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The Global Demographic Transition

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ASSUMPTIONS AND CONVENTIONS

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during July 7–August 4, 2004, except for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to remain constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies in industrial countries, see Box A1); that the average price of oil will be $37.25 a barrel in 2004 and 2005, and remain unchanged in real terms over the medium term; that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 1.6 percent in 2004 and 3.4 percent in 2005; that the six-month euro deposits rate will average 2.2 percent in 2004 and 2.8 percent in 2005; and that the six-month Japanese yen deposit rate will yield an average of 0.1 percent in 2004 and of 0.3 percent in 2005. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available through mid-September 2004.

The following conventions have been used throughout the *World Economic Outlook:*

. . . to indicate that data are not available or not applicable;

— to indicate that the figure is zero or negligible;

– between years or months (for example, 2002–03 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 2002/03) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

In figures and tables, shaded areas indicate IMF staff projections.

Minor discrepancies between sums of constituent figures and totals shown are due to rounding.

As used in this report, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

FURTHER INFORMATION AND DATA

This report on the *World Economic Outlook* is available in full on the IMF's Internet site, www.imf.org. Accompanying it on the website is a larger compilation of data from the WEO database than in the report itself, consisting of files containing the series most frequently requested by readers. These files may be downloaded for use in a variety of software packages.

Inquiries about the content of the *World Economic Outlook* and the WEO database should be sent by mail, electronic mail, or telefax (telephone inquiries cannot be accepted) to:

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PREFACE

The analysis and projections contained in the *World Economic Outlook* are integral elements of the IMF's surveillance of economic developments and policies in its member countries, of developments in international financial markets, and of the global economic system. The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department, the International Capital Markets Department, the Monetary and Financial Systems Department, and the Fiscal Affairs Department.

The analysis in this report has been coordinated in the Research Department under the general direction of Raghuram Rajan, Economic Counsellor and Director of Research. The project has been directed by David Robinson, Deputy Director of the Research Department, together with James Morsink, Division Chief, Research Department.

Primary contributors to this report also include Nicoletta Batini, Tim Callen, Xavier Debrun, Hamid Faruqee, Dalia Hakura, Thomas Helbling, Toh Kuan, Nikola Spatafora, and Marco Terrones. Hussein Allidina, Harald Anderson, Paul Atang, Angela Cabugao, Nathalie Carcenac, Yutong Li, Paul Nicholson, and Bennett Sutton provided research assistance. Nicholas Dopuch, Mahnaz Hemmati, Casper Meyer, and Ercument Tulun managed the database and the computer systems. Sylvia Brescia, Celia Burns, and Seetha Milton were responsible for word processing. Other contributors include Anders Åslund, Roel Beetsma, Robin Brooks, Jean Chateau, Milan Cuc, Markus Haacker, Peter Heller, Simon Johnson, Cem Karacadag, Kalpana Kochhar, Laura Kodres, M. Ayhan Kose, Thomas Krueger, Warwick McKibbin, G.A. Mackenzie, Gian Maria Milesi-Ferretti, Christopher Otrok, Sam Ouliaris, Thomas Rumbaugh, Martin Sommer, and Mehmet Tosun. Marina Primorac of the External Relations Department edited the manuscript and coordinated the production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the report on September 1 and 3, 2004. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

FOREWORD

Let me start by thanking David Robinson, James Morsink, members of the World Economic Studies Division, and all the other IMF staff who have worked many long hours to bring this to you.

Unless events take an awful turn, the world economy will enjoy one of its strongest years of growth this year. It is but natural then that the equilibrating forces bringing growth back to trend will come into play. Commodity prices are increasing, while central banks are slowly withdrawing the accommodative conditions that were put in place to deal with the recession. This is as it should be.

The key development in the past few months has been that oil prices, which had been quiescent for many years except for short spikes in times of heightened geopolitical risk, shot up once again. This time it has been a volatile combination of heightened demand, very limited spare capacity, and geopolitical threats to existing capacity. While as of this writing oil prices had fallen back somewhat, there is no guarantee that volatility will abate. It would be myopic not to draw lessons from this experience.

The first lesson, as I emphasized in the last *World Economic Outlook*, is that policymakers need to take every opportunity to recover the policy options that have been expended in ensuring the recovery. Without these options, we have little with which to manage the unknown risks that surely are out there.

The second lesson is that long-term trends will eventually, and most unexpectedly, become short-term policy concerns. For instance, we always knew that the phenomenal growth of China and, to a lesser extent, India, would eventually weigh on global energy resources. But that future is now upon us. There are some obvious steps countries can take to ensure that growth is sustainable, such as greater efforts at conservation and efficiency and a reduction of unnecessary impediments to exploration and production. There may also be a need to explore new ways of reducing energy-related risk in the world economy.

