Cuffelinks
Connecting investors with ideas

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The world by 2050

Warwick McKibbin

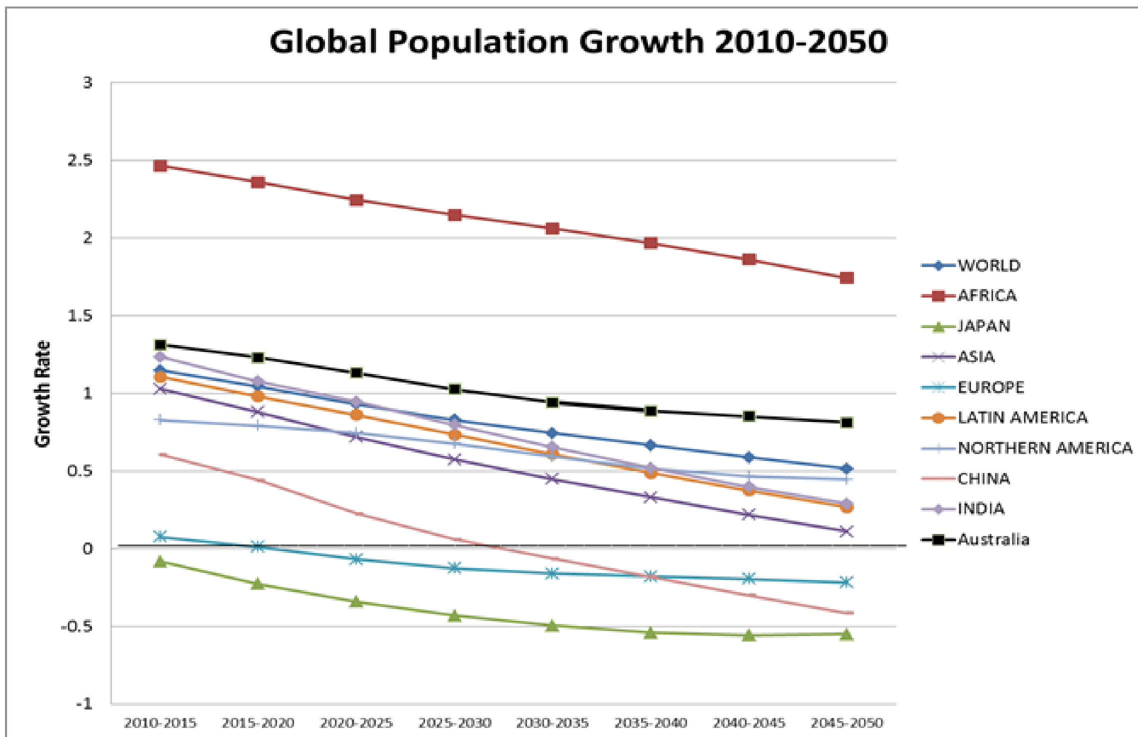
Australia is an island, but what happens in the world economy matters a great deal to what happens in the Australian economy. We don't know what the world will look like in 2050, but that doesn't mean we shouldn't think about it and plan for different future scenarios. We do know a few things, and one of these is that demographics is destiny – almost. Demographics drives economic growth, both within Australia and globally, but it's not everything. Economic growth also comes from productivity growth and capital accumulation, including investments in private and infrastructure capital and human capital.

Demographic change

A key insight from thinking about future scenarios of the world to 2050 for the design of a retirement system is that the system needs to be flexible and be able to adapt as new events unfold. A system needs to be sustainable and withstand the volatility and uncertainty that the world faces. Understanding the demographics is a good place to start but productivity growth is just as important, especially in the retirement income space.

Figure 1 shows UN projections of population growth around the world. There is a wide range of assumptions underlying demographic projections, so these are not certain but a reasonable estimate for thinking about the future. At the lowest part of the graph is Japan, which is already shrinking. The line above that is Europe, which is also disappearing demographically. These two historically key drivers of the world economy are shrinking demographically. It is clear from Figure 1 that all lines are trending down, so while the world economy is expected to be growing, it will do so less quickly over future decades.

