The silver tsunami is almost upon us

The growth in the Eurozone's labour force is ending, adding yet more challenges to numerous economies

When we talk about whether the Eurozone economy is in a soft patch or the start of a protracted downswing, it's often overlooked that several structural challenges are threatening to lower potential growth. Ageing is clearly one of them. Focusing on developments of the labour force as opposed to overall population growth shows the Eurozone workforce will hit retirement later than some expect. But rest assured – it will hit it.

Just look around, the Eurozone is in the middle of the grey revolution. The demographic change statisticians have been predicting for a long time, has already started. According to Eurostat estimates, the working age population started to shrink in 2009 and these estimates already take into account some continuing immigration over the next few decades.

Not only does our analysis suggest the end of growth in the labour force will happen soon, it also suggests a strong divide between Eurozone countries. If this scenario materialises, Germany, Spain and Italy will have significantly more difficulty achieving economic growth than, for example, France and the Netherlands, having to rely far more on productivity growth. While robots are often feared, much of the Eurozone may be wishing for their arrival sooner rather than later, though this will leave the European Central Bank having to deal with significantly diverging economies from a labour market perspective.

Thanks to higher participation rates and increases in retirement ages across all countries of the Eurozone, the more severe impact on growth can be postponed for some time. In fact, when focusing on labour force developments, instead of the total or working age population, we find that the active population will only start to shrink in 2020 and the process will be much more gradual than expected.

However, further cushioning of demographic change by higher participation rates will become increasingly difficult. Over the past few years, participation rates in the 55-64 year-old age group have significantly increased, sometimes even doubled. Let's also not forget increasing participation ratios don't fall out of the sky. They have been and will continue to be the result of active labour market policies, investments, strong economic growth and job creation.

Given the demographic changes will only start in 2020, the ECB could first be confronted by inflationary pressures due to an even tighter labour market but face even lower (neutral) interest rates during and after the next recession. Even though expectations about the peak of any rate hikes in the current recovery are already very low, ageing could be the trigger to lower this peak further beyond the next rate cycle.
Challenges stemming from ageing populations have been on European agenda for more than 20 years...

...but there is still unfinished business...

....even though the active population has not shrunk too far...

Postponing retirement has masked weakening demographics for years

The challenges stemming from an ageing population have been on the European agenda for more than 20 years. The 1994 European Summit was the first to flag the need to improve job opportunities for older workers. At the 2001 European Council in Stockholm, a strategy to tackle the (financial) challenges of ageing was agreed that included the reform of pensions. This has been put in place across the Continent and has had a significant impact on labour market demographics over the past few years.

The roll out of this strategy, however, hasn’t mean the challenges have been dealt with; the Eurozone is in the middle of an ageing process and it won’t be much longer before the ‘grey revolution’ finally unfolds. The working age population in the Eurozone, defined as the age group between 15 and 64, peaked in 2009. The decline in this working age group had been anticipated for a while, as the babyboom generation shifts to retirement age. Since 2009, 1.2 million people have fallen out of the 15-64 age group in the Eurozone.

In this piece, we refer to the total population within the 15-64 age group as “working age population” and those that are employed and officially unemployed as “active population” or “labour force”

However, so far, the active population hasn’t shrunk. In fact, despite going through the biggest crisis of the post-war period, the number of labour market participants has continued to increase in the Eurozone. Most of this growth has been driven by people extending their working lives. The labour market reforms of the 2000s have masked the demographic changes seen in recent years. The increase in pension ages and disencouragement of early retirement across Europe has resulted in a much higher participation of older generations.

Fig 1  Eurozone working age population has been flat for a decade but active population has continued to grow (Index, 2000=100)

Fig 2  Participation among 55-64 age group has increased significantly over recent decades

The main trigger to keep the active population growing has been an increase in retirement ages across most Eurozone countries. The participation rate in the 55 to 69 age group increased significantly between 2000 and 2016, from 37% to 60%. At the same time, the participation rate in the 15 to 24 age group declined. This trend has altered the labour supply, making the market top-heavy. While in 2000 the largest
group of workers was still the 35-40 year-old age category, the largest group this year is likely to be the 50-55 year-old category.

