Michael C Bonello: Population ageing - a major challenge for policymakers

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the opening session of two workshops on pension reform, organised in Floriana, Malta, by the World Bank Institute, 9 June 2003.

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I should first of all like to thank the World Bank Institute for choosing Malta as the venue for this Workshop and to welcome you all to our country. Your presence here continues a centuries-old tradition whereby Malta exploits its location at the centre of the Mediterranean and its reputation for hospitality to bring people and ideas together.

Malta is currently undergoing a rapid transformation in a bid to seize the opportunities arising from accession to the European Union and from the further consolidation of its trading relationship with its Southern and Eastern neighbours. The economy, albeit small, has a number of vibrant sectors ranging from high-tech manufacturing to world-class conference tourism. As in the case with many other countries, however, the long-term prospects for economic development in Malta will be inevitably affected by the impact of population ageing. Given that the population support ratio, defined as the number of persons of working age to those of pension age, is expected to halve over the next 25 years to just over 2, this impact is likely to be significant.

The global and regional dimensions of population ageing

Malta is by no means an exception in this regard. By the middle of this century, the median age of the world population is expected to increase by 10 years to 36 years. Globally, the proportion of persons aged 60 years and older is forecast to double. The fastest growing group of the older population is made up of those who are 80 years old or more. This age category is projected to increase more than five-fold over the next 50 years.

While ageing is indeed a global phenomenon, it is likely to represent a more onerous challenge for developing countries than for developed ones. The majority of persons aged 60 and over will be found increasingly in developing countries; and as the pace of population ageing is much faster in these countries, they will have less time to adjust to its effects than the developed countries. Developing countries, moreover, will have to meet this challenge starting from a lower level of socio-economic development. For instance, the elderly in developing countries will be living mostly in rural areas and hence will face additional difficulties compared to their counterparts in developed countries who tend to live in urban centres.

These differences imply that the policymaking capacity of developing countries will be tested more severely. More specifically, there will be important decisions to take regarding social security schemes, particularly traditional pension systems in which today's workers pay for the benefits of today's retirees. This will no doubt involve making difficult choices, some of which may have painful consequences in the short run, but which are essential for sustained economic development.

The economic consequences of population ageing

This is the case because population ageing is expected to have wide-ranging and long-lasting economic effects, involving not just government revenue and expenditure but also national saving and investment ratios as well as the labour market.

The main issue that comes to mind when mentioning population ageing is its impact on government finances. Most countries, including Malta, presently operate pay-as-you-go pension systems. The ageing phenomenon undermines the financial viability of pay-as-you go systems by reducing the number of contributors relative to beneficiaries. Ageing also entails increased government expenditure on health, and especially on the care of the elderly. The challenge to public finances is even greater if, as is the case in Malta, the budget is already in deficit.

Changes in the age distribution of the population are also likely to affect a country's private consumption and saving patterns. The 'life-cycle hypothesis' suggests that individuals tend to even out consumption outlays over their lifetime, such that a person saves during the working years in order to finance consumption during retirement. A rising trend in the proportion of elderly people, therefore, tends to be accompanied by a decline in the national saving ratio. OECD projections, in fact, point to a reduction in saving rates of between 5 and 12 percentage points of GNP over the period 1980 to 2025. Such a contraction could lead to a vicious circle, as the resulting higher interest rates reduce investment, adversely affecting economic growth and, in turn, the ability to finance social security commitments.

Ageing could also have a negative impact on financial markets. Pension funds are at present major players in most stock markets. As the baby boom generation retires during the current decade, most of these funds will have to gradually liquidate their assets, probably leading to downward pressures on share prices. This would in turn create a negative wealth effect, as declining asset prices dent the purchasing power of households and give rise to a reassessment of consumption patterns.

