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The ageing population: a threat to the European Union's international role?

Summary

This paper analyses the consequences for the European Union of the tendency for our society to age, a trend which will deepen over the coming decades. Ageing will affect the economic potential of the EU, as the proportion of dependents in our society grows and the proportion of workers declines. This will in turn feed through to the relative economic position of the EU as compared with societies which are ageing less rapidly, most notably the USA.

However, there is still time prepare for - and even to mitigate - these unprecedented demographic changes. A range of policy options could be effective, particularly if implemented together. We consider ways in which our governments, at national and EU level, can address the problem. They may try to alter the underlying trend, for example by extending working lives. They may also work to reduce the burden on national budgets and the load on future populations, for example by encouraging private pension provision, and greater capital funding instead of pay-as-you-go.

As bankers we focus in particular on the perspective of the international financial markets. The markets will penalize our governments, through their debt ratings and borrowing costs, if they are unable to finance their pension obligations. On the other hand, we highlight the benefits for the euro and for investment in the EU if the problem is tackled.

We conclude that, for the banking sector, current demographic trends offer many new business opportunities. For governments they offer a huge challenge, requiring the courage to take unpopular decisions, but one which is not insurmountable.

Throughout this paper, references to the European Union are to the Union prior to the enlargement which took place on 1st May 2004. The source of data is Eurostat unless otherwise stated.

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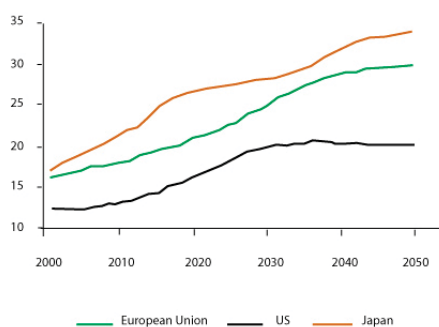
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1. The problem: two parallel demographic trends

In most EU member states, two parallel demographic trends - declining fertility and increasing life expectancy - are leading to a significant increase in the percentage of the population over the age of 65 years. This tendency for the population to age will be accentuated from 2010 onwards as the post-war baby boom generation reaches retirement.

Birth rates have fallen markedly in recent decades. The number of children per woman has declined from an average of 2.7 in 1960 to 1.5 in the EU, which is among the lowest levels in the world. In many EU countries, births have been below replacement level (an average of 2.1 children per woman for the EU as a whole) for some years.

For the past 150 years, life expectancy has been growing, thanks to medical advances and higher living standards. Life expectancy now averages 75 years for men and 81 years for women, compared to 67 and 73 years respectively in 1960. The traditional pyramid population structure, with large numbers of young people working to support a smaller number of the old, will be inverted and the so-called dependency ratio will worsen. Today, for every person over 65 years in Europe, there are 4 people of working age; by 2050, there are projected to be 2¹. As not all people of working age do in fact work, the real ratio of dependents to workers will be even higher. Currently benefit systems in many countries encourage early retirement. Around the EU, on average only 40% of the people between the ages of 55 and 64 are in official employment.



Graph 1: Over-65s in major world economies
(Source: US Bureau of the Census, ABN-AMRO)

Although the ageing problem is widespread in the developed world, not all economic areas will be hit as hard as Europe. In the USA, the population will age significantly, but higher fertility and immigration should ensure that the average age of the population rises more slowly than in Europe. The proportion of over-65s in the US should flatten out between 2030 and 2050 at 20% of the population. The US population is expected to continue to grow steadily through to 2050, whereas after 2020 the EU population is expected to be declining. In Japan, the ageing trend is more serious even than in Europe, with nearly 35% of the population forecast to be over 65 years old by the middle of this decade. (Graph 1)

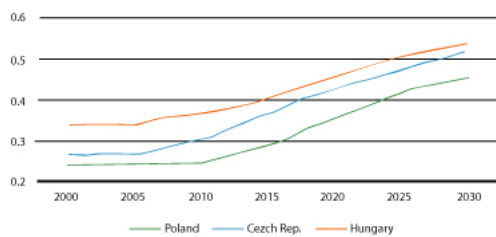
The ageing trend is not uniform among EU countries. It is most marked in the Mediterranean countries. Italy, Spain and Greece have the lowest fertility rates in the EU (an average of 1.24, 1.25 and 1.29 children per woman respectively), and have experienced alongside this significant improvements in life expectancy. In Spain, for example, average male life expectancy rose from 67 years in 1960 to 76 years in 2001, and female life expectancy from 72 to 83 years over the same period. By 2050, it is estimated that the population of over-65s as a percentage of the working age population will have reached 60% in Italy and Spain. Ageing is least apparent in Ireland, Luxembourg and the Netherlands. France and Germany are close to the average, although France has a significantly higher fertility level than Germany². Labour participation rates are also lower in some Mediterranean countries, where early withdrawal from the workforce is commonplace.

The Central and Eastern European countries are experiencing a slump in birth rates that is far more precipitous than that of the EU-15. This is also combined with an increase in life expectancy, a trend that is likely to gather momentum as their economies modernize. Since 1975, for example, the birth rate in the Czech Republic has fallen from 2.4 to 1.1 children per woman, one of the lowest in the world. Because the decline in fertility is recent, the ratio of dependents to workers in the Eastern European countries is still favourable.

¹ Annex, Table 3

² Annex, Tables 1 and 2

Current projections suggest that ageing will begin to accelerate around 2010, at the same time as in Western Europe. By 2030, the ratio of pensioners to workers could have almost doubled.