Figure 1: Global Population Growth

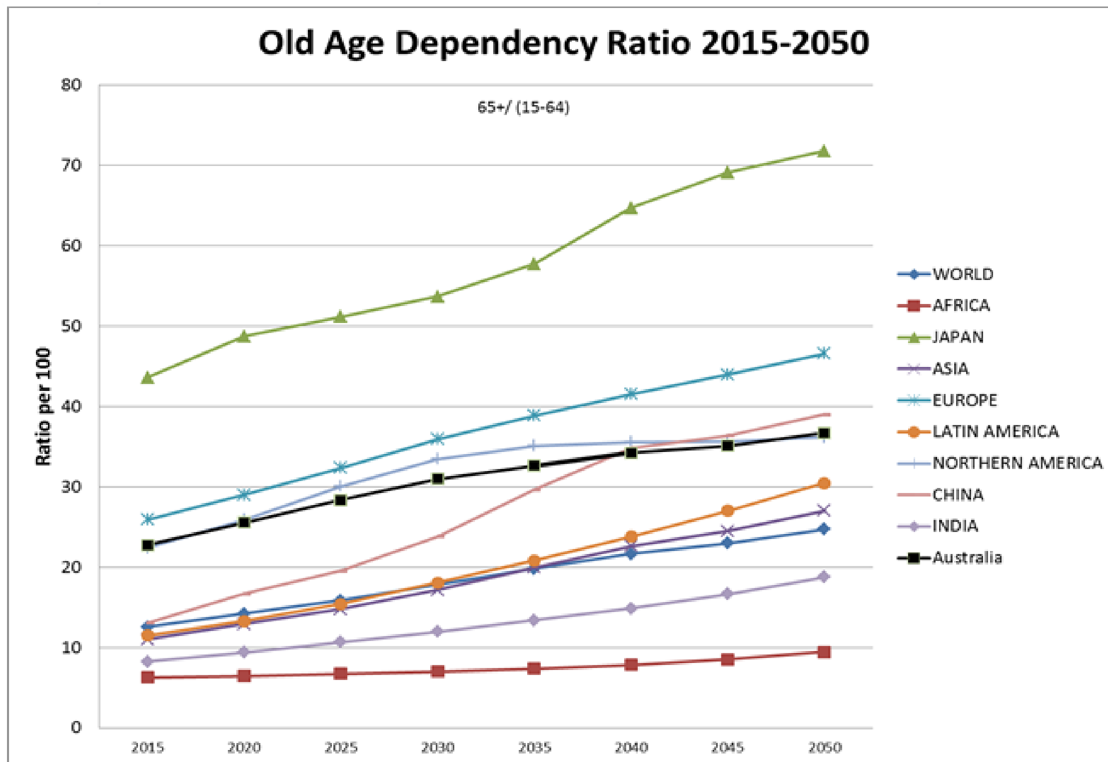


Source: UN Population Projection 2012 Revision, Medium Fertility

Changing demographics changes the rates of return on various assets. The stronger the world grows, the more likely the return on capital will be high, as well as returns on a wide range of asset classes. Now focus on China, third from the bottom. China shrinks very quickly and follows Europe and Japan into negative population growth within the next 10 to 15 years. This is mostly due to the one child policy in China. Relying on China for Australia's growth over the next 30 or 40 years will not be coming from the demographics but it may be driven by productivity growth. Australia's demographic trend compares favourably with the other major countries.

Another issue that matters from a superannuation and retirement point of view is what happens to the old age dependency ratio. This is the ratio of people aged 65 and above divided by the number of people between 15 and 64 (as a measure of working age population). These measures are not a good guide of actual dependency in the sense that people will have to work longer, as the people who will be in the 15-64 age cohort will not be financially able to support this scale of dependency. Already in Japan, for every 100 people of working age there are 44 people over 65. By 2050, it will be 70 older people per 100 workers. This will be very difficult to finance across the world.

