The new decade: Labour shortages, lower growth, lower rates

A decline in the eurozone's working age population over the coming decade could mean lower economic growth, lower interest rates and higher house prices. It's hard to overestimate the impact

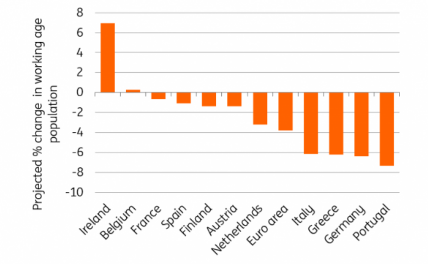
Source: Shutterstock

This time it really is different. By the end of the decade, the entire baby boom generation will have turned 65 and the working age population will be firmly in decline. While growth in the age group 15-64 – which is how the working age population is currently still defined – stagnated in the 2010s, it will shrink by almost 4% over the coming decade for the eurozone as a whole and by over 6% in countries like Germany and Italy. This means that demographics will become key in policy making in the years ahead. Think of labour shortages, lower potential growth, higher health care costs and pressure on pension systems. In fact, the most recent Finnish elections were centred around ageing and the costs that this will bring. This may be a taste of what's to come as Europe feels the impact of the baby boom retirement throughout the decade.

The working age population starts to shrink

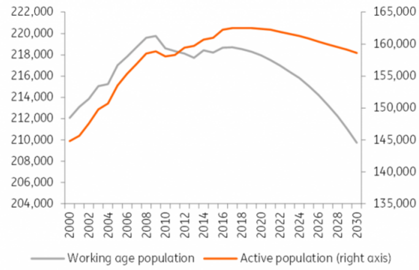
The working age population in the eurozone peaked about a decade ago and went into decline during the European debt crisis, when unemployment surged and many migrant workers returned to their home countries. Pure demographics and ageing populations have added to the gradual shrinking of the working age population ever since. According to Eurostat projections, the decline will intensify in the years ahead. As figure 1 shows, there is a large difference between countries, but none of the large eurozone countries will escape this fate.

Fig 1 The working age population is going to shrink in almost all major countries, but differences are large



Source: Eurostat, ING Research

Fig 2 The amount of active people will start to shrink quickly too

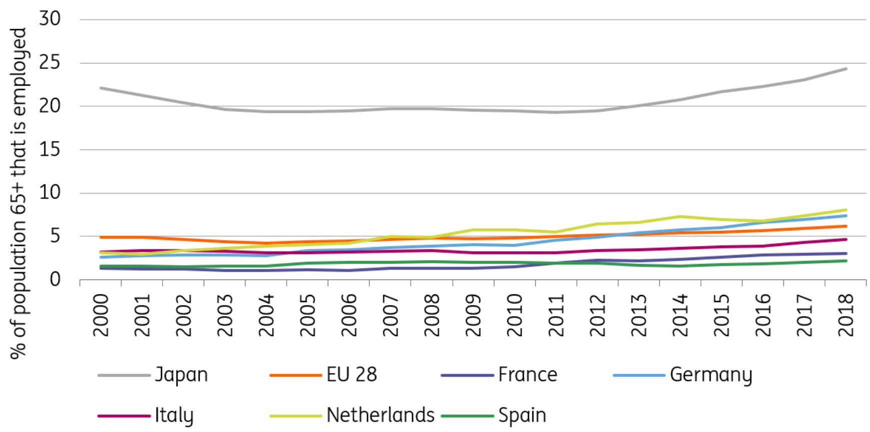


Source: Eurostat, ING Research

There is a difference between a shrinking working age population and a shrinking labour force though as not everyone at working age actually participates in the labour market. For the past two decades, governments have been trying to mitigate the ageing population problems by increasing the retirement age and disincentivising early retirement. The latter has caused a significant improvement in the amount of active people between 50 and 65, which had been at a very low level compared to the United States for example. The labour force has therefore continued to grow, but projections by the ILO of participation by age cohort along with population projections by Eurostat show that there is little time left before the labour force will start to decline.

A shrinking working age population comes with significant issues for the labour market. With a smaller pool of workers, labour shortages are set to become a more chronic issue in the eurozone job market. This does not mean that it will always be hard to find workers, but it will be a constraint in a larger part of the business cycle. That will, in turn, curb the growth potential of the eurozone economy, meaning that demographic elements are in part to blame for structurally lower growth expectations for the 2020s compared to the previous decades.

Fig 3 - Above 65, the increase in workers has been marginal compared to Japan



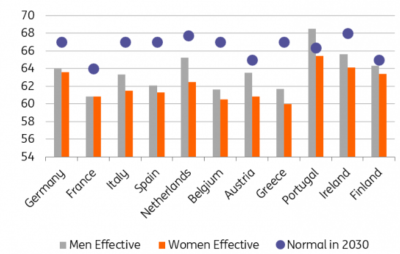
Source: OECD, ING Research

Can it be avoided?

There are still improvements to be made in the effective retirement age over the coming decade. The effective retirement age is still catching up to the actual retirement age in many countries – all except for Portugal in fact – and over the course of this decade, the retirement age will be raised further, potentially increasing the labour force. By the end of the decade, a normal retirement age of 67 will be more or less standard practice for the larger eurozone countries. That should cushion some of the negative effects, although the question is whether the effective retirement age will increase enough to keep the workforce growing altogether.

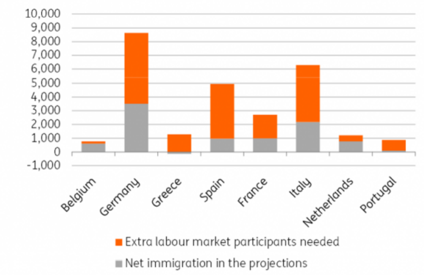
Immigration could also be an important factor in mitigating the decline in the working age population. In fact, migration swings can often be large enough to make demographic projections significantly off the mark. While this is indeed difficult to predict, the current political environment in the eurozone would seem to preclude large immigration flows in the coming years. In fact, as figure 4 shows, they would have to be very large for the working age population to remain stable.

Fig 4 Will the effective retirement age increase to the retirement ages set for 2030?



Source: OECD, ING Research

Fig 5 To maintain labour force growth at 2000-16 average, immigrants are most needed in Germany and Italy



Source: Eurostat, ING Research

The impact on the economy will be significant

It is hard to overestimate the impact of the decline in the working age population. 'Japanification' is a common theme in the markets these days and this comparison to Japan is heavily reliant on demographics. According to a recent Banque de France working paper (2019), the impact of ageing on the economy will be seen in:

- Lower economic growth
- Lower interest rates
- Higher house prices
- Higher aggregate savings ratio
- Higher net foreign assets

Perhaps most relevant, besides the impact on economic growth, is the effect on interest rates. This is significant as BdF (2019) has estimated that global demographic developments between 1980 and 2015 pushed real interest rates down by 157 basis points, and the negative impact is set to continue over the coming decade. This decline is due to a higher aggregate savings rate among older households (on average) and people saving more for retirement, given rising life expectancies. This suggests we are likely to see a continuation of subdued interest rates, as the ageing population starts to bite.

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