Graph 2: Over-65s in selected CEE
(Source: UN, Eurostat, HVB Group)

In many developed countries, ageing has been accompanied by an increase in immigration. In the USA, the foreign and foreign born labor force had grown from 9.8% of the total in 1993 to 12.4% by 2000. Some EU countries have also experienced strong growth in immigration over the last decade, although few approach the level currently seen in the USA. By 2000, for example, the foreign contribution to the labour force had reached 10.5% in Austria, 3.4% in Denmark, 3.7% in Ireland, 3.6% in Italy, 4.9% in Norway and 5% in Sweden. In Germany it remained more or less stable between 1997 and 2000, at 8.8%. In 2000, 850,000 new permanent immigrants arrived in the US, with a further 2.7 million arriving on a temporary basis. By way of comparison, various official sources indicate inflows of foreign population of 119,000 to France, 271,000 to Italy and 289,000 to the UK in the same year. (OECD).

2. The consequences of an ageing society:

(i) weaker output, higher prices

Ageing will have a fundamental effect on the EU's wealth and international competitiveness unless steps are taken to counter the current trends.

Other things being equal, an ageing, shrinking population will tend to reduce potential output, as the proportion of workers in the population falls, and the number of dependents grows. If adequate provision has not been made by earlier generations of workers, the tendency of these factors to depress growth will

be exacerbated. Those who are in employment in the future will have to finance the increasingly heavy cost of pensions, healthcare and other needs of society's older members at that time. The resulting increased burden of tax and social security contributions may undermine employees' ability to consume, as well as reducing the incentive to work and be productive. Employers may be deterred by higher non-wage labour costs from taking on staff and investing in their business.

On the demand side, the pattern of investment will need to change to reflect demographic trends, increasingly serving the needs of the old (for example with the construction of more residential homes) rather than the young (schools, universities). The consumption of the new generation of retirees is likely to be higher than in previous generations, reflecting their improved health and more active lives. Notwithstanding this, investment needs will tend to fall as the working population declines. Empirical studies show that population ageing also has a direct effect on savings. The savings rate tends to be lower as the proportion of the population above retirement age grows, since savings begin to be drawn down from late middle age onwards. The more spendthrift ways of future retirees will tend to deepen this trend. A lower volume of savings reduces the funds available for productive investment and output, unless capital can be attracted in from outside.

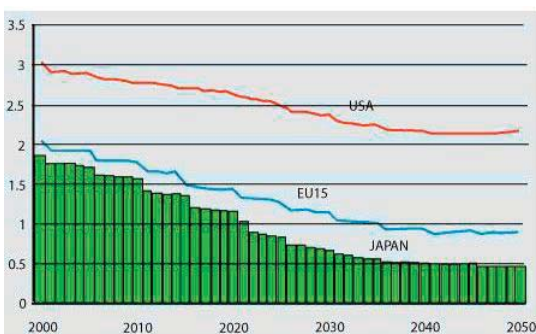
Inflationary pressures may mount on all sides. If governments are unprepared for the cost of ageing, they will find it hard to avoid an inflationary cocktail of higher taxes/social security contributions and borrowing. The tighter labour market and higher social charges will both tend to push up wages. Nor is enlargement likely to bring the bonus of cheaper labour: by the time the EU-15 are ready to allow immigration in large numbers, wage levels are likely to have risen in the countries of origin.

Commission studies based on their economists' ageing model present a potentially bleak outlook. If policies remain unchanged, they estimate that between 2000 and 2050 current population trends will cause the average rate of growth in living standards (or GDP per capita) to be about 0.4% a year lower in the EU and Japan, and about 0.25% a year lower in the US. The EU's potential growth will have fallen from the present underlying rate of 2-2.25% possibly to below 1%. The US should continue to enjoy an annual average potential growth rate of 2.5% over the next 50 years.

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The Commission offers a stark warning about the EU's ranking in the world economy:

“In terms of the distribution of global output, these persistent differences in potential growth rates between the EU and the US result in large changes in their relative economic importance in the world, with the EU's present share of 18% of world production falling to 10% in 2050 and with that of the USA continuing to rise from 23% in 2000 to 26% in 2050.”³



Graph 3: Impact of ageing on potential growth rates, EU, USA, Japan (Source: Commission Services)

(ii) a devastating deterioration in public finances?

Government spending on health and pensions has been rising steadily in recent decades. In most EU countries, pensioners rely on the state to provide most, and in some cases as much as three quarters, of their post-retirement income. Exceptions are the Netherlands and the UK, and to a lesser extent Denmark and Ireland, where capital-funded supplementary pensions account for a significant part of pensioners' income.

The scale of the welfare burden at present (about one third of all EU government expenditure) demonstrates the challenge ahead as ageing progresses. If an ever-higher proportion of output is hypothecated for such spending, the burden on the working population will spiral. Governments will be faced with the unappealing options of increasing their budget deficits; boosting revenues through higher taxes; or reducing pension entitlements. No matter which of the two traditional ways governments use to cover increased costs - taxation or borrowing - the charge will act as a drag on the economy, in turn reducing the scope for fund-raising.

Projections from the European Council's Economic Policy Committee (EPC) show the age-related portion of public spending (notably pensions, health care and long-term care) leading to an increase in public spending of between 3 and 7% of GDP in most member states by 2050, if policies remain unchanged. In most countries, the Committee reports, the budgetary impact of ageing will begin to take effect from as early as 2010.⁴

A graphic presentation of the fiscal effects of leaving the problem untreated is provided by ABN AMRO Bank's State Pension Analysis (SPA) model⁵. The model was applied to forecast demographic data for the EU to generate estimates of the effect of population ageing on the state pension bill. The basic scenario, which assumes no change in policy, shows pension spending growing from around 10% of GDP to 28% by 2050. The growing burden on the public sector would then lead to a spiral of higher deficits and interest payments on debt.