Figure 2: Old Age Dependency



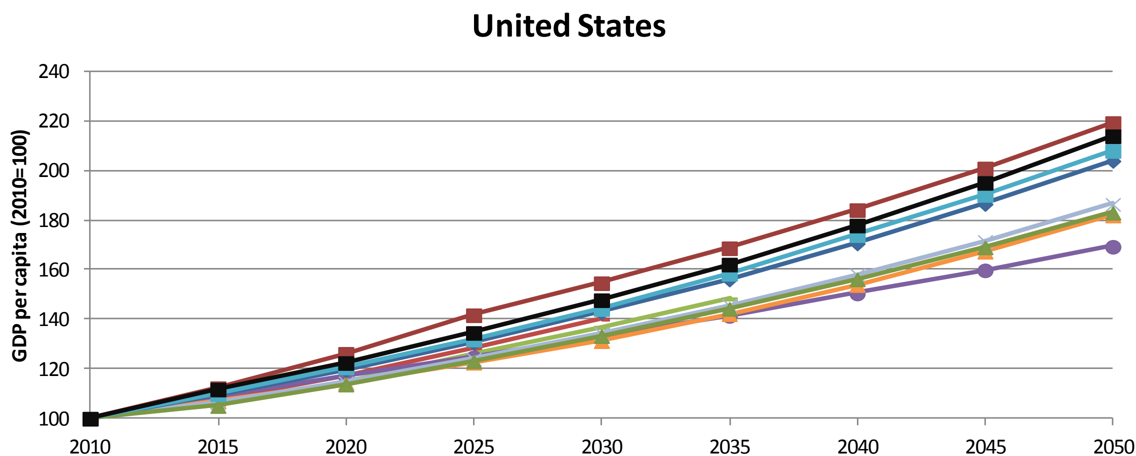
Source: UN Population Projection 2012 Revision, Medium Fertility

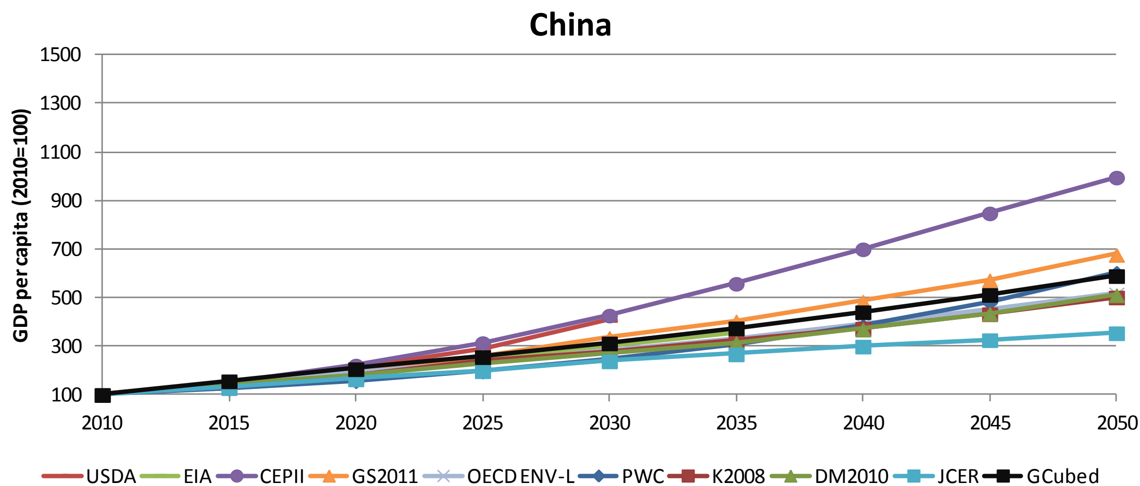
In Figure 2, Australia is the black line. Again Australia's situation is better than many other countries, and this relative position makes a difference to how we might adjust.

China's economy bigger than the US

Many people have thought about the future to 2050 using large global economic models and assumptions about demographics and possible productivity growth rates. Key assumptions are how far countries are behind the technology frontier and how quickly they will close that gap. There are many different scenarios that generate very different outcomes by 2050. For example, Figure 3 shows you what the United States and China are projected to look like using many different global economic models (including my own G-Cubed model). In Figure 3 GDP per capita from each model is normalized to an index of 100 in 2010. These projections are in per capita terms so they are the outcomes or productivity growth and capital accumulation netting out the demographic effects outlined above.

