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How to Open Economic Doors When Canada's Demographic Window Closes

Linda Nazareth

Do you hear that sound? It is the sound of a series of 'demographic windows' slamming shut, and it spells hazards for Canadian economic growth.

This could be a golden age for Canada: we have come through the recession if not unscathed, at least less scorched than many countries in the world and we have resources of all kinds. There is lots of potential for us – except that something is about to turn resolutely against our favour. Our population is not just aging, but adjusting in such a way that we will soon be beyond what is known as the 'demographic window', the period of time in which the conditions for economic growth are at their best. Perhaps even more importantly, the closing window in Canada is being mirrored in many places around the world.

Through the last 50 years or so, much of the developed world has benefited from a wide-open demographic window – a time when the age of the population creates the ideal climate for growth. That, as much as anything else, gave us what we in the developed world will likely look back on as a period of stellar expansion. With the demographic window now slamming shut, we have some challenges ahead of us. All is not lost however: the aging world should not be thought of as sounding a death knell for the global economy. Well-designed policies could go a long way toward reversing the "demographics as destiny" mantra that is sometimes taken as absolute.

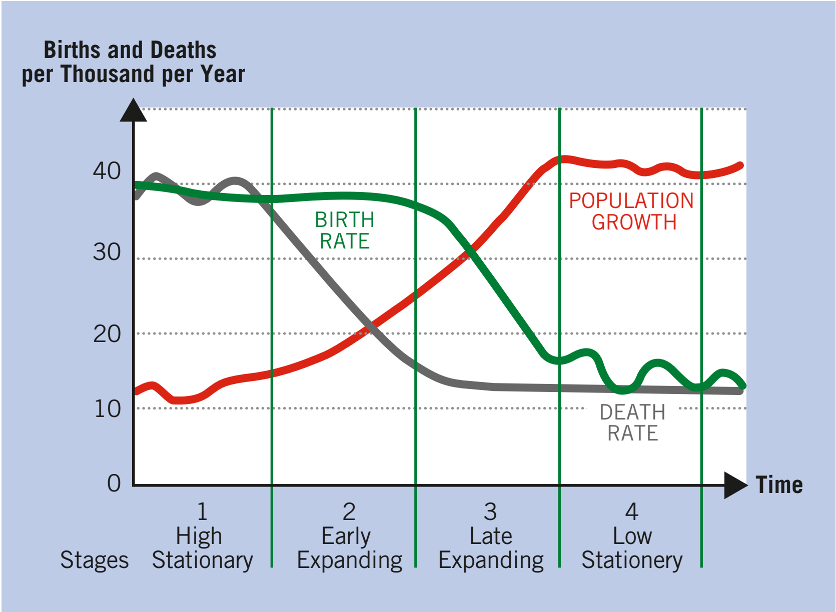
Demographics and Growth

We all know the basic arguments on demographics and economic growth: we have heard for years that an older population buys less – or at least different things – than a younger one, and that will change the economic landscape. That is true, of course, but in a macroeconomic sense there is a broader way to look at it.

As countries go through different stages of industrialization, the demographic composition of their population changes. You can get an idea of how this works by looking at the demographic transition model (chart 1), which was developed in 1929 by an American demographer named Warren Thompson.[1]

CHART 1 Demographic transition model

The demographic transition model shows the way that births and deaths ebb and flow with economic development.



Based on the model specified by demographer Warren Thompson in 1929.

STAGE 1

Stage 1 is associated with pre-modern or primarily agrarian times. Birth rates are high and so are death rates, meaning that population stays pretty stable or grows slowly. It is a time when disease is rampant, infant mortality is high, and sanitation standards are low.

Although most of the world has moved past these conditions, there are a few pockets in places such as Sub-Saharan Africa that are likely still in Stage 1.

STAGE 2

In Stage 2, the country gets more industrialized; health improves and death rates decline, and there is an increase in life expectancy. Birth rates are generally unaffected at this stage and stay high. With lower death rates (including lower infant and child mortality), the population increases and there is also a subtle shift in the population's age structure, which becomes increasingly youthful.

The years associated with the Agricultural Revolution of the 18th century are thought to be a good illustration of this stage of development, but these conditions can also be found today in newly industrialized countries. You can certainly see the rise in life expectancy the world over: on a global basis, life expectancy in 1950 was 48; as of 2005–10, it was about 76 years (United Nations 2012, 3).