These figures are for pensions costs alone. While ageing will reduce pressure on some types of public spending, such as education and child-care, other non-pension spending, in particular healthcare and long term care for the elderly, will be under relentless upward pressure. The increased pressure from these categories of spending will far outweigh the savings elsewhere. It is difficult to estimate future healthcare costs, given the speed of medical advance. It is particularly difficult to predict the likely demands of our future, more energetic retirees. We can be almost certain that demand will exceed expectations, pushing healthcare spending well beyond its current level of 6- 10% of GDP in most EU countries.

Among the existing EU members, there are wide differences in the level of preparedness and in the sustainability of the ageing burden. This is partly because of differences in the generosity of public support and therefore likely outgoings on pensions, and partly because of differences in revenues, for example

³ European Commission, *European Economy N° 6/2002*

⁴ Economic Policy Committee "The impact of ageing populations on public finances", October 2003

⁵ ABN AMRO report "Desire to retire: The European pensions problem" February 2003

due to labour participation rates and other social factors. The level of public indebtedness is also relevant, as it affects government's ability to fund increased social payments, whether through current revenues or borrowing. The EPC's evaluation of member states' reports on the sustainability of public finances for 2002 indicates that on the basis of current budgetary positions there is a risk of budgetary imbalance in breach of the Stability and Growth Pact (SGP), measured against the 60% of GDP debt reference value, in around half of the cases.

The SPA model results provide a useful basis for comparison, by estimating the amount countries would need to set aside now to cover pension commitments up to 2050, assuming no change in policy. Their estimates of the resulting pensions debt show Spain and Greece facing by far the most serious difficulties but France, Portugal, Finland and Belgium in a grave situation. Only the United Kingdom seems well-placed to meet its pension obligations.

Pensions debt by 2050*			
% of GDP			
UK	14	NL	85
IE	150	D	188
L	199	SW	201
A	223	I	230
B	296	DK	264
F	327	PT	327
FR	332	E	665
GR	698		
* Net present value based on unchanged policies			

Table 1: Country-by-country, pensions debt as % GDP
(Source: ABN AMRO)

These projections are based on the assumption of unchanged policies and present a scenario which is unlikely to be realized. EU member states are already introducing changes to their pension systems and other measures to address the problem. Nevertheless, as demographic developments can largely be anticipated, these projections give policy-makers an indication of the scale of the problem while there is still time to influence the outcome. Unfortunately, so far the changes introduced are not sufficient to deal with a problem of this magnitude.

3. What EU policy makers must do to defuse the threat

There is a common interest among EU countries in achieving sustainable social security funding, just as there is a common interest in fiscal sustainability as a whole. Both are foundations for future growth, which is one of the major attractions of membership of the EU club.

The EU authorities have made serious efforts to focus attention on the issue. Successive European Councils have put pressure on member states to reform their pension systems (in particular the Council of Laeken in December 2001), and to put public finances in order so as to prepare for the fiscal pressures caused by ageing (a continuing theme of European Commission reports on the sustainability of public finances). In addition the microeconomic reforms envisaged in the Lisbon Strategy include measures to enhance productivity and increase employment levels. In November 2003, the Council of Economics and Finance Ministers invited the Economic Policy Committee to present by end-2004 a study on economic incentives affecting retirement, in light of the Lisbon Strategy objective of raising the employment rates of older workers (55-64 years old) to 50% by 2010. In March 2004, the Brussels European Council again reaffirmed the importance of these structural reforms.

But efforts to coordinate action at EU level are limited, as tax and social welfare policies remain a national prerogative. A further complication is that no single measure taken at national level will deal with such a large-scale problem. A range of measures will be necessary, to enlarge the working population, control outgoings and generate new sources of funding. The mix of policies required will depend on the features of the domestic economy. One of the great advantages of Europe is the diversity of policy approaches in the different countries. We have a range of competing ideas and approaches from which to draw lessons. While there will be no single panacea applicable throughout the area, some measures will be more effective than others. Attempts to change the demographic trends themselves may bring results relatively quickly. For example, the quality of child-care in the Scandinavian countries is a major factor in encouraging fertility and female participation in the labour force. (This message has not been lost on the German government, for

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one, which is budgeting for greatly increased services for parents.) Such steps are inseparable from efforts to promote sustainable economic growth in the longer term, and some farsightedness will be required from political leaders to implement them. Their results will be seen over a longer time horizon than the perspective of most politicians - over decades rather than years.

(i) stimulate production potential and lower the dependency ratio; reform pension systems

Micro-economic reform alone cannot swing the pendulum back far enough to make forecast pension liabilities financially viable, but it can reduce the scale of the problem.

Perhaps the most crucial step would be to raise employment and activity levels closer to those achieved in the US. There is plenty of scope for increasing the employment rate of the 55-64 year age group, which ranges from less than 30% in Belgium and Italy to nearly 70% in Sweden. In part, the frequency of early retirement reflects rigidities in the labour market, such as the lack of retraining opportunities. A range of labor market and welfare reforms, such as those envisaged in the Lisbon agenda, are required. The reforms should focus primarily on raising participation levels - in particular, to lengthen working lives, increase female employment and reform benefit systems which discourage work - and promoting labour market flexibility. There are signs of progress in undertaking such changes. In Germany, for example, pension entitlements are being cut for early retirees, and increased for those who retire after the age of 65. Italy and Austria have introduced similar measures. In a good number of member states, the statutory retirement age is being increased, scope for early retirement is being restricted, and the link between contributions and benefits is being strengthened.