Figure 3: Survey Projections of Real GDP per Capita Growth for the US and China





Source: Stegman and McKibbin (2013) "Long Term Projections of the World Economy: A Review" CAMA working paper 14/2013

Figure 3 illustrates the great deal of uncertainty in projecting to 2050. Under a wide range of assumptions, these projections suggest that the US economy in per capita terms will be between 170% and 220% bigger than it is today. That's a big expansion in an economy that is on the technological frontier. The uncertainty is even larger for China, with the models suggesting that China will be between 300% and 950% larger than today in per capita terms by 2050. When multiplied by the population, it is clear that China is expected to be substantially larger than the US.

Focussing on the relative size of income per capita in the emerging markets in the same sets of studies, there's an enormous difference in outcomes. But for example, the French model (CEPII) has China at 80% of US GDP per head by 2050. That's an amazing catch up in productivity and capital accumulation when you consider China is currently 20% of US levels. Clearly even with an unfavourable demographic future in China, it is expected that the amount of productivity catch up and physical capital accumulation may be substantial and enable China to grow in per capita as well as in absolute terms.

World economy will be vastly different

Put all this together and the world economy is expected to be a vastly different place in scale and composition by 2050. Emerging markets will likely be a very large share of the global economy. This is good news, because the rates of return in emerging markets, if robust economic structures are put in place, will drive economic activity to these areas and generate wealth globally even under a scenario of stagnation in advanced economies.

These models give us important insights rather than reliable forecasts. One key issue is that given productivity gaps and the potential for catch-up, particularly in emerging economies, there is still potentially a lot of economic growth in the world economy but it may not be in the traditional regions. In fact, in the scenario of the 'great stagnation' where there is a long period of low economic growth in advanced economies, this certainly need not be true for the emerging world. What will matter is the extent that emerging countries can catch up to the productivity frontier that already exists.

Productivity growth in Australia is a key issue for Australia's future prosperity and the sustainability of retirement systems. Australia has good demographics relative to many other countries which is an advantage. But also important is tapping into trade and investment opportunities in emerging economies, especially in the Asia-Pacific region. China is only part of the story of Australia's future as the rest of the emerging economies may well dominate the global economy by 2050.

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Superlinks - not a gift to the rich

Garry Weaven

Congratulations on the 100th edition of Cuffelinks and thank you for asking me to make some observations on the state of the superannuation system.

We have a system that has grown rapidly to a scale considerably larger than the entire market capitalisation of our stock market so it is little wonder that it is never long out of the news or the thoughts of our politicians. Despite our pleadings this is unlikely to change. Rather, we must be vigilant and energetic to ensure we avoid disastrous policy swings and encourage moderate and rational reforms.

Currently some commentators are highly focused on the tax breaks available for super in relation to both its compulsory and voluntary forms and see attacking these as a simple solution to the structural public deficit implied by current spending and taxation projections.

Place super concessions in context

There is undoubtedly a case for some reform, but context is important.

Firstly, the current tax incentives are in fact far less than those applicable up to 1983, well before the system became universal.

Secondly, the various estimates made by Treasury over the years of the amount of tax revenue foregone are somewhat debatable. They assume that, in the absence of these concessions, the system would still have sufficient political support to continue into the future, but with contributions taxed at personal tax rates. In reality, the long term outcome of removal of concessions cannot be known and is not measured by Treasury.

Thirdly, those that lobby for winding back superannuation or its preferred tax treatment often do so on the quite erroneous assumption that governments would direct the savings towards support for welfare recipients and lower-income households. There is little evidence to suggest that this Government would rank the case of the welfare sector ahead of the strident demands of corporate Australia for reduced company tax and a lower marginal tax rate on high income earners.

Superannuation for the average worker and particularly for working women had to be fought for. That much does not change.

It is also true that some estimates of the extent to which tax concessions on super accrue to the rich are misleading because they do not take account of the extent to which this is caused by the fact that a very high proportion of contributions, and especially of voluntary contributions, are made by those who are relatively well off.

Worst public policy was a 'parting gift to the rich'

Having said all of that however, it is undoubtedly the case that former Treasurer Peter Costello's parting gift to the rich, massively raising the amount they could contribute to super while simultaneously abolishing any earnings tax on funds held in a superannuation pension environment, must rank as one of the worst pieces of public policy in living memory.