The simultaneous decline in fertility rates, meanwhile, is expected to adversely affect the supply of labour and its quality. A smaller labour force would act as a drag on potential output growth, and impact negatively on competitiveness by tightening labour market conditions, leading to upward pressures on wages and inflation. An older work force is also likely to be less mobile and flexible, albeit more experienced.

Policy measures to address the challenge

In economic terms, population ageing is tantamount to a negative supply shock, of which the fiscal impact is but a manifestation. More fundamentally, the ageing phenomenon undermines the economy’s productive base and its competitiveness. The adverse effects of the reduction in output are meanwhile compounded by higher consumption, which tends to crowd out investment expenditure and exert adverse pressures on price levels and the external balance of payments.

The desirable outcomes of policies intended to meet population ageing are, therefore, not hard to identify. Such policies must aim at producing an increase in productive capacity and output, and stimulating saving and investment, thereby alleviating pressures on inflation, fiscal resources and the external account. Indeed, these outcomes are desirable independently of population ageing, but are rendered even more urgent by the onset of the phenomenon. It is the way in which this strategy is to be implemented that is often subject to contention.

Opinions tend to diverge because it is not always appreciated that any course of action chosen, including a passive stance, involves sacrifices. An increase in resources devoted to pensions must imply higher taxation, a reduction in funds allocated to other equally worthy causes, or burdens on society as a whole in terms of higher inflation and interest rates. On the other hand, reforms that should engender a win-win situation in the long run could perhaps impose sacrifices on a number of individuals in the short term. It is, therefore, important to promote an informed debate which takes account of the costs and benefits involved in any course of action, with a view to reaching agreement on viable solutions.

The nineties, in fact, saw many governments implementing pension reform initiatives, generally based on the three-pillar approach advocated by the World Bank. Under this approach, individuals may have up to three different sources of revenue during retirement, namely a basic state pension, the balance accumulated in a mandatory pension account and voluntary saving arrangements. A number of international studies show that the replacement of pay-as-you-go pension regimes by funded systems provides more incentives for private saving, and reduces the scope for tax evasion by linking contributions paid into the system directly to the benefits received. This contributes to increased investment and augments the productive base, thereby facilitating the financing of social security expenditure commitments.

Apart from specific reforms in the social security system itself, an improvement in the fiscal position would have an overall positive macroeconomic effect, compensating in part for the addition in aggregate demand brought about by ageing. The lower absorption of resources by the State could also lead to a higher average level of productivity and to an improvement in the country’s balance of payments. Productive capacity would also be enhanced if the State creates fiscal and other incentives for individuals to provide for their own needs after retirement, leading to an increase in the household saving rate and, consequently, also to a faster accumulation of capital.

Fiscal consolidation will, however, only solve part of the problems created by population ageing. The negative supply shock caused by this phenomenon must also be countered by a positive shock.

Supply-side reforms aimed at increasing the availability and the efficient use of economic resources are, therefore, essential. The efficiency of markets can be improved by implementing a vigorous competition policy and reducing public sector involvement in the economy. Productive capacity would also be improved through such policies as market liberalisation, greater investment in infrastructure and education, and a market-driven industrial policy. Structural rigidities in the labour market must be eliminated in order to decrease their disincentive effects in terms of the labour supply and the work ethic. A labour market policy intended to increase skills, and consequently the employability of individuals, is also desirable.

Conclusion

This "grey cloud" on the horizon, therefore, appears to have a silver lining in the form of appropriate policy responses that would effectively enhance the welfare of populations. Moreover, as the Secretary-General of the United Nations, Kofi Annan, has said: "Trees grow stronger over the years, rivers wider. Likewise, with age, human beings gain immeasurable depth and breadth of experience and wisdom. That is why older persons should be not only respected and revered; they should be utilized as the rich resource to society that they are." The wealth of skills and experience that older people bring to the workplace, to public life and to the family are generally not recognized. Technological advances and new ways of organizing society can be put to good use to increase the participation of older people in work and to make appropriate socio-economic changes.