More generally, almost any economic issue seems to have international spillovers nowadays. The analytical section in this *World Economic Outlook* highlights four such issues.

The first essay in Chapter II focuses on the current house price boom in industrial countries. House prices across countries are surprisingly highly synchronized, with about 40 percent of the movement in house prices explained by global factors, which in turn reflect key variables such as changes in world interest rates. Since what goes up excessively must come down, policymakers should be aware that they will likely be dealing with the consequences of depressed house prices at a time when house prices elsewhere, and thus external demand, are also likely to be low.

The IMF was set up, in part, because of the recognition that exchange arrangements have spillover effects. In the past few years, the IMF has been advocating more exchange rate flexibility for some countries in emerging Asia, not only because it believes more flexibility will be in the best interest of the countries themselves but also because increased flexibility will contribute to reducing global imbalances. The second essay examines the shift from fixed exchange rates to floating exchange rates in emerging market countries in the 1990s. Countries typically moved in steps from fixed to floating, and those who did it voluntarily spent time strengthening monetary and financial policy frameworks. However, countries did not typically have all frameworks in place before making the change. For example, many who decided to float introduced an inflation targeting regime only after the transition. This suggests that while countries need to prepare for floating, some key institutions can be put in place after the float.

Common currency arrangements again have obvious cross-border effects. Five years after the adoption of the euro, the third essay in Chapter II finds that there is still considerable divergence in member countries' cyclical positions. As a result, the common monetary policy in the euro area has differed from what country-specific conventional policy rules suggest would be appropriate. This means fiscal policy still has a role to play in stabilizing growth outcomes. Unfortunately, the essay finds that while governments have tended to spend more in bad times after the adoption of the euro, they have also tended to spend more in good times. The latter is not only destabilizing; it also creates an unsustainable deficit bias in government policies. The essay reinforces the point that the euro area needs a better mechanism to ensure government spending is disciplined in good times.

This loss of discipline is especially worrying given the looming fiscal costs of aging. Let me highlight some results from Chapter III, which is on demographic change.

Given the magnitude of the demographic changes facing us, there will be no single magic bullet. For instance, if we intended to stabilize the ratio of labor force to population at current levels by 2050 in a group of advanced economies, using only an increase in labor force participation, we would require an average increase of 11 percent. Using only immigration, immigrants would make up on average more than 30 percent of advanced economies' populations by 2050. Relying only on an increase in retirement age, we would require an average extension of our working lives by more than 7 years. These not only exceed the limits of what is politically feasible, but in some countries they also exceed what is physically possible: in Japan, participation rates would have to be above 100 percent.

But if a multipronged approach is adopted, a solution seems well within political reach. One would only require an increase in participation of 3¾ percent, an increase in immigration to 10 percent of population and an increase in retirement age of 2.3 years to stabilize the ratio of labor force to population.

Also, even if solutions achieve similar ends—such as ensuring solvency of pensions—they may have very different implications for economic growth during the transition. For instance, raising the retirement age appears to be more friendly to consumption growth than a decrease in retirement benefits. The latter induces workers to save more for retirement, thus inhibiting consumption, while the former may induce additional consumption as workers know they have a longer period in which to save.

Chapter III emphasizes the role that international movement in goods, people, and capital will play in reducing the costs of aging and exploiting its benefits. We need better international rules of the game to govern such movement, to ensure that trade is free, to ensure that investor rights are protected, and to ensure that the universal human rights of immigrants are respected. International organizations like ours will have an increasingly important role.

In sum then, if there is one message in this *World Economic Outlook*, it is that no country is an island. Policies in one country spill over to the rest of the world through many channels—prices, interest rates, trade, capital flows, people, ideas, conflict, and even through example. This is why it is increasingly important for the outside world that countries that need to reform do not succumb to reform fatigue.

And that fatigue is spreading. Politicians seem to be giving up on reform because people seem to reject it. But, if people are merely rational and self-interested rather than myopic or deaf, there may be ways to bring them around to accept reforms. In fact, there may be no better time to reform than the present: a time of recovery when recent adversity reminds citizens of the cost of standing still, while growing surpluses help ease the pain of reform. Sensible design can help. A reform that increases retirement age should be accompanied by measures to increase labor market flexibility and adult education so that the older workers have more opportunities. Even with good timing and clever design, people will need to be spoken to plainly and convinced to come along. But that is where leadership needs to take over from mere politics as usual. I am hopeful we will see such leadership in the years to come.

Raghuram Rajan
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