Far better to skew the tax concessions the other way, that is to the low paid who will struggle to build an adequate retirement nest egg and who will make the greatest claim on future public spending on the age pension and associated health care needs.

Funding infrastructure needs

A second area of significant current public focus is the question of funding for infrastructure. While it may have appeared, following a number of public statements by NSW Premier Mike Baird, that there was finally an awareness among politicians for the need to show leadership in creating new infrastructure,

even if this meant recycling existing state-owned assets, the recent Queensland election landslide has again cast doubt upon the possibilities of a consensus model.

It is not yet clear whether the Queensland result was triggered by the particular circumstances, such as substantial public sector job losses or perhaps an allergic reaction to excessive Abbotism. What is clear is that we require a new way to reconcile the need for private sector funding for our substantial future infrastructure needs with the justifiable public aversion to a sell-off of assets to (potentially foreign) financial intermediaries and others primarily interested in short term profit and possibly lacking the long term interest in the public benefit to be derived by these assets.

On a number of occasions in recent years I have attempted to advance a model that might be characterised as the 'mutualisation of infrastructure' by more directly linking our world class superannuation system to our need for nation building economic, social and environmental infrastructure. The model is most recently set out in my March 2015 paper '[Mutualisation of Infrastructure]'.

Our super system has evolved to the point where it has the potential to lead this country's newest and strongest source of comparative advantage, abating our dependence on commodity exports. For example, IFM Investors already has many more offshore clients than Australian clients and manages money not only for leading pension funds, but for some of the world's largest insurance companies.

Fair system can also be engine of growth

Our system needs reform at the margin to ensure it has credibility from a fairness point of view. But with appropriate nurturing our system can also be an engine of advancement for our nation, solving our needs for infrastructure development, while taking the pressure off the public purse and simultaneously creating a clean and prosperous new sector of world comparative advantage.

Garry Weaven is Chair of IFM Investors, ME Bank and 'thenewdaily.com'. As ACTU Assistant Secretary in the 1980's, he played a seminal role in the development of the industry super fund movement.

Where to put your money these days

Phil Ruthven

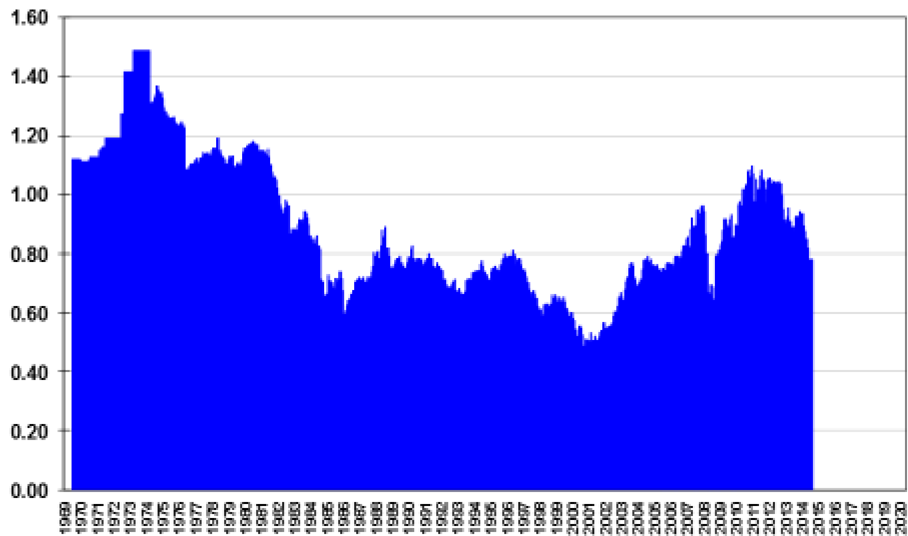
Editor's note: The author is not a licensed financial advisor, and opinions are given as a personal conviction and as a futurist, not advice to investors.

It is getting very tricky for Australian investors with over $3.7 trillion in super and other financial assets to know which asset classes are the best in terms of short or long term yield and capital appreciation. Or safest, regardless of yield.

