IeC Experience and Insight on Demand

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UK Economy: Demographics the 'silent witness'

Most economists believe that constant growth has become normal in today's economy. Their view is based on the SuperCycle seen between 1982-2007, when any minor dip in the UK economy was followed by a surge in pent-up demand.

Thus since 2009, most debate has centred on which policies – quantitative easing, austerity programmes, tax and/or spending cuts etc – will most quickly return us to growth.

This Note argues, in contrast, that the idea of constant growth is wishful thinking. It instead suggests that the major changes now underway in UK demographics mean that low, or even negative growth, is likely to be the 'new normal'.

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Our argument is simple, and based on just one key assumption, that demographics drive demand.

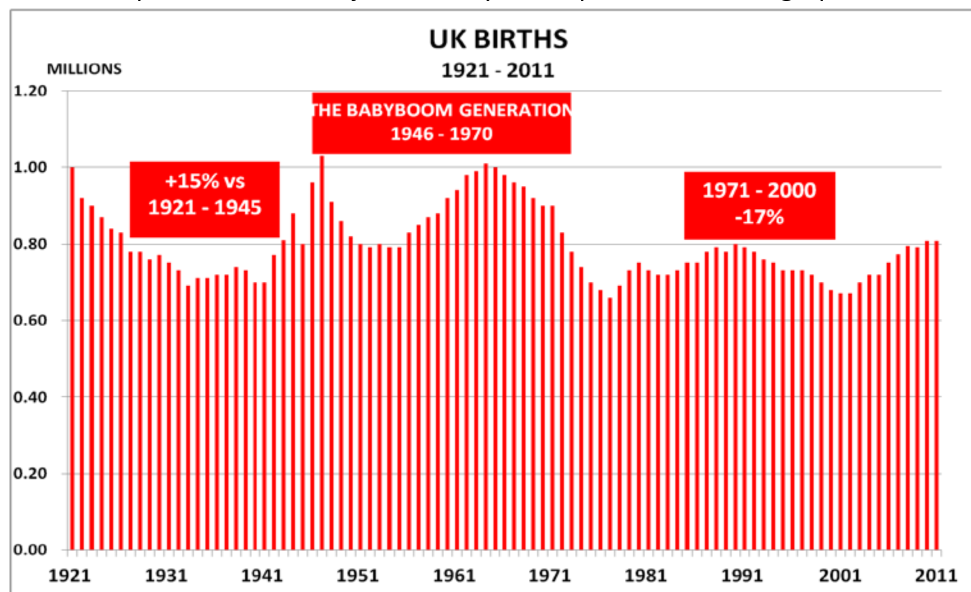

Chart 1: The UK's BabyBoom generation is now ageing

Chart 1 shows the size of the **demographic windfall** that boosted the UK economy until recently. Births rose 15% between 1946-70 compared to the previous 25 years[i], from an average of 784k/year to 901k/year. This added 3m babies to the population – the equivalent to the current population of Wales. As these babies grew up, and the UK economy prospered, it therefore became almost inevitable that they would spark a growth SuperCycle when they reached the Wealth Creator 25-54 age group, typically the period of peak consumption. They were, after all, the largest and richest generation that the UK has ever seen.