The largest shift in participation rates took place in the 55-64 age group. For those aged 55-59, just half were active in the labour market in 2000, while now it is around 75%. The jump among the 60-64 year olds is also impressive, from 21% to 43%. Changes to labour market regulation have been far from consistent across Eurozone countries, but growth in participation rates has been remarkably synchronised. As Figure 3 shows, almost all of the large Eurozone economies have seen participation rates among 55-64 year olds increase, even in Spain and Italy where the global economic crisis caused unemployment to soar. As older workers often work under indefinite contracts that provide significant protection, many remained employed during the crisis.

The momentum behind increasing pension ages seems to have faded though and there is clearly a limit to what can realistically be achieved here anyway. Indeed, several governments have recently started to lower the retirement age for certain (admittedly small) groups of the labour market. Despite successful short-term fixes to combat an ageing workforce, the inevitable will happen at some point and the active population will start to shrink.

According to Eurostat estimates, the Eurozone’s total population of 15-64 year olds started to shrink in 2009. To get a sense of how long it will take for the active population to start declining, we use the population projections by Eurostat and link them to the International Labour Organisation (ILO) projections of labour market participation by age category for the Eurozone and the larger Eurozone economies. The combination of these two projections gives a more realistic idea of future labour force developments than mere population forecasts as the shifting participation rates play such a crucial role in past, current and future active population developments.

The results show the shrinking trend will come, only a bit later. Even though participation rates are set to continue to rise, the demographic projections show that the Eurozone labour force is unlikely to continue to grow for much longer. The pace of increasing retirement age is not keeping up with the number of people leaving the workforce. According to the projections, the active population in the Eurozone starts a gradual decline from 2020 onwards and will be 2.4% smaller in 2030 than it was in 2017. Germany, the Eurozone’s largest labour market, will start to see a decline in active population from 2021 onwards and Portugal, Italy and Spain will experience this even more starkly.
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sooner. Countries with younger populations or stronger projected growth in participation rates will not experience a decline before 2030, although the growth rate of the active population will decrease over time. These countries include France, the Netherlands, Belgium and Greece.

Fig 5 The active population in the Eurozone will start to decline after 2020 according to these projections (000)

If the recent growth in participation rates were to continue, particularly in the older age groups, the results could be slightly different. Assuming continued growth in participation rates in the 55-64 age group, with the 55-59 cohort reaching similar participation rates as those seen in the 30-54 age group (85%), and the 60-64 age group increasing from 45% to 65%, this would delay the turning point in Eurozone participation until 2025.

From all of the above, it seems a turnaround in the active population can only be postponed but not avoided. This is both good news and bad news; it would give policymakers more time to tackle the challenges but this could lead to complacency. As we have said, let’s not forget increasing participation rates don’t fall out of the sky. They have been and will continue to be the result of active labour market policies, investments, strong economic growth and job creation. Postponing the turning point would require a significant acceleration of participation rates in the 65 and older age group.

**Wider implications for the labour market**

The phenomenon of ageing economies is often associated with lower GDP growth rates, low interest rates and a preference for low inflation. However, during the transition period, demographic change will have wider implications for the labour market. Already, there is a shortage of qualified workers in several sectors and countries and this demographic change will only make this problem more acute.

To tackle the problem of finding the right workers, employers and policymakers can revert to only three options: (1) immigration; (2) automation and robots; or (3) higher wages. With the third option, higher wages alone may not be enough to attract qualified workers. Furthermore, higher wages could be a consequence of ageing.

