

Australian G-20 Secretariat Background Note  
Prepared for the  
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**Demographic Change**

**Introduction**

All G-20 countries face the inevitable challenge of demographic change with its significant economic and social consequences. The challenge is to ensure the transition boosts, rather than detracts from, economic development, growth, and living standards.

A combination of policies will be required to meet this challenge, including improving public finances, encouraging labour force participation, and promoting productivity growth. An open and efficient international financial system, that allows smooth flows of capital between countries at different demographic stages, will help facilitate adjustment to demographic change.

Demographic change has been on the G-20 agenda since 2004. The group has previously considered the likely effect of demographic change on economic growth and the role of migration as a policy response. The financial market implications of demographic change, as well as some further aspects of labour mobility, are the focus of this year's discussion.

**Financial markets**

Demographic change has the potential to affect saving behaviour, capital accumulation, labour supply, asset returns, international capital flows and the relative demand for different types of financial instruments. There is evidence of plausible, measurable effects of demographic variables on asset prices,<sup>1</sup> although these have historically been small. While a 'melt down' in asset prices as large cohorts of workers retire is posited by some experts, most consider this to be unlikely.

Open and well-functioning financial markets can play a role in smoothing the impact of demographic change on financial markets and asset returns. In particular, because countries are ageing at different speeds, cross-border capital flows will be an important factor in ameliorating the impact of ageing. Emerging economies with young and rapidly growing populations are typically expected to have more investment opportunities than domestic saving can finance, while mature developed economies with older, aging populations might be expected to have the reverse. As a result, in the long run, capital would be expected to flow from the ageing developed economies to the young developing ones—the opposite of what has been seen in recent years. Deeper and more open financial markets are a key element in enabling financial flows to emerging market economies.

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<sup>1</sup> The impact of demographic change will vary depending on the underlying cause. Low and falling fertility implies slower population growth, which in principle could reduce the supply of labour relative to capital. Greater longevity, to the extent that it is accompanied by better health through the later stages of life, will tend to increase the relative supply of labour (if retirement ages are not fixed/distorted), but will also require people to fund longer periods of retirement, adding to capital accumulation.

While financial markets can play a role in facilitating adjustment to demographic change, there is no single ‘magic bullet’ from financial engineering or greater capital mobility that will be sufficient to fully offset the impact of demographic change.

Demographic change affects the structure of financial markets. Regulatory arrangements should be formulated with a view to accommodating changes associated with the demands of an ageing population, such as a greater role for pension funds and other long-term investors. Policy-makers should foster efficient financial markets and need to remain alert to any unintended consequences of regulation. Efforts to avoid excessive fund management fees may be beneficial.

There is likely to be demand for additional financial markets and instruments to assist in the management of retirement incomes. For example, annuity markets, housing equity withdrawal products, and long-term indexed bond markets remain underdeveloped in most countries compared to possible demand. Improved information on mortality and house prices may assist in the development of these products, and others like traded longevity indices.

Regulatory and tax regimes could be reviewed to ensure they do not hinder the development of new financial products. In some cases, governments may consider directly supporting market development, either by issuing instruments or mandating market participation, but should consider carefully the associated issues of market efficiency and risk management, and be alert to unintended consequences. In addition, if insurance and pension schemes turn out to be underfunded, perhaps due to unanticipated increases in longevity, governments may be exposed to contingent liability, implying a need for high quality supervision and adequate fiscal space.

Policy-makers should ensure households are aware of the risks they face in managing their retirement income, and have the capacity to manage them effectively. Appropriate measures may include simplifying complex retirement systems, improving financial literacy, and enhancing consumer protection.

Policies to manage the impact of demographic change should complement one another. Pension design principles, tax and regulatory regimes, and financial market development policies need to work together to best manage the effects of ageing. For example, in countries where the bulk of risk lies with households, there may be the need to combine adequate investor protection with efforts to encourage private retirement saving.

It is also clear that pension systems need to be placed on a sustainable footing. Maintaining flexibility within systems—for example by linking retirement ages and pension eligibility to life expectancy—would help economies adjust to demographic change.

In considering policies to best manage the effects of demographic change, countries may learn a great deal from others’ experiences. Developing countries can learn from the problems now faced by industrialised countries with inflexible retirement-income policies. Likewise, countries facing challenges reforming well-established systems may learn from innovative systems in developing countries.

**Labour mobility**

Increased labour mobility has the potential to be part of the overall policy mix designed to ameliorate the impact of demographic change but the impact of migration is highly complex. It can have long-term consequences which depend heavily on the individual economic, social and political circumstances of each country.

Policies and institutions should facilitate the types of migration that support economic development, growth and stability—recognising the impact national policies can have on other countries.

Migrant remittances data have serious limitations, and improving the efficiency of remittance payment systems and reducing the cost of remittances could release substantial resources for migrants and their families. Work is underway to address these issues through the International Working Group on Remittance Statistics and the Committee on Payment and Settlement Systems and the World Bank.

Improving the portability of social security and health care benefits has the potential to lower the cost of migration. However, a better understanding of how portability affects the migration decision and of the potential fiscal costs is necessary before new policies can be assessed and implemented.

In terms of different types of migration, high-skilled migration is generally found to result in a net economic gain for destination countries. The overall impact of low-skilled migration on destination countries remains uncertain — particularly the effect on the domestic labour market – and will depend on the economic and social circumstances of each country.

For source countries, research by the multilateral development banks suggests that temporary low-skilled migration is likely to create the greatest benefits. High-skilled migration raises concerns around the impact of ‘brain-drain’ but is widely considered to be beneficial, as it can improve access to capital, technology, foreign exchange and business contacts. The opportunity for migration may also lead to a larger investment in education by citizens of source countries than otherwise, although whether this increases overall post-migration skill levels remains an empirical issue.

Designing and implementing migration policies which are of benefit to both source and destination countries remains a key challenge for policy-makers.

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