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The economic impact of an **aging Europe**

The aging of European populations will threaten living standards and prosperity.

Article at a glance: By 2025, one in five Europeans will be more than 65 years old, up from 16 percent in 2002. With more retired citizens, who tend to consume their savings, and fewer working-age citizens, who create most of those savings, the absolute level of savings will plunge across most of Europe. In the United Kingdom, Germany, and Italy—three of Europe's largest economies—household financial wealth will be $4 trillion less than it would have been if historical growth rates had persisted. That is a threat to the continent's living standards and economic well-being.

The take-away: If left unchecked, the coming slowdown in Europe's savings and financial wealth could depress investment, economic growth, and living standards. But a concerted effort to increase the returns on financial assets by increasing productivity throughout the economy and to boost savings rates can avert this outcome.

The economic impact of an **aging Europe**

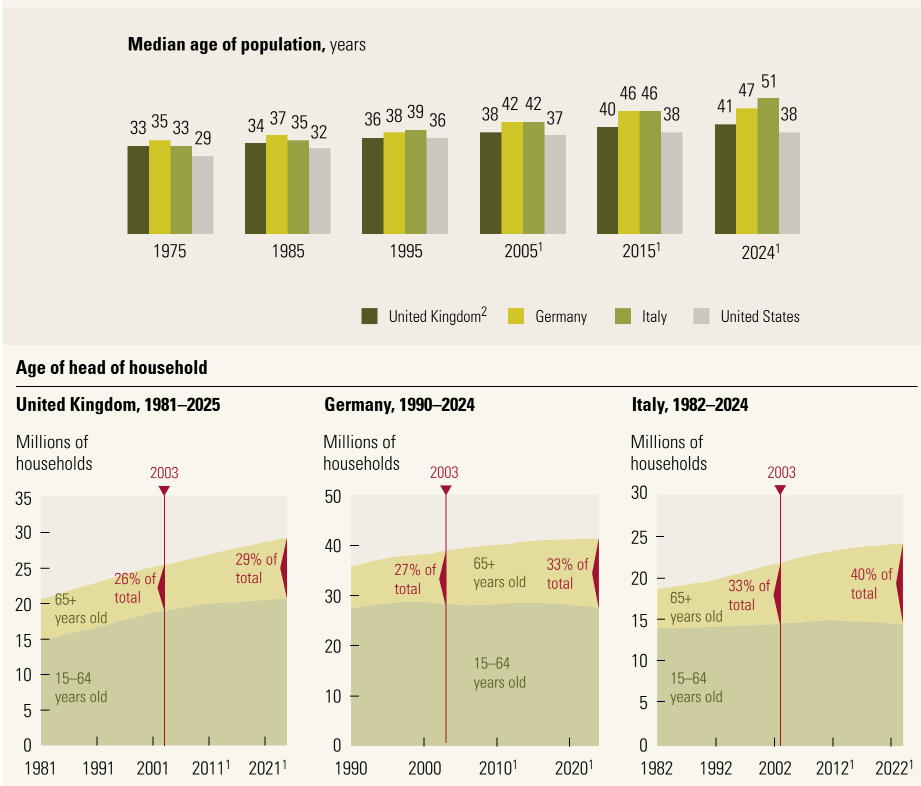
Diana Farrell

By 2025, one in five Europeans will be more than 65 years old, up from 16 percent in 2002.[1] Across the continent, the number of working-age citizens will stagnate or shrink while the number of retirees explodes (Exhibit 1). As a result, household financial wealth, which had enjoyed steady, healthy growth during past decades, will slow drastically over the next 20 years, according to new research by the McKinsey Global Institute (MGI). The slowdown will leave households in three of Europe's biggest economies—the United Kingdom, Germany, and Italy—with a total of more than $4 trillion less than they would have accumulated if historical growth rates had persisted (Exhibit 2).[2] Around the world, the picture is similar.

If left unchecked, the slowdown in savings and in the accumulation of financial assets by Europe's wealthiest countries could depress investment and economic growth, causing living standards to rise much more slowly. But the economic impact of aging populations could be blunted by raising the savings rates of governments and households and by increasing the returns earned on their savings. These challenges require tough choices today but could ease the pain in the future.

EXHIBIT 1

Going gray



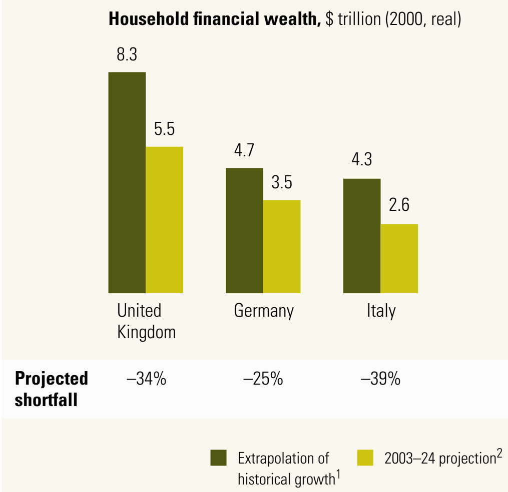
[1]Projected.
[2]2025 data (not 2024) shown for median age of population in United Kingdom.