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1 This is mainly because of faster increases in participation rates in Germany in recent years on the back of strong economic growth and migration. At the same time, future participation projections for the harder-hit Eurozone economies could be influenced by people having dropped out of the labour force, hence underestimating actual future rates.
1) Can immigration close the gap?
Immigration is often mentioned as a possible solution to labour shortages arising from ageing populations. While there is no doubt that importing labour can help mitigate the problem, it is unable to fully resolve the issue. The projections by Eurostat already include a significant amount of net migration until 2030, but to maintain the pace of labour force growth seen in the period between 2000 and 2016, a substantially higher number of participants would need to be added. Simply to keep the labour force constant, ING calculations suggest that the Eurozone would already need about 3.9 million extra labour market participants and Germany would need about 1.4 million. However, to maintain the average pace of labour force growth seen in the current millennium, the Eurozone as a whole would need 20 million extra labour market participants on top of what the European Commission is already projecting. Germany would need around 5.1 million, while Spain and Italy would each need around 4 million extra migrant workers by 2030. So while it could certainly alleviate the burden, migration is unlikely to patch a slowdown or decline in the labour force of most Eurozone economies.

Fig 7  Immigration would need to be far higher than projected and at relevant skill levels (000)

Simply to keep the labour force constant until 2030, Eurozone would need 4 million additional labour market participants

2) Will automation negate the problem?
With the labour force set to shrink, it might actually be a relief that robots are coming. Automation is expected to take the place of jobs worldwide over the coming decades, and could counter the retirement of the baby boomer generation. However, it is not certain that automation can replace the types of jobs made vacant by baby boomers leaving the labour market. In a best-case scenario, automation solves the problem of ageing but, in a worst-case scenario, automation simply enhances the mismatch in the labour market. The jury is still out.

Too early to tell

3) Will wage growth finally improve?
Whether wage growth is set to gain from the declining labour force is a big question. While intuitively it makes sense that a declining labour force would lead to labour shortages and therefore higher wage pressures, the jury is still out. Currently, the strong cycle in the Eurozone with an increasing demand for skilled workers has shown just
modest signs of higher wages. Upward pressure is likely to occur, although it might be more subdued than in previous cycles, as is being seen in the US at the moment. Looking beyond the economic cycle, wage growth in an ageing economy will suffer from compositional effects of baby boomers (normally with high wages) retiring, subduing the overall increase. Japan is a good example of this; wage growth has remained subdued despite low levels of unemployment and a shrinking labour force.

**Does it matter for the ECB?**

In general, ageing could pose a new challenge for central banks and bring about a more modest economic outlook for the years ahead with unclear effects on wage growth, which is something that is increasingly on the ECB’s radar.

While the ECB is currently seeking any inflationary traces to finally have the full legitimacy to stop quantitative easing (QE) and start normalising monetary policy, an ageing workforce is adding a new unknown to the ECB’s inflation compass. In fact, it adds several challenges for the ECB.

Barring any economic downturns, the coming decade will see a high number of workers retiring, putting more pressure on an already strained labour force. This could insert more upside pressure on wages and, consequently, inflation. At the same time, without a strong pickup in productivity, the shrinking labour force will dampen economic growth, hence putting downward pressure on (neutral) interest rates. Given the demographic change is due start only in 2020, the ECB could first be confronted by inflationary pressure due to an even tighter labour market but face even lower (neutral) interest rates during and after the next recession. Even though expectations about the peak of any rate hikes in the current recovery are already very low, ageing could be the trigger to lower this peak even further looking beyond the next rate cycle.

**The retirement cliff will come, only a bit later**

Not only does our analysis suggest that the end of growth in the labour force will happen soon, it also suggests a strong divide between countries. If this scenario materialises, Germany, Spain and Italy will have significantly more difficulty achieving economic growth than, for example, France and the Netherlands, having to rely far more on productivity growth. While robots are often feared, much of the Eurozone may be wishing for their arrival sooner rather than later and the ECB will have to deal with significantly diverging economies from a labour market perspective.
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