To some extent, working lives should lengthen naturally as life expectancy improves. Future generations of more active older people may also have a stronger desire to work so as to maintain their standard of living. Governments and employers will need to take steps to help older workers to be reintegrated into the official workforce. The new generation of retirees will be on average healthier and better educated than their predecessors, so preconceived ideas about productivity may need to be revised.

Some measures risk being counter-productive. The linking of state pension entitlements to means, for example, penalizes thrift and encourages dependency. Public pension payments need to be decoupled from earnings. Otherwise, improvements in education and investment in technology and innovation, which improve productivity, will also lead to increases in pension entitlements. Similarly, an increase in the retirement age may lead to higher pension entitlements.

Attempts by governments to be pro-active, and adjust pension conditions in advance, are deeply unpopular. Recent public demonstrations against pension reform in France, Italy and Austria, show the sensitivity of a powerful section of the population to change, particularly when it concerns the retirement age or otherwise tinkers with existing entitlements. But reform is inevitable. Governments need to make their populations aware of this and take on the responsibility of changing attitudes to retirement. Despite the complexity and unpopularity of labour market and welfare reform, some EU countries have shown that progress in this area - albeit slow - is possible.

(ii) reduce the state's share of the cost of social welfare

Most Western European state pension systems, are based primarily on the Pay-As-You-Go (PAYG) system, with the current workforce paying the retirement benefits of the current generation of pensioners. If no steps are taken to increase labour market participation in Europe, the dramatic reduction in the workforce will make state pensions funded by PAYG unaffordable.

One option is for the public sector to switch from PAYG to capital funding, whereby the government sets aside capital, on which interest will be earned, to pay pensions in the future. This has the attraction of inter-generational equity: it requires the present generation of workers to pay for their own pensions. But a full switch is unlikely to be workable given the stretched state of public finances, as it would require current workers to shoulder the load of paying for the future as well as the current generations' pensions. Capital funding is also inherently more risky than PAYG as returns on capital are uncertain, leaving the government exposed to the risk of being expected to make up any deficiency. However a partial shift to capital funding could help to cover against future reductions in PAYG contributions,

while not imposing too heavy a charge on the current workforce. Ireland's pension reserve fund offers a useful model. Established in 1999, by 2002 its assets amounted to some 7% of GNP. The government is committed to set aside 1% of GNP for the fund each year, so that a substantial block of capital should be available when pension demand accelerates. A prerequisite for such reforms is that governments have, and maintain, control over debt levels.

Direct resort to the private sector, by increasing the tax/pension load for individuals and their employers, carries with it a risk of perverse consequences - with individuals less willing to work and companies to employ - and must therefore be handled sensitively. Those countries expecting to maintain high tax ratios in order to meet funding targets - notably Denmark, Finland and Sweden - are likely to pay a price in lost competitiveness and some shrinkage of the tax base, as the factors of production, labour and capital, are increasingly mobile. Nonetheless, countries with tax-financed systems may do better than countries with social security-financed systems: whereas tax spreads the burden among the whole population, social security places the load on the shoulders of the working population alone.

Governments will never shed the burden of funding pensions entirely, and it seems likely that public pension schemes will continue to be the main source of post-retirement income in most member states. But the partial privatization of pensions through the encouragement of supplementary savings is an attractive way to reduce the strain on the public purse. It may offset the tendency for personal savings to fall as the population ages and should also improve labour mobility. The differences between EU member states' reliance on state pensions suggests that there is scope to change national habits, for example through tax incentives. There are signs that private pension provision is becoming increasingly important, and the mixed public/private model exemplified by the Netherlands, Ireland and the UK is increasingly popular. The UK has succeeded in shifting worker and employer expectations over a period of decades, with the result that there is a relatively low reliance on state pensions and high use of private and occupational pensions and tax-advantageous investments. Its government has the objective of increasing the share of pensions provided privately from 40% to 60% by 2050.

If the shift towards a mixed system is to occur, careful regulatory oversight will be needed to protect

investors and limit the risk of pressure for a government bail-out if investments do not bring the anticipated returns. Government can foster a climate that encourages private saving by educating their population about the need to save, reducing the complexity of pension procedures and promoting investor confidence.

(iii) ensure public finances are sustainable in the longer term

At the core of the EU's growth initiative are efforts to bring down public debt to manageable levels. Since March 2001, the EU Council has begun to review regularly the long-term sustainability of public finances, including the expected strains caused by demographic change. Public finances must be as healthy as possible if the new demands are to be supported.

So far, the countries which have developed comprehensive strategies to cut debt levels and run surpluses ahead of the ageing pressures are in a minority. France, Italy and Germany are struggling to return their finances to conformity with the terms of the Stability and Growth Pact, while facing fierce domestic opposition to pension and welfare reform. The disciplines of the SGP should bolster member states' efforts to introduce necessary but unpopular policies. This has been the case for Belgium, where a reduction in the public debt has been a high priority in its strategy for dealing with ageing pressures. Unfortunately, currently the SGP is facing a crisis of confidence. In order to ensure its survival, greater flexibility in its application is needed. Countries with low levels of public debt could be given greater latitude in running deficits than countries with high debt levels, provided that they will not be faced with above-average liabilities, for example for pension payments, in the future. To ensure consistency in comparing future pension liabilities, it would be necessary to differentiate between funded and unfunded obligations. It would also be helpful to distinguish between types of spending, favouring investment over current expenditure and encouraging a focus on good quality growth. Consideration could be given to offering financial incentives from the EU budget to stimulate appropriate reforms. Above all, the SGP needs to be the centrepiece of a broadly-based strategy to revive the growth potential of the EU economy.