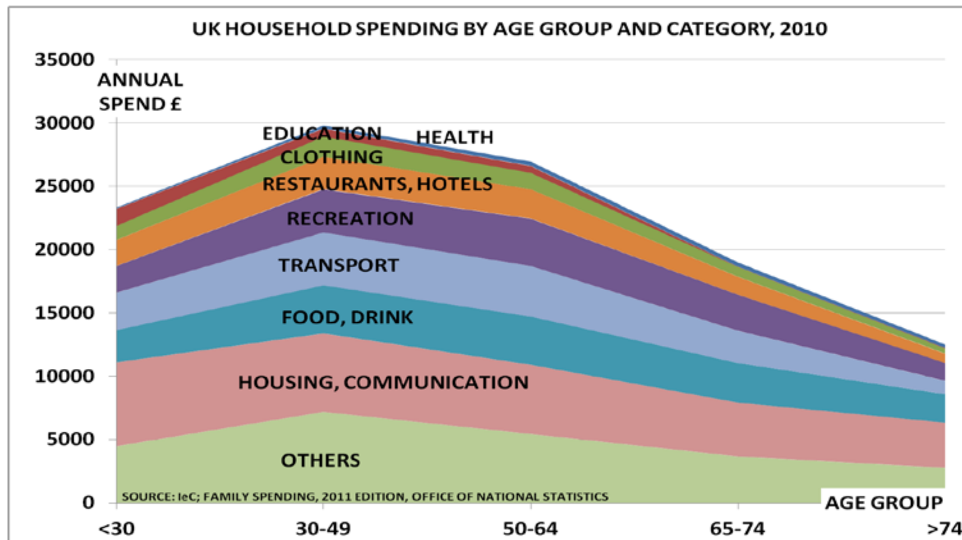

Chart 2: UK Household spend by age, 2010

But now, the UK's Boomers are ageing fast. The oldest Boomers began to join the New Old 55+ generation in 2001, and it now contains 18 million people[ii]. They are 28% of the UK population and their numbers are growing all the time. Growth will inevitably be very much slower than in the 1982-2007 SuperCycle years. The reason is straightforward:

- When people are young, they need to buy new things
- And the Western BabyBoomers had lots of money to spend, particularly during the credit boom
- But now the kids have left home, and the Boomers don't need many new things
- Instead, they mainly buy replacement products, and only when these wear out
- The only area of major household spend that currently increases after 50 years is recreation

Chart 2 illustrates this point by reference to official UK[iii] household expenditure data, by category. The survey shows how **spending peaks after the age of 50 years, and then falls away quite sharply as people age**.

UK household consumption is 60% of GDP[iv]. Thus **s**uch major changes in spending patterns must inevitably impact GDP growth. This clearly helps to explain the unprecedented surge in demand during the 1982-2007 SuperCycle, as the Boomers entered their peak consumption ages of 25-54 years. Equally, nothing lasts forever. Future economic growth must now slow as **more and more Boomers pass into the New Old 55+ age range**. As chart 1 showed, UK births between 1971-2000 averaged 17% less than in the Boomer years, at just 746k/year. The younger generation is therefore too small to compensate for their parents' spending slowdown.

This pattern on its own will have a major impact on economic growth and financial markets. The Boomers drove stock markets to record levels in their Wealth Creator years. But now they are becoming uncomfortably aware that their savings may prove insufficient to fund their extra decade of life expectancy compared to previous generations. Their focus is moving from return **on** investment, to return **of** investment, as witnessed by the continuing decline in yields for UK government bonds. Thus the ageing Boomers may well spend even less than the historical average.