STAGE 3

The third stage of economic transition is characterized by a decline in birth rates, much as we have seen in the developed countries of the world since the end of the 19th century. Actually, the measure to track is the fertility rate, which is roughly defined as the number of children a woman has over her lifetime.

Fertility rates fall with industrialization. As societies become more urban, there is less need for lots of kids to work the farm, and with lower child mortality there is less need to have multiple children to ensure some survive. As well, as a country industrializes, women become more educated and tend to enter the workforce, and have fewer children.

These factors, combined with continued health improvements, lead to population growth during this stage, but at a slower rate than in Stage 2.

STAGE 4

Stage 4 is associated with an old and older population. Birth rates are low and so are death rates, and in some cases the former cannot keep up with the latter. You can possibly extend the model even further. In a possible fifth stage, fertility rates drop below the replacement level, and population declines.[2]

The key figure to keep in mind for fertility rates is 2.1: that's the average number of children a woman has to have over her lifetime to replace herself and her assumed partner. At this point, about 48 percent of the world's population – including in Canada and the US, Europe, China, Brazil, the Russian Federation, Japan, and Vietnam – is in "low fertility" countries where this ratio is not met (United Nations 2012, 3).

One useful idea is to think of things in terms of the 'demographic window': effectively the years in which the stars are lined up for any country's economic growth. It takes the right mix of population: a balance of children, those working and paying taxes, and the elderly who have completed their work lives. The United Nations uses a precise definition of the demographic window, defining it as a time when the youth-dependency ratio (the proportion of persons aged under 15 as a percentage of the working age population aged 15 to 64) is under 30 percent, and the elderly-dependency ratio (the proportion of the population aged over 65 as a percentage of the working-age population) is under 15 percent. But even without doing any calculations, you can instinctively see how things move.

The sweet spot for economic growth is when countries are moving from Stage 2 (high birth rates, declining death rates) into Stage 3 (declining birth rates, declining death rates). That's when the working age population is on the rise, and it is when a country experiences its first demographic dividend. When the labour force is expanding more quickly than the youth-dependency rate, more money is being paid in taxes and less is going into education, relatively speaking, and strong conditions are created for economic expansion. For example, arguably, much of Ireland's economic success in the 1990s, during the heady days when it was called the "Celtic Tiger," came about because of a sharp increase in the working-age population relative to the birth rate.[3]

A second demographic dividend for industrializing countries comes about when newly expanded workforces age – although not too much. Workers in their middle years are cognizant of the fact that they will live longer, so they start to put money away for retirement. That increases the supply of capital available, which facilitates lending and business expansion. It also juices the financial markets: more money going after the same stocks is going to send equity prices higher. Given that fact, you can argue that the intermittent bull market in North American stocks in the 1990s and early part of this century had a lot to do with aging baby boomers looking for returns on their retirement savings.

A Series of Slamming Windows

Over the past half century, Canada has benefitted both from the fact that our demographic window was wide open and the fact that those of our trading partners were as well. We have experienced the positive spin-offs from that set of circumstances – but those conditions are about to be reversed.

The baby boom happened in full force in North America, and its aftermath is being felt six decades later. In the US, births peaked in the years from 1946 to 1966, while in Canada (which actually experienced a larger baby boom, in percentage terms) the boom ended a year or two later. Despite a bit of skewing because of a later boom in the 1980s and some distortion because of immigration, it is the baby boom that is still dominating the North American population pyramid, and it is the baby boom that will create a host of economic and social issues in the coming years.

Of course, not every part of the world is aging. In fact, the world as a whole is actually experiencing a population surge, although the quickest growth is taking place in very concentrated areas, including Sub-Saharan Africa, the Middle East, and parts of Asia (see table 1). The demographic window is wide open in these countries, and there should be an expansion in growth as well as population in these areas of the world. Trouble is, it will be economic growth starting from a weak base and can hardly be expected to offset the effects of demographics on more developed economies.

TABLE 1 International demographic windows

The demographic window shows the 'sweet spot' for growth – the time when the percentage of those aged under 15 comprises less than 30 percent of working age population, and those over 65 comprise less than 15 percent of working age population.

	BEGINNING	END
World	2005	2045
Africa	2045	2080
Asia	2005	2040
India	2010	2050
China	1990	2025
Latin America	2005	2040
Australia/New Zealand	1970	2010
North America	1970	2015
Eastern Europe	Pre-1950	2015
Western Europe	Pre-1950	1990

Sources: United Nations database and author calculations.

