ECONOMICS FOCUS

Economics focus

A future meltdown?
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The ageing of the baby-boomers casts doubt over asset prices, too

IN TODAY'S electronic age is it really worth travelling 17 hours from London to attend an economics conference? If that conference is the annual symposium of the Federal Reserve Bank of Kansas City, held in Jackson Hole, Wyoming, at the base of the majestic Grand Teton, and attended by central bankers and economists from around the world, the answer is definitely yes.

The topic of this year's symposium was the future economic impact of ageing populations. The papers presented went much further than the well-known implications of ageing for labour-force growth and public finances, and focused more on its effects on future economic growth rates, the return on capital, interest rates and exchange rates. One of the most interesting papers was by James Poterba, an economist at the Massachusetts Institute of Technology, who explored how demographic change might affect financial markets.

As a result of declining birth rates and longer life expectancy, rich countries will in future have more old people and fewer young. In addition, as the baby-boomers retire, the ranks of the middle-aged will also dwindle. Between 2000 and 2050 the share of America's population over the age of 65 will grow from 12% to 21%, while the share of the population aged 40-64 will fall from a peak of 33% in 2010 to 28% by 2040. In Japan and some European countries, the shift will be even more dramatic.

The significance of this change is that people tend to save most, and to accumulate financial assets, during middle age. According to the standard "life-cycle" theory, people vary their saving rate over their lives in order to smooth consumption. When young, people borrow, to spend more than they earn; in middle age, they repay their debts and build up a nest egg for retirement; when old, they sell assets to finance their retirement. This suggests that changes in the age structure of the population will affect total saving in the economy and thus asset prices.

During the past 40 years the real level of the S&P 500 has indeed moved broadly in line with the share of the adult population aged between 40 and 64, allowing for occasional bubbles and busts (see chart). Thus in the 1990s, as the baby-boom generation reached their prime working years and their time of greatest asset accumulation, share prices soared. The worrying implication is that when this group starts to retire after 2010, share prices will fall as they become net sellers of assets to the next, less numerous generation of investors.
To explore the risk to future asset prices, Mr Poterba analysed the relationship between America's changing demographic structure and the level of asset prices in more detail between 1926 and 2003. He finds a positive correlation between the level of share prices and the share of the population aged between 40 and 64. The result is, however, highly sensitive to the exact specification of the model used to control for other factors.

So will share prices fall in future as the baby-boomers age? One flaw in this theory, Mr Poterba points out, is that detailed savings data suggest that, while older people stop accumulating further net wealth, they do not run down their assets as fast as the life-cycle theory implies. Because they do not know when they will die, or because they want to leave something for their children, retired people reduce their assets only gradually, in order to ensure they have sufficient capital to live on or to pass on to their heirs. As a result, there may be no sudden rush to sell assets when baby-boomers retire.

Another reason for thinking that any fall in share prices will be more modest than crude models suggest is that it is common knowledge that the baby-boomers are nearing retirement, so market prices today should already be taking account of future demographic developments. Share prices should therefore adjust relatively smoothly over time, thereby avoiding a meltdown. A third moderating effect is that the market for capital is global. Because savers can invest abroad in foreign assets, the link between an ageing population and domestic share prices will be muted.

**Wobbly foundations**

One area not addressed by Mr Poterba is the housing market, on which ageing could have a bigger effect than on share prices. After all, homebuyers are generally not professional investors, and are therefore less likely than equity investors to take account of falling future demand in the prices they pay today. Moreover, whereas in the past most homeowners tended to live in the family home throughout retirement and then leave it to their children, a house purchase is now increasingly viewed as an investment which can be used to finance one's old age, either by trading down to a smaller home or by selling a “buy-to-let” property. According to a survey by Mintel, a market-research firm, two-fifths of Britons think that investing in bricks and mortar is now the best way to save for retirement. In
other words, they may be buying property with the very aim of selling when they give up work. If the baby-boomers all try to sell at the same time, and there are fewer buyers, then house prices could slide.

However, using demographic forecasts to predict house prices is a dangerous game. In 1988, a widely publicised study by Gregory Mankiw, now chairman of President George Bush's Council of Economic Advisers, and David Weil, of Harvard University, predicted that American home prices could fall by 47% in real terms by 2007. Their reasoning was that, as the smaller “baby bust” generation entered its house-buying years, demand for residential property would grow more slowly in the 1990s than at any time in the previous 40 years. Instead, since the mid-1990s America has seen its biggest-ever rise in real house prices, buoyed by strong immigration, cheap money—and the unrealistic expectation that property prices will soar for ever.


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