Source: Eurostat; Istituto Nazionale di Statistica (ISTAT); Office of Deputy Prime Minister, United Kingdom; Office for National Statistics, United Kingdom; Scottish Executive; World Population Prospects, United Nations; McKinsey Global Institute household-financial-wealth model; McKinsey analysis

[1] *World Population Prospects: The 2002 Revision*, Population Database, United Nations Population Division (http://esa.un.org/unpp).
[2] MGI has also studied aging in Japan and the United States. For a more comprehensive treatment of this work, see "The demographic deficit: How aging will reduce global wealth," *The McKinsey Quarterly*, Web exclusive, March 2005 (www.mckinseyquarterly.com/links/17268).

EXHIBIT 2

Falling short



[1]United Kingdom, 1975–2003; Germany, 1991–2003; Italy, 1986–2003.
[2]Based on demographic trends.

Source: xe.com; McKinsey Global Institute household-financial-wealth model; McKinsey analysis

The spectrum of aging

Demographic forces will have a different impact on each of the three countries we studied. According to our analysis, the impact on the United Kingdom will be mild. Germany will experience moderate repercussions, and Italy will face the most severe challenges.

The United Kingdom ages in moderation

The effects of aging will be least severe in the United Kingdom, partly because its birthrate is higher than that of Germany or Italy. The median age in the United Kingdom will rise to 41 by 2025—only three years higher than it was in 2005. The share of over-65 households will also increase slowly, from 26 percent in 2003 to 29 percent by 2025.

Unlike most other developed countries, where flows of new savings will slow down or even decline as populations age, the United Kingdom is expected to benefit slightly in the years ahead. Even though its current savings rate is relatively low—about 6 percent of disposable income—we expect the flow of new savings to increase at an annual rate of 2.3 percent until 2024, averaging £56 billion ($106 billion) a year, up from £42 billion.

The life cycle savings curve shows the difference between income and consumption over an individual's lifetime. The United Kingdom's curve actually increases with age, and its peculiar shape is the main reason for this counterintuitive result. In the United Kingdom, savings peak at age 55 and remain at that level into retirement—a pattern unlike that of most other developed countries (Exhibit 3).

Meanwhile, we project that the United Kingdom's annual growth rate in liabilities will decline to 3 percent through 2024, from 6.1 percent during the past 30 years. Combining these trends in savings and liabilities makes it possible to measure household financial wealth. With increasing savings and declining liabilities, we believe that the United Kingdom's rate of wealth accumulation—an impressive 5.1 percent from 1975 to 2003—will decline to a healthy 3.2 percent for the ensuing two decades.

Even so, over the next 20 years slower growth means that total UK household financial wealth will be 34 percent, or £1.9 trillion, lower than it would have been if historical growth rates had persisted.[3] While this slowdown isn't insignificant, it will be much milder than what the other countries we have analyzed will probably experience. Our estimated annual growth rate for UK household wealth—3.2 percent—is twice as high as the rate for the United States during the same period.

Storm clouds over Germany

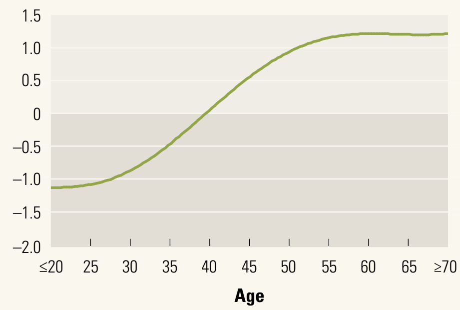
The effects of aging will be more dramatic in Germany than in the United Kingdom. Germany's population, with a median age of 42 today, is already significantly older than the populations of the United Kingdom or the United States. By 2024, Germany's median age will climb to 47. The number of people aged 65 and older will rise from 27 percent in 2003 to 33 percent by 2024.

[3]Unless otherwise noted, all growth rates are given in real terms; values are in 2000 constant pounds or euros.

EXHIBIT 3

Not too shabby

United Kingdom, actual and projected annual savings per household,[1] £ thousand (2000, real)



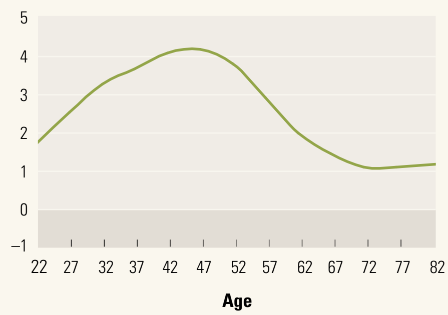
[1] 1936–40 birth cohort; based on survey data, not calibrated to national accounts level.