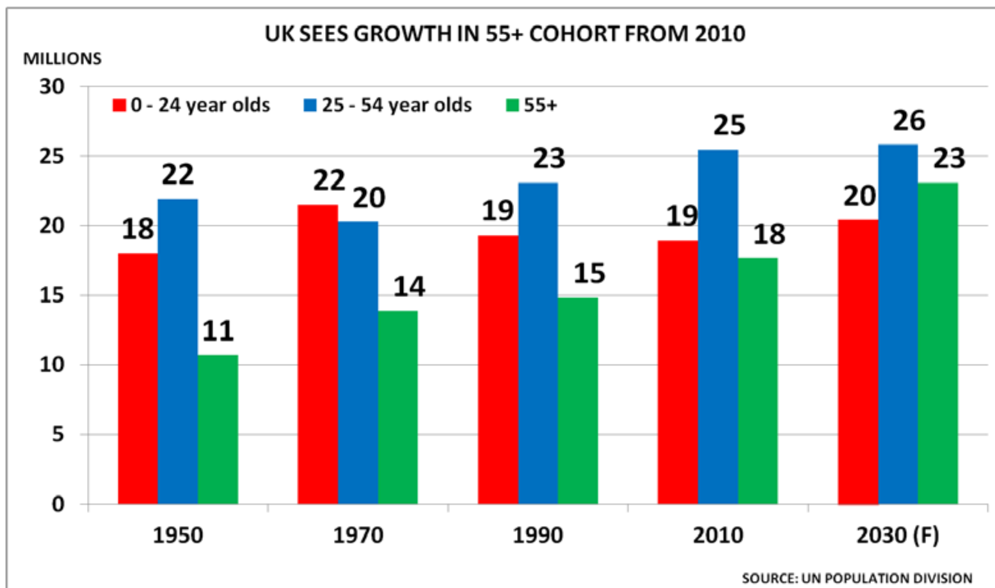

Chart 3: The New Old 55+ generation is the only growth sector in the UK

Chart 3 shows that the New Old 55+ generation is now the only growth cohort within the UK population. The numbers of those in the 0-24 and 25-54 age groups have already plateaued. This is another reason for today's slowdown, as most companies are still focused on the age groups that have gone ex-growth. They ignore the evidence of increased life expectancy, and imagine that the New Old 55+ generation only require Zimmer walking frames and sanitary products. This lack of available products and services is creating an entirely avoidable headwind for the economy.

The sun may not be just setting on Japan

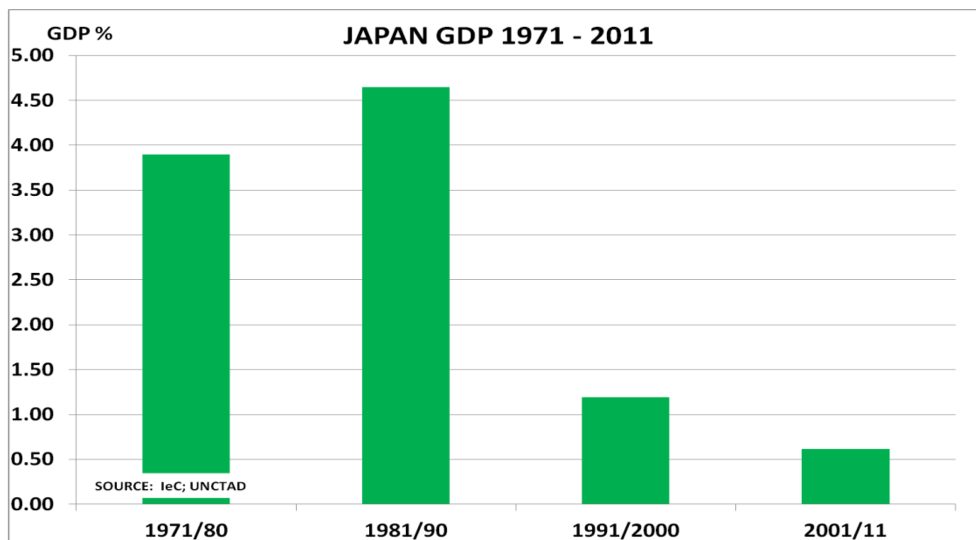

Chart 4: Japan's GDP growth slowed sharply as its Boomers aged, despite export strength

Japan offers a clear precedent for the impact of an ageing population on economic growth. Its BabyBoom took place earlier than in the UK and was focused in the 1940-1952 period. This meant

that all its Boomers were in the Wealth Creator 25-54 age group between 1977-94. Its Nikkei stock market index peaked in 1989 at 38,916 and its government bond interest rates at 8%. It introduced quantitative easing, and massive stimulus spending to try and kick-start growth after 1989. But as chart 4 shows, GDP growth has since averaged less than 1%/year, versus 4%/year in the Boomer years. This has clear implications for the UK economy.

The Governor of the Bank of Japan warned earlier this year in a speech at the LSE that "*the similarities far outweigh the differences*[v]" between Japan's subsequent economic performance and the demographic position today in the UK. He added that *"The implications of population aging and decline are very profound, as they contribute to a decline in growth potential, a deterioration in the fiscal balance, and a fall in housing prices Other developed countries will face the same problems despite some differences in timing and magnitude."*

Conclusions

The demographic evidence needs to be discussed

Demographics have been the silent witness in today's economic debate. Yet their evidence deserves to be heard and discussed by policymakers, governments and investors. It suggests that the UK has already entered a 'new normal' of much slower economic growth. But this should not be seen as a disaster waiting to happen, as long as we are sensible in our response. Today's increase in life expectancy represents one of the greatest achievements of the modern age. We have only ourselves to blame if we now turn this triumph into disaster.