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(iv) promote the single market and pension flexibility

Governments have a crucial role to play in facilitating the efficient allocation of capital, in particular by liberalizing the rules for asset allocation by pension funds and life assurance companies, and in promoting the free movement of workers around Europe. Within the EU, the regulatory environment for pensions is improving. On the one hand, barriers are being torn down, taking advantage of the single currency, so as to unify financial markets. On the other hand attempts are being made to encourage the creation of EU-wide pensions, to allow pension-holders to benefit from cross-border provision of occupational pensions and portability. A Commission Communication of April 2001 sought to eliminate national tax rules which discriminate against occupational pension contributions paid into a pension fund in another member state. The Commission has since launched proceedings against a number of member states, and its efforts are bringing results. The Occupational Pensions Directive, which was approved in May 2003, makes it possible for a multinational company to operate a single pension fund in one member state to cover all its employees within the EU. Over time, we should see a reduction in tax and other obstacles to the cross-border-provision of occupational pensions. These measures, taken alongside steps to improve the cross-country portability of social security rights, will help to improve labour mobility (in which the EU is at a distinct disadvantage to the US) and develop the EU's growth potential.

Alongside such advances, an appropriate regulatory structure for pension funds is needed to ensure a climate of investor confidence. This would allow the market to expand to meet the growing needs of the new pensioners, giving pension funds broader horizons - perhaps reducing their bias towards domestic investment - and permitting individuals to seek out the most advantageous arrangements with a clearer understanding of the risks.

(v) look afresh at immigration, trade and development policies

International migration has been on the increase since the mid-1990s, although not all EU countries have participated in this trend. As Table 4 in the Annex shows, the UK, Spain and Italy have seen significant increases

in immigration whereas the Scandinavian countries among others have not seen such a clear upward trend. The immigration of skilled labour, allied with labour force mobility, is a driving force of economic strength, and is one of the reasons for the vitality of the US economy. The US Census Bureau's central projection suggests that over the period 2000-2050 more than one third of the expected increase in the US population will come from international migration flows. Whereas the US population was half that of the EU in 1950, by 2050 it is expected to be 40 million higher (excluding the effect of EU enlargement). A new look at the issue by EU governments could suggest policy changes to moderate the ageing trend. The German government's new Immigration Law indicates that it recognizes the need to attract skilled foreigners to the domestic workforce.

Governments would also do well to bear in mind the importance for the more developed economies of sustaining growth in the more populous and slow-ageing developing world. The income from investments outside the EU will help to maintain our greying economy's standard of living.

4. The financial markets: challenges and opportunities

(i) market disciplines and sanctions

In the absence of preparatory measures, ageing is likely to reduce the international competitiveness of the EU as a producer of goods and services. It may also affect the desirability of the EU as a destination for investment, although the EU will be benefiting in the coming years as the investment synergies from the greater integration of its enlarged economic area take effect. Our prime international competitor, the USA, will not be as severely affected by ageing. In the longer run the value of the euro will reflect the extent to which EU governments tackle this demographic divergence.

The financial markets also impose fiscal discipline on governments directly through their cost of borrowing. As the credit rating agency Standard and Poor's (S and P) notes in a recent report⁶, countries which have to borrow very heavily to fund their age-related spending, may see their sovereign credit ratings come under downward pressure. S and P identifies the Czech Republic, Poland, Portugal, France, Germany, Greece and the

Netherlands as the European countries particularly at risk of fiscal deterioration. It observes that:

“Using fiscal balance trends as empirical long-term proxies for sovereign creditworthiness, a collective slide down the ratings scale would commence early in the next decade. It would continue until the mid-2030s, by which time the vast majority of countries would display fiscal characteristics that today are associated with non-investment grade sovereigns.”

Although the report stresses that this is not a prediction and that it is unlikely that governments would allow their finances to spiral out of control in this way, it presents a sobering warning.

(ii) global developments induced by ageing

Whatever the policy stance of governments in the face of this challenge, there will be fundamental changes in the structure of world financial markets and world-wide financial flows as a result of demographic changes.

Ageing can be expected to exert downward pressure on interest rates overall, as the demand for capital to support the working population declines. European Commission forecasts point to a fall in worldwide real interest rates of the order of 0.75 per cent over the next 50 years⁷.

Global demographic differences, particularly between the developed and developing worlds, can be expected to affect savings and investment balances around the world. These will in turn influence external net asset positions and real exchange rates. As ageing progresses in the developed world, the EU and Japan in particular, it may well lead to a decline in the total amount of savings and a reduction in the investment in the domestic capital stock as requirements fall. Unless investment opportunities at home are good, any excess savings will then seek out higher returns abroad. Changes in the net volume of investments held overseas and the balance of payments will affect the real exchange rate of the euro. The Commission estimates that the EU could benefit from growing current account surpluses in the coming decades if it succeeds in encouraging domestic savings to grow. Other things being equal, this should lead to an appreciating euro. The moral is clear: structural reforms now will boost domestic wealth in the future.

There will also be changes both in the composition and the destination of the capital flows. If steps are taken ahead of time to fund the needs of retirees, by boosting savings (public and/or private), the resources of pension funds are likely to grow significantly. The more obligations are provided for in advance, the more rapidly this pool of savings will accumulate. The size of private pension funds in relation to GDP varies considerably among developed countries. There appears to be scope for further development of this source of funding in the EU countries, where only the Netherlands and the UK have achieved levels comparable to the US figure of 75%⁸. The flows of pension and insurance fund monies across borders will themselves encourage greater integration in financial markets.