Demographic windows are closing throughout the industrialized world. Europe also experienced a baby boom in the post-World War II years, which resulted in a flood of labour force entrants by the early 1970s. The demographic window was open during the years from about 1950 through 1990. Now, the population is aging rapidly. The median age in the 27 nations that make up the European Union is now 41.5 years, up from 35.7 in 1992.

Germany, the largest nation in the Eurozone, actually has the worst demographics (the median age in the country is 45) but ironically it is the one with the strongest economy (Eurostat quoted in Cohen 8 May 2013). The reason? Very strong economic productivity, a situation that is not mirrored in many other European countries. Spain, for example, has a horrendous problem with unemployment (and particularly with youth unemployment). The signs suggest that the overall picture will only get bleaker in Spain, and elsewhere, as public finances become strained with ever-increasing numbers of elderly and a relatively smaller working-age population. Still, the German case gives a glimmer of hope, illustrating the possibility of triumphing over demographic change provided that there is an offset from productivity.

Then there is Japan, which is the textbook case of an aging population. The country has the longest life expectancy in the world (81.25 years as of 2006) and a fertility rate of 1.35 per woman. And, unlike North America, the country has very low levels of net immigration. Accordingly, the population (which was at about 128 million as of the 2010 Census of Population) is declining by about one million a year. The population aged above 60 is already close to 25 percent of the total, and if present trends continue will be close to 40 percent by 2060.[4]

But aging in Europe and Japan are old problems, and we really need to be worrying about a new one: aging in China. Here is a scary statistic: in the year 2050, there will be more people over the ago of 60 in China alone than there were in the entire world in 2010. That's according to statistics from the World Economic Forum, and they illustrate a starkly different reality for China than the one that exists today. China has built an economic miracle by having a strong working-age population and by putting that population to work in the ever-growing factory sector. Now, the cohort that staffed the factories – those aged 15 to 24 – is set to decline by 62 million between now and 2025. At the same time, the population above the age of 60 is set to double by 2030, rising by about 180 million. If not a recipe for disaster, it is a recipe for a completely different country, demographically speaking.

The wide-open demographic window in China has been a strong positive for Canada and for many other countries which have benefitted from China's strength. Were it not for China, the world economic crisis of 2008 would have been scarily worse: the country has been an economic powerhouse for the last decade or more, and that fact has papered over the cracks of weakness in the world economy. Now China is facing its own problems, which will put pressure on everyone else to solve their own problems too.

India is thought to have the best chance of a big demographic dividend over the next decade or so. And it's true that many things are lined up in the right direction. About half of India's population is under the age of 25, and 65 percent is under 35. Between 2010 and 2040, a quarter of the total increase in global working-age population will stem from India, during which time the population in this age group will comprise 69 percent of the country's total population. As mentioned earlier, the demographic window in India will be fully open in 2015 (the first year that the population aged under 15 drops to less than 30 percent of the total) and will not close until 2060.

The Challenges of a Closing Demographic Window

So then, what exactly does it mean that the demographic window is closing in the developed and much of the developing world? Simply put, it means that the demographic circumstances that created many of our positive economic outcomes are disappearing. The new demographics will create an economic situation that is very different – unless policies are put in place to offset the adjustments.

The reality is that we are working with a problem-within-a-problem: Canada will be dealing with the realities of population aging within a world dealing with the realities of population aging.

1 A WORLD WITH A LOWER SPEED LIMIT ON ECONOMIC GROWTH

An older population consumes differently than a younger one, and they work differently as well. That's going to weigh on Canadian growth, but the situation is going to be made that much worse given that the rest of the world is also experiencing the same impact of the closing demographic windows. That is going to be particularly true in the case of the US: one study by the McKinsey Global Institute found that the presence of boomers in their prime buying years helped to fuel US economic growth at an average rate of 3.2 percent per year between 1965 and 2008 – a level that they see dropping to 2.4 percent for the next few decades (Farrell et al. 2008).

In Canada, projections by the Bank of Canada show that in the absence of any adjustments, the average incomes of Canadians could be as much as 20 percent lower by 2032 than they would have been without population aging (quoted in Boivin 2012). Growth in working-age population and growth in an economy as a whole go hand in hand. An older society means a growing proportion of people not paying taxes. As an official from the Bank of Canada put it in a 2012 speech, it is like a "pie growing more slowly than the number of eaters – less for everyone" (Boivin 2012).

