prolonged period of low real interest rates as shifts in savings, investment, plus shifts in portfolio preference for risk-free assets point to a lower natural rate than the pre-2008 level, exacerbated by accommodative monetary policy to close output gaps and return economies to potential growth. During recent business cycles, monetary policy in the main OECD areas tended to be too loose during booms and then eased too aggressively during busts (Borio, 2012, 2014).

Among countries selected in our sample, Germany and UK are important countries in the functioning of the Euro Zone and financial markets in Europe, respectively. UK is an immigration country not only for non-EU nations, but also for recently acceded EU member countries from Central and

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