Source: James Banks and Susann Rohwedder, "Pensions and life-cycle savings profiles in the UK," in Axel Börsch-Supan (ed.), *Life-Cycle Savings and Public Policy: A Cross-National Study of Six Countries*, New York: Elsevier Academic Press, 2003, pp. 257–313; McKinsey Global Institute household-financial-wealth model; McKinsey analysis

EXHIBIT 4

An early decline in savings

Germany, actual and projected annual savings per household,[1] € thousand (2000, real)



[1] Representative cohort from study by Börsch-Supan, Reil-Held, Schnabel; based on survey data, not calibrated to national accounts level.

Source: A. Börsch-Supan, A. Reil-Held, R. Schnabel "Household Savings in Germany," in Axel Börsch-Supan (ed.), *Life-Cycle Savings and Public Policy: A Cross-National Study of Six Countries*, New York: Elsevier Academic Press, 2003, pp. 257–313; McKinsey Global Institute household-financial-wealth model; McKinsey analysis

Falling birthrates will cause Germany's population to start contracting in 2015. As a result, overall savings are expected to grow slowly up to that year and to fall steadily thereafter. It should be noted that Germany's savings rate, at around 11 percent of income, is much higher than that of the United Kingdom or the United States.

Although Germany has the traditional hump-shaped life cycle savings curve, it also has a rather unique pattern: savings rise steeply to a peak in the late 40s, slope markedly down in the late 50s, and then plateau at a low level into retirement (Exhibit 4). Compared with other countries, savings start tailing off at a relatively early age, and this magnifies the impact of aging.

Germany's high savings rate declined following reunification with the former East Germany, and savings flows fell too. They will be static over the next two decades. On the other side of the wealth equation, overall liabilities are projected to grow by 1.8 percent over the same period, down from 3.4 percent during the 13 years to 2003. Over the next two decades, these shifts mean that the rate at which Germany accumulates financial wealth will slip to 2.4 percent a year, from 3.8 percent a year (1991–2003). In 2024 German household wealth will be 25 percent, or €1.2 trillion, below what it would have been if historical growth rates had continued. This effect would be even more pronounced were it not for the high savings rate of Germany's population.

Italy feels the most pain

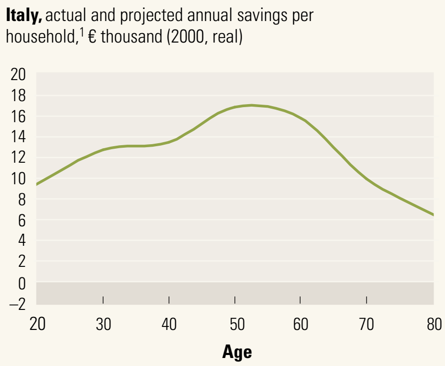
Of the major European economies we studied, aging will have the most severe impact on Italy, which has seen big demographic changes over the past two decades. The number of households aged 65 and older increased by a staggering 55 percent from 1986 to 2003. By 2024, Italy will have more than one million people over the age of 90, and the median age will be 51—by far the highest of the countries we analyzed.

A falling birthrate has led to an overall decline in the growth rate of Italy's population. Moreover, after 2012, the absolute number of Italians will start to fall. With progressively fewer households in their peak saving years, total savings will be lower. Overall, savings will decline slowly during the next two decades.

Italians are by no means low savers, however: even as the population's growth rate has fallen, they saved nearly 10.5 percent of their disposable

EXHIBIT 5

A gradual decline



[1]Representative cohort from Baldini-Mazzaferro study; based on survey data, not calibrated to national accounts level.

Source: Massimo Baldini and Carlo Mazzaferro, "The consolidation of the public budget in Italy (1985–2000): An analysis of the re-distributive effects on Italian households," Universita di Modena e Reggio Emilia, Dipartimento di Economia Politica working paper, Center for the Analysis of Public Policies (CAPP) series, Number 14, 2003; McKinsey Global Institute household-financial-wealth model; McKinsey analysis

income in 2002. But the late 1980s and the 1990s saw a drop of 5.2 percent a year in the flow of new savings. This trend will continue, albeit at a slower rate; we project a 1.7 percent drop over the next two decades.

The unique savings behavior of Italy's population will prevent the country's predicament from getting much worse; in Japan, for instance, we expect living standards to fall.[4] The Italian life cycle savings curve is also hump shaped, with higher savings in the middle years (Exhibit 5). But in contrast to countries such as Japan and the United States, where people spend more than they earn during certain periods of their lives, Italians consistently save at a high level. Changes in the average lifetime savings of Italian households are thus mild, and aging has a smaller impact on savings.