A high and rising volume of private pension fund savings will be seeking a home in good quality investments, particularly equities and corporate bonds. Although we may see an increase in the supply of securities as governments take on new debt, if governments have succeeded in shifting the burden away from the public sector fresh demand could put upward pressure on prices overall, and downward pressure on rates of return. The portfolio and risk preferences of older people will affect the relative prices of stocks and bonds, or the “risk-premium”. Normal expectations of investor behavior may not apply when ageing is accompanied by a lengthening of life expectancy. It is generally expected that aversion to risk increases with age, but there may well be a greater willingness to accept risk if the investor’s time horizon is longer.

(iii) new opportunities for financial services providers

Financial service providers have an important role to play in shifting the burden of welfare provision from governments and providing financial security to the retired. The demand for ageing-related financial services will continue to grow, reflecting the fact that people are living longer and state pensions are becoming less generous. Demand for private and corporate

⁶ “The Western World Past its Prime - Sovereign Rating Perspectives in the Context of Ageing Population”, March 2004

⁷ European Commission, *European Economy* n° 6/2002

⁸ Preliminary 2001 figures, OECD

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pension schemes will inevitably expand. The profile of all pension providers, public and private, must take account of a new factor: the increase in longevity risk. Occupational pension schemes will increasingly seek to avoid the risk by switching from defined benefit to defined contribution schemes. Banks can help to cover this risk through providing annuities, although the return on annuities is likely to become less attractive.

Individuals, facing the possibility of a retirement lasting as long as 50 years, will be aware that their accumulated wealth and benefits may have to be spread over many more years than those of previous generations. In addition to seeking traditional pension products, they will be demanding services tailored to the specific needs of the new elderly, such as equity release schemes, wealth management (in particular for lump sums), investment advice, and insurance for long term care. Financial advice will need to be tailored to the risk and investment preferences of the new elderly. Increasingly, the notion of catering to the customer's needs over the life cycle will take hold.

5. Conclusion: seize the moment

The chief economists of European banks and banking federations urge EU member states to face up to the challenge of ageing, which will affect all areas of public policy.

Governments' main efforts should be concentrated on tackling three problem areas in particular.

- 1) Increasing the birth rate is particularly important since in many EU countries births have been below replacement level for some years and are expected to stay below replacement level in the foreseeable future.
- 2) Switching to partially capital-funded pension systems, eventually considerably decreasing the pay-as-you-go share of the final pension of the retired individual.
- 3) Limiting early retirement possibilities for existing employees and eliminating the additional incentives for early retirement. Even more, timely retirement should be encouraged, at least for the time being. A gradual and moderate increase of the retirement age should also be considered as an option.

The economic and social consequences of inaction are

fairly clear. Europe is likely to be less prosperous than it would be otherwise, and its population less contented. The political consequences of inaction are harder to measure. Since Europe's international role to a great extent reflects its relative wealth and economic importance, its influence may decline. Beyond this, if the EU is seen to have failed to secure the longer term wellbeing of its citizens, the glue which binds the countries of the Union may weaken.

Governments have the time to introduce measures before the impact of demographic changes begins to be felt. If they build on the reforms that they have already introduced, we believe that they have a good chance of addressing the problem and maintaining Europe's economic and social cohesion. The rewards of success should include not only greater prosperity and financial security for its citizens, but also a consolidation of Europe's international position.

This edition of the Letter is written by the Economic and Monetary Affairs Committee of the FBE, which has the following members:

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Georges MARTIN - Association Belge des Banques (Belgium)

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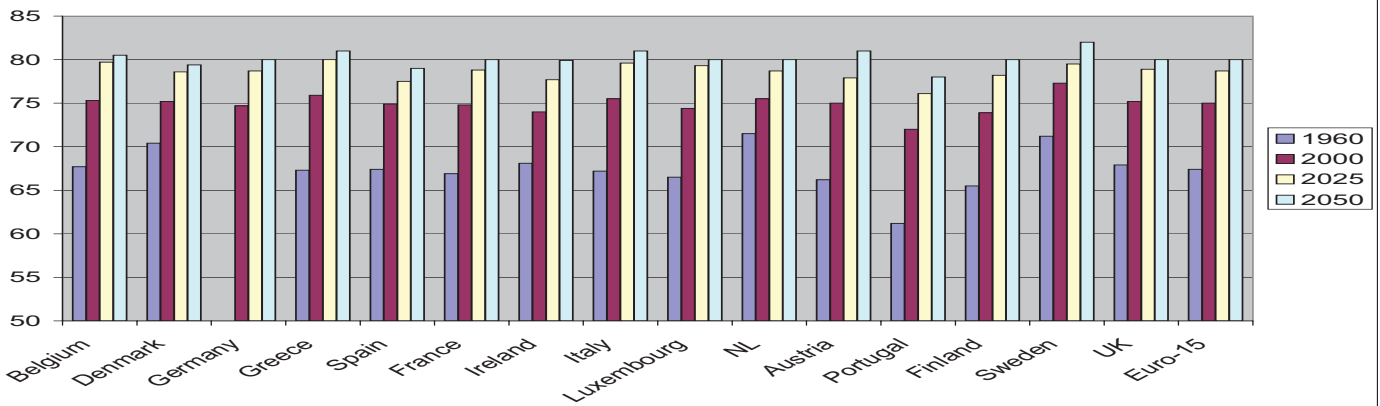
Jeremy PEAT - The Royal Bank of Scotland Group (United Kingdom)