❷ RESTRICTIVE FISCAL POLICY

A lot of issues, for other countries and for Canada, will stem from the fact that governments have simply not prepared enough for population aging. According to research done by the International Monetary Fund Group of 20, countries will have to spend four times the current output to pay for health care, pensions, and long-term residential care associated with aging over the period from 2009 to 2040 (Ronald and Mason 2011). That is money that will have to come from somewhere, whether from taxes or siphoned away from potentially productive spending.

The first choice is to offer less in terms of publicly funded programs, something that is already being tried in various places in limited ways. For example, new employees in the public sector might be offered much more limited pensions than were available to existing employees. In more extreme cases, governments might also have to claw back or not make good on previously negotiated pensions. The second (and perhaps the inevitable) choice when it comes to keeping existing systems going is to simply tax workers and businesses more as the bills mount. But that is a tricky proposition: high taxes in some jurisdictions will drive companies to others where the tax bills may be lower.

But these measures, although they might help balance some books in the short term, are quite unambiguously restrictive ones. They will slow growth, which will do little to boost a Canadian economy that is already biased towards slowing. Those provinces or regions which have slightly younger populations may be able to resist adopting some of the more restrictive measures for a time, which will give them something of an advantage. All in all, the next decade is going to feature an ugly tug-of-war between regions as they struggle to adjust their tax structures, and between those with competing priorities as they struggle for what little government spending exists.

❸ A CREDIT CRUNCH

Another issue that will come with the closing demographic window is that the stock of capital – basically, savings – will be impacted. As the boomers earned money, they saved some of it too, not just in North America but in other countries as well. There was lots of liquidity available, and, as a result, interest rates could be relatively low, as indeed they were during the period from the 1990s on. As that trend reverses, Canada may be one of many countries that finds itself with a lot less available capital, a situation that could lead to an effective 'credit crunch'.

What we do know is that an older population saves less than a younger one. Given the aging trend throughout the world, this means that countries with older populations will see available capital decline, forcing up interest rates or forcing borrowers to access capital from outside the country. Of course, there are ways to encourage savings – providing tax breaks for money put into specific savings vehicles, for example – but any such program is fighting a generational trend. Canada has taken some relatively small steps to encourage savings in recent years, through measures such as raising the allowable contributions on Registered Retirement Savings Plans, and by creating Tax Free Savings Accounts. The results of these measures have been mixed, suggesting that much more aggressive means will be necessary if the next generation of younger people are to be encouraged to save rather than spend. Or perhaps they will not be: if they are privy to the example of parents and grandparents forced to make uncomfortable choices because they have not saved enough, then perhaps that will be a stronger advertisement for making careful choices than any campaign that could be waged by governments.

A world with an older population is, therefore, likely to be a world with a tendency for higher, not lower, interest rates. If that happened, it would be a sea change from the very low interest rates experienced globally for the past decade or so, and it would have severe consequence for a younger cohort. While the older population would be thrilled to have higher rates – it would give them a decent return on their savings without having to take substantial risks – the younger population would be forced to borrow at high rates to finance mortgages or loans. As a result, the conflict between generations, already stoked by the taxes the working-age population has to assume to pay boomer health care, would only burn hotter.

❹ A DEMOGRAPHICALLY DRIVEN BEAR MARKET

The stock market could also conceivably be a victim of an old and older world. After all, older people draw down on their holdings, meaning that they are more likely to sell their stocks than to buy new ones.

Households spend and save differently at different points of their lives, and the sum total of their actions affects the economy and the markets. For example, households in their twenties and thirties do not tend to be big savers. These are typically the years when people buy their first house, start a family, get a start on paying back their student loans, and generally act like consumers. As they hit their forties, however, things change a bit. Retirement is looming and they start to think more about accumulating assets; maybe they acquire a financial adviser or start learning about the markets on their own. Once past 65, people start to draw down on their savings and investments rather than adding to them.

There are a couple of ratios that are instructive in looking at where the markets are going. One is the *middle-young* ratio which looks at the ratio of those in their forties to those in their twenties; the second is the *middle-old* ratio which looks at the ratio of those in their forties to those in their sixties. The higher each is, the more likely is it that the financial markets will go up. A population with high proportion of people in their middle years relative to other groups means that there will be a pool of savings likely to flood into equity markets and bid stock prices higher.