UK economic policy in the new normal

Policy-makers need to recognise that **today's financial crisis is a symptom of the impact of changing demographics.** The **UK economy faces a clear risk of decades of lower economic growth** due to the structural decline in household expenditure and the growing emphasis on replacement-based consumption**.** But there is no reason for this to translate into 'lost decades', if policy makers accept the demographic reality and act to refocus the economy accordingly.

- ❖ Demographic trends therefore need to be properly understood by policy makers. At the moment, they are being widely ignored. It has been too easy to assume that Japan's issues are associated with policy errors, rather than being the inevitable result of an ageing population.
- ❖ Policy makers also need to recognise that managing population ageing is rather like captaining a supertanker. Short-term manoeuvres have little impact, and may unintentionally create additional hazards. Instead, they need to navigate with their eyes firmly on the long-term horizon – clearly a major challenge in today's Twitter-age of focus group-driven policy.
- ❖ Japan's example suggests that major stimulus programmes such as new airports and rail links, no matter how well intentioned, will have only a temporary impact on economic growth. The reason is that a decline in the main economic driver – household consumption – cannot be reversed by simply pumping more money into the economy.

- Policy makers also need to recognise that ageing is a global mega-trend, impacting China (due to its 'one child policy') just as much as the West. The UK is therefore unlikely to be able to easily rebalance its economy towards exports.
- **The consequences of continuing to ignore demographics are extremely dangerous for the economy.** Declining household consumption will not only negatively impact corporate profits and investment. The lower growth that results may also make it very challenging for the UK to pay down its debt burden, as tax receipts will come under increasing pressure.
- Equally, the UK may find it increasingly difficult to deal with the expenses associated with an ageing population, such as the rising costs of medical care and state pensions.

Investing in the new normal

The impact of demographic decline and the related financial crisis has led **to a near permanent state of volatility, uncertainty, complexity and ambiguity** in financial markets since 2008. This has created a challenging environment for investors in terms of asset allocation.

- Such are the levels of fear and uncertainty that investors have increasingly focused on ensuring **the return of their capital, rather than a return on capital.** Hence bonds of highly rated countries now often trade with negative real yields, as with the JUUGS countries (Japan, US, UK, Germany and Switzerland). We believe that the **JUUGS sovereign bond markets may continue to deliver record low yields** for many more years to come, despite likely credit downgrades for some members of the club, as long as domestic political stability can be maintained.
- Investor confusion is compounded by the distorting effects of aggressive monetary stimulus measures carried out by the world's main central banks. This has led to correlation trading across major asset classes in alternate 'risk on, risk-off' mode. This is extremely dangerous, as it means markets are failing to perform their true task of price discovery. Thus **no major market currently knows what it is pricing, as fundamentals are being overwhelmed by liquidity flows.**
- This is particularly true of oil markets (see our note 'Central banks will make downturn worse', last month). Central bank liquidity is currently driving oil markets to a second successive year of record high annual prices, despite worsening fundamentals of supply and demand. These high prices are further eroding already weak consumer spending power, and corporate profits.
- Central bank liquidity has also blindsided investors on the inflation issue. Weak global demand means that inflation is unlikely to become a major problem, unless quantitative easing is taken to extreme levels. Instead, we are probably now seeing a secular reversal of the inflation initially created in the 1970's as the early Boomers moved into the Wealth Creator 25-54 age group, and the SuperCycle began to develop. Deflation may therefore be a far more potent medium-term risk for portfolios.
- Investors therefore should not ignore the risk that today's seeming healthy stock market may **eventually fall in value, once the impact of liquidity starts to reduce and fundamentals reassert themselves**.

References

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[i] Births data from Office of National Statistics, Vital Statistics
[ii] Population data and projections from UN Population Division, 2010 Revision
[iii] Office for National Statistics, Family Spending, 2011 Edition, Table A9
[iv] Office of National Statistics, Blue Book 2012 edition, table 1.3
[v] Masaaki Shirakawa, Lecture at the London School of Economics, 10 January 2012

About IeC: IeC is a London-based strategic consultancy advising numerous Fortune 500 and FTSE 100 companies, investment banks and fund managers.

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