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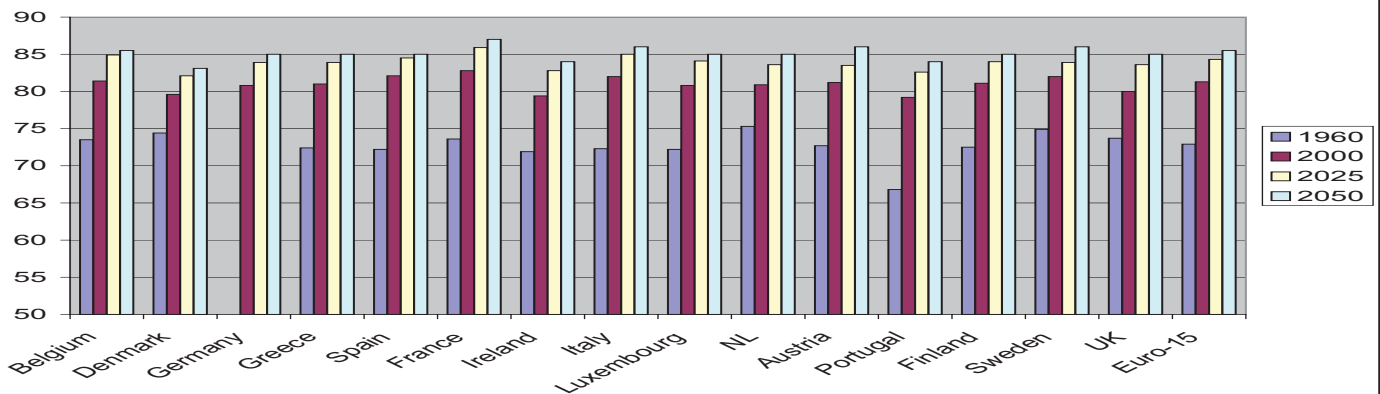
1. Life expectancy at birth								
	MALE				FEMALE			
	1960	2000	2025	2050	1960	2000	2025	2050
Belgium	67.7	75.3	79.7	80.5	73.5	81.4	84.9	85.5
Denmark	70.4	75.2	78.6	79.4	74.4	79.6	82.1	83.1
Germany	n.a.	74.7	78.7	80.0	n.a.	80.8	83.9	85.0
Greece	67.3	75.9	80.0	81.0	72.4	81.0	83.9	85.0
Spain	67.4	74.9	77.5	79.0	72.2	82.1	84.5	85.0
France	66.9	74.8	78.8	80.0	73.6	82.8	85.9	87.0
Ireland	68.1	74.0	77.7	79.9	71.9	79.4	82.8	84.0
Italy	67.2	75.5	79.6	81.0	72.3	82.0	85.0	86.0
Luxembourg	66.5	74.4	79.3	80.0	72.2	80.8	84.1	85.0
NL	71.5	75.5	78.7	80.0	75.3	80.9	83.6	85.0
Austria	66.2	75.0	77.9	81.0	72.7	81.2	83.5	86.0
Portugal	61.2	72.0	76.1	78.0	66.8	79.2	82.6	84.0
Finland	65.5	73.9	78.2	80.0	72.5	81.1	84.0	85.0
Sweden	71.2	77.3	79.5	82.0	74.9	82.0	83.9	86.0
UK	67.9	75.2	78.9	80.0	73.7	80.0	83.6	85.0
Euro-15	67.4	75.0	78.7	80.0	72.9	81.3	84.3	85.5

Eurostat: European Social Statistics (2002), figures for 1960 only / Central Demographic Scenario (Oct. 2001)

Life expectancy at birth - Male



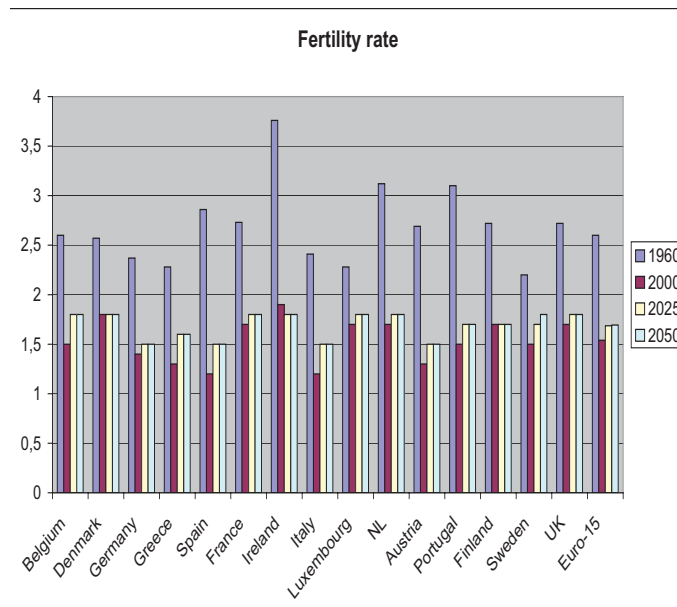
Life expectancy at birth - Female



2. Fertility rate

	1960	2000	2025	2050
Belgium	2.56	1.5	1.8	1.8
Denmark	2.57	1.8	1.8	1.8
Germany	2.37	1.4	1.5	1.5
Greece	2.28	1.3	1.6	1.6
Spain	2.86	1.2	1.5	1.5
France	2.73	1.7	1.8	1.8
Ireland	3.76	1.9	1.8	1.8
Italy	2.41	1.2	1.5	1.5
Luxembourg	2.28	1.7	1.8	1.8
NL	3.12	1.7	1.8	1.8
Austria	2.69	1.3	1.5	1.5
Portugal	3.10	1.5	1.7	1.7
Finland	2.72	1.7	1.7	1.7
Sweden	2.20	1.5	1.7	1.8
UK	2.72	1.7	1.8	1.8
Euro-15	2.59	1.54	1.69	1.69