Empirically, there seems to be a nice fit between the way that these two ratios and the financial markets in North America have moved together over the past two decades. Indeed, if you look at the bull market around tech stocks in the 1990s, it seems to have less to do with the amazing new technologies being introduced and more to do with the fact that there was a mass of baby boomers in their prime savings years all looking for returns.

Looking forward, we are clearly facing a reversal of the situation: the middle-young and middle-old ratios in North America are going to trend lower, signaling lower equity prices. Indeed, using population projections and calculating their direction indicates that Canada and the US could be headed into a secular bear market that lasts until the early years of the 2020s. Looking abroad for better returns could give investors a bit of breathing room, but the closing demographic windows elsewhere also suggest that countries like China cannot count on endless bull markets either.

Changing the Future

In spite of the oft-repeated phrase, demographics is actually *not* destiny and does not have to mean the end of a prosperous society. If the demographic train is going to be stopped, however, it will have to be through well-designed policies and safety nets, not through luck or blind hoping for the best. So let's get down to brass tacks: there are only a couple of ways you can grow the economic pie. One is to have more people working more hours and producing more things. The other is to produce more with the inputs that you do have. That is, you can change your population structure in a bid to force the demographic window open a bit, or, you can change the reality such that the demographic transition model is less important than it has been historically. The global economy is a bit too ambitious to tackle, but let's look at how Canada can deal with the two options.

(1) Look at the Policy Options for the Next Stage of Demographic Transition

Like many developed countries, Canada has a very low fertility rate and is headed into a period when natural increase will be decisively negative. That means that in the absence of policies to prevent it, even 20 years down the line, the working age population is going to be relatively low.

Encouraging increases in birth rates is a sensitive issue and any decision around it should be undertaken with caution. 'Bonuses' for having children would be a crude policy tool and likely not the best one to undertake. However, we have seen other policy actions, such as Quebec's provision of very low daycare rates, have a positive impact on birth rates. We can also look – with wary eyes – at the actions now being taken in Japan, the country with the oldest population in the world. In an effort to make young women both workers and mothers, some measures are now being taken to make child care more available and workplaces more welcoming for parents.

The key with looking at birth rates and policies is to realize that the problems are society wide, and any measures undertaken should acknowledge that, rather than being simply an issue for business. Hence the costs of any policies should not fall entirely on the business sector.

(2) Fine Tune Immigration Policy

The first issue, that of having more people to do the work, is one that could be tackled by immigration. Actually, that is already the case anyway: were it not for immigration, Canada's population would be in decline. The numbers could be ramped up somewhat to change the demographic profile of Canada, but it would have to be done very carefully. Bringing in young workers is one thing, but it would have be done in such a way to ensure that at the same time there was not a corresponding spike in young children or the elderly. That might mean making deliberate choices in terms of the numbers of immigrants allowed in under economic rather than family reunification grounds.

As an aside, Canada should not take it for granted that we will have the pick of the crop of new immigrants in perpetuity. As other countries (such as China) age, there will be a push to keep younger workers at home, and perhaps to bring in workers from nearby countries. The competition for those with the highest skills and potential is likely to increase, not decrease, in the future, meaning that Canada will need to actively pursue the immigrants deemed to be of the most value in an economic sense.

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(3) Plug In Foreign Labour as Necessary

As well as bringing in foreign workers as necessary on a permanent basis, Canada's future may include bringing in workers on a temporary basis to meet short-term labour force needs. Of course we see some of this already. Projects such as the oil sands in Western Canada are only possible because the appropriate workers, of whatever skill levels, are let into the country to meet short-term needs. Having said that, we also know that there can be fear and resistance to bringing in foreign workers. In fact, when a major Canadian bank recently attempted to use the Temporary Foreign Workers Program to meet a need for technical workers, a public uproar erupted and the bank bowed to public pressure and discontinued the program.

As the demographic window closes, Canada may need to become more realistic about filling labour needs. The right workers will need to be plugged into the right places, and companies will need to be given the freedom to decide when it is appropriate to find workers from outside the country.

(4) Boost Productivity Through Innovation

Demographics is not the only driver of the economy. While human capital matters, getting the most out of the financial capital that exists matters as well. At the heart of this entire issue is labour productivity: if you cannot get a larger mass of working-age persons to pay the bills, you need to get people working at more effective jobs, making more money and paying more taxes because they themselves are well compensated. That takes good macroeconomic and tax policies, and the right kind of investments in technology, but if you push all the right buttons, you can solve the problem of demographics. That is, we know that historically the development of machinery has allowed us to get more out of an acre of farmland, as has the development of various chemicals. We know that computerization has allowed office efficiency to flourish. And we know, or we have to believe, that there are innovations that could offset any aging of the population.

Of course, the productivity issue is a chronic Canadian problem as well. Study after study shows Canada as being less productive than it could be, and certainly less productive than the US. A demographic squeeze, however, might be just the thing to encourage initiatives to improve Canada's productivity picture.

What can we do about it? We can encourage innovation, whether that means creating new innovation tax credits or simply reducing the bureaucracy that makes it difficult to take out a patent. We can take measures to increase the number of graduates we produce in science and technology, perhaps by providing scholarships or simply by waging a publicity campaign that makes these fields seem enticing. Indeed, making education a top priority has to be a cornerstone of any effort to increase productivity.

Most importantly we can ensure that money flows towards businesses who will invest in things that improve productivity. This might be the most difficult measure of all, however. For credit to flow freely, you need to create an atmosphere of business confidence, one in which financial institutions feel at ease to lend money. It is not something that can be legislated to happen, no matter how low interest rates are – as we have seen from recent history. Banks only lend when they feel confident that they can borrow, and the majority of businesses do not want to take on debt if they do not believe that they can pay it back. If either side looks at the future and sees stagnation, credit flows will be impacted.

Changing legislation and attitudes, building confidence, encouraging more education in certain areas – none is a quick fix to the issue of flagging growth ahead. Then again, creating a new baby boom and hoping that it fixes things in the future isn't a realistic option.

This can still be a golden age for Canada. The demographic window may be closing, but the effects of that will not be felt all at once, and indeed may not be felt too harshly at all if we accept the realities ahead and deal with them sooner rather than later. This is the time to be ahead of the curve compared to other countries and realize that we need to create our own destiny.

About the Author

Linda Nazareth is an economist, broadcaster, and speaker. She is the author of *The Ever-After Effect* and *The Leisure Economy*, as well as a commentator in the national media. The Senior Fellow for Economics and Population Change at the Macdonald-Laurier Institute, she is an expert on demographics and trends, and speaks frequently to business groups, translating big-picture trends into information they can use for their own strategic planning. For more information, visit www.economorphics.com.

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Endnotes

1 For more on the demographic transition theory see Keith Montgomery, "The Demographic Transition."

2 There is also a possible sixth stage, at which point the high level of industrialization causes an increase in fertility.

3 For more on the Irish boom and demographics, see David Bloom and David Canning, "Contraception and the Celtic Tiger."

4 See Associated Press, 30 January 2012, "Japan's Population Decline: Estimate Shows One-Third Shrink by 2060."

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- The vulnerability of Canada's critical infrastructure;
- Ottawa's regulation of foreign investment; and
- How to fix Canadian health care.

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What people are saying about the Macdonald-Laurier Institute

I commend Brian Crowley and the team at MLI for your laudable work as one of the leading policy think tanks in our nation's capital. The Institute has distinguished itself as a thoughtful, empirically-based and non-partisan contributor to our national public discourse.

PRIME MINISTER STEPHEN HARPER

As the author Brian Lee Crowley has set out, there is a strong argument that the 21st Century could well be the Canadian Century.

BRITISH PRIME MINISTER DAVID CAMERON

In the global think tank world, MLI has emerged quite suddenly as the "disruptive" innovator, achieving a well-deserved profile in mere months that most of the established players in the field can only envy. In a medium where timely, relevant, and provocative commentary defines value, MLI has already set the bar for think tanks in Canada.

PETER NICHOLSON, FORMER SENIOR POLICY ADVISOR TO PRIME MINISTER PAUL MARTIN

I saw your paper on Senate reform [Beyond Scandal and Patronage] and liked it very much. It was a remarkable and coherent insight – so lacking in this partisan and anger-driven, data-free, ahistorical debate – and very welcome.

SENATOR HUGH SEGAL, NOVEMBER 25, 2013

Very much enjoyed your presentation this morning. It was first-rate and an excellent way of presenting the options which Canada faces during this period of "choice"... Best regards and keep up the good work.

PRESTON MANNING, PRESIDENT AND CEO, MANNING CENTRE FOR BUILDING DEMOCRACY