Compared with other developed economies, Italy has unusually low household debt levels, because of restrictive lending policies and the Italian consumer's general aversion to debt. The growth in household liabilities will slow from 7.5 percent a year during the past two decades to 2.6 percent annually through 2024.[5]

Despite Italy's positive savings behavior, the combination of declining savings and falling liabilities will decrease the rate of wealth accumulation significantly. By 2024, the country's financial wealth will be 39 percent, or €1.8 trillion, below what it would have been if historical growth rates had continued. Since the number of working-age households is growing more slowly than the number of elderly ones, Italy's demographic structure will become increasingly less capable of supporting the accumulation of wealth. As in Germany, that is likely to mean weaker growth in living standards and lower household savings to support retirees and fuel economic growth.

The overall damage

The impending reduction in financial wealth may pose a number of risks to the economies of all the countries we studied. The scenario could go something like this: lower levels of savings decrease the amount of capital available to fuel growth; the resulting slowdown in GDP reduces corporate earnings and government tax revenues at a time when Europe will be grappling with fast-rising health care costs; and the decline in tax revenues leads to higher government budget deficits, which increase the risk of rising real interest rates, thereby crowding out private-sector borrowers and causing investment to decline further. While this scenario is hypothetical, the likelihood that it will become a reality increases significantly as savings and financial wealth fall to lower levels.

Changing course

Europe has no easy policy solutions. Some frequently mentioned options, such as increasing

[4] Diana Farrell and Ezra Greenberg, "The economic impact of an aging Japan," *The McKinsey Quarterly*, Web exclusive, May 2005 (www.mckinseyquarterly.com/links/17408).

[5] To forecast the growth of Italy's liabilities, we assumed that its liabilities-to-income ratio will grow in line with historical levels. The US liabilities-to-income ratio, currently around 1.2, served as our base case. We estimate that Italy's ratio will be 0.83 in 2024—still well below the US benchmark.

immigration or encouraging families to have more children, would have little impact during the next 20 years. Given the significant increase in average life spans over the past half century, one sensible step would be to raise the retirement age, thereby prolonging the period when households are typically most prone to save. But to make a real difference, European countries must not only increase their savings rates but also boost the returns on those savings by improving productivity and capital efficiency throughout the economy.

In view of the United Kingdom's high rate of financial-asset appreciation, it is unrealistic to expect much progress in that area, so the country's priority must be to raise its low savings rate. Research on behavioral economics shows that savings increase dramatically when, for example, a company automatically enrolls its employees in a voluntary savings plan (letting them opt out if they wish) rather than requiring them to sign up actively.

In countries such as Germany and Italy, where savings rates are already robust, improving the returns on these assets will be critical for reversing the future shortfall in savings and wealth. There is ample room for improvement. From 1991 to 2003, German financial assets depreciated in value by an inflation-adjusted rate of 1.1 percent a year; Italian assets declined in value by 1.6 percent annually over a similar period. (By comparison, the value of the United Kingdom's financial assets increased by 0.87 percent annually over the past 30 years.) Raising German and Italian rates of return to levels anywhere near those of the United Kingdom and the United States will be difficult. More efficient financial intermediation will be required to ensure that savings are channeled to the most productive investments. Competition and innovation should be encouraged not only in the financial sector but also throughout the economy.[6] Because households in these countries keep a large portion of their financial assets in deposit accounts, diversifying their assets is also an important way to promote a more efficient allocation of capital.

Finally, if Germany and Italy are to achieve higher financial returns, these countries must increase productivity throughout their economies. Governments will have to do away with regulations and policies that protect inefficient companies, prop up "local champions," prevent mergers and acquisitions, and maintain trade barriers against the rest of the world. They will also have to make it easier for new companies to do business, ease zoning and land regulations that inhibit the development of large enterprises, and continue the process of privatizing the many state-owned companies. Last, they will need to make labor policies more flexible and increase the incentives to work.[7]

The combination of rapidly aging populations and poor investment returns in much of Europe will produce a shortfall in its savings and financial wealth, thus squeezing the amount of capital to fuel growth. The challenge varies in different economies, but options are available. Europe needs to start working on them now. Q

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[6] For a synthesis of MGI's research on how to increase the level of competition and innovation in an economy, see William W. Lewis, *The Power of Productivity: Wealth, Poverty, and the Threat to Global Stability*, Chicago: University of Chicago Press, 2004.

[7] For a detailed discussion of these reforms, see Martin Neil Baily and Jacob Funk Kirkegaard, *Transforming the European Economy*, Washington, DC: Institute for International Economics, 2004 (www.iie.com).

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