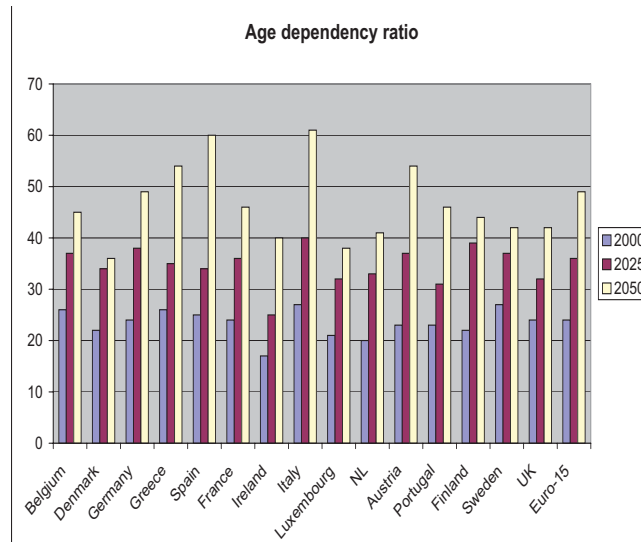
Eurostat: European Social Statistics (2002), figures for 1960 only /
Central Demographic Scenario (Oct. 2001)



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3. Age Dependency Ratio			
	2000	2025	2050
Belgium	26	37	45
Denmark	22	34	36
Germany	24	38	49
Greece	26	35	54
Spain	25	34	60
France	24	36	46
Ireland	17	25	40
Italy	27	40	61
Luxembourg	21	32	38
NL	20	33	41
Austria	23	37	54
Portugal	23	31	46
Finland	22	39	44
Sweden	27	37	42
UK	24	32	42
Euro-15	24	36	49

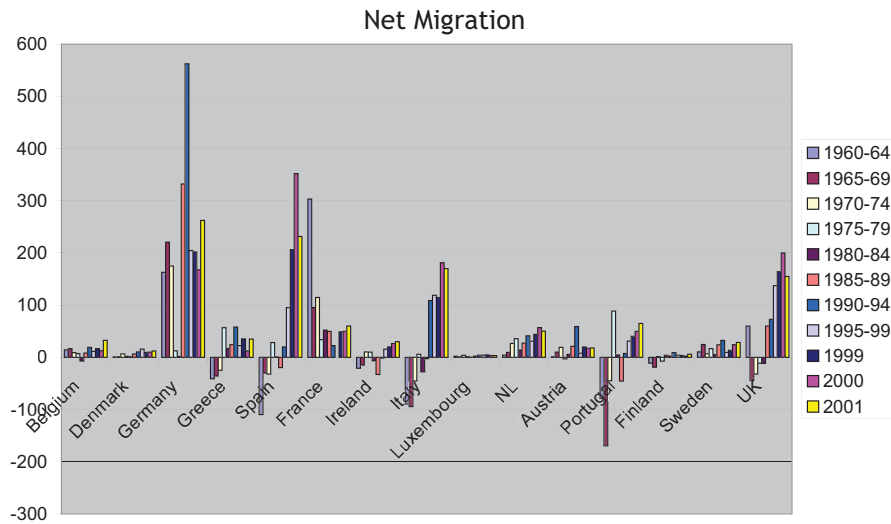
Population aged 65+ as % Population aged 15-64
Eurostat: Central demographic scenario (2001)



4. Net migration

	1960-64	1965-69	1970-74	1975-79	1980-84	1985-89	1990-94	1995-99	1999	2000
Belgium	14.3	16.7	9.0	7.2	-7.1	8.2	19.3	11.5	16.7	12.9
Denmark	0.9	1.0	6.5	2.0	1.1	6.4	10.6	15.7	9.4	10.1
Germany	162.9	220.7	175.1	12.6	1.8	332.2	562.6	204.5	202.1	167.9
Greece	-41.2	-35.8	-24.8	56.8	17.2	24.4	58.1	22.5	35.4	12.3
Spain	-109.7	-30.1	-32.1	28.3	0.8	-19.7	20.1	95.4	206.4	352.1
France	303.4	95.3	114.8	33.8	52.3	49.8	22.5	0.0	48.9	50.0
Ireland	-20.9	-14.8	10.3	10.1	-6.6	-32.9	-1.4	15.8	20.0	26.5
Italy	-89.5	-94.3	-45.2	6.0	-27.8	-2.5	108.9	118.9	114.7	181.3
Luxembourg	2.1	0.9	3.9	1.4	0.4	2.2	4.1	4.2	4.7	3.6
NL	4.2	9.6	26.7	35.7	14.2	27.4	41.4	31.0	43.9	57.0
Austria	1.0	10.0	19.1	-3.0	5.6	21.1	59.0	8.0	19.9	17.3
Portugal	-78.4	-169.7	-45.0	88.8	4.5	-45.4	7.3	31.3	40.4	50.0
Finland	-11.2	-18.9	1.3	-7.3	4.1	2.4	9.0	4.2	3.4	2.4
Sweden	10.6	24.6	6.9	16.7	5.2	24.1	32.5	9.6	13.6	24.4
UK	59.9	-44.6	-32.0	-11.3	-11.6	60.0	72.8	137.3	164.2	200.1
Euro-15	208.4	-29.4	194.5	277.8	54.1	457.7	1026.8	709.9	943.7	1167.9

Eurostat: European Social Statistics (2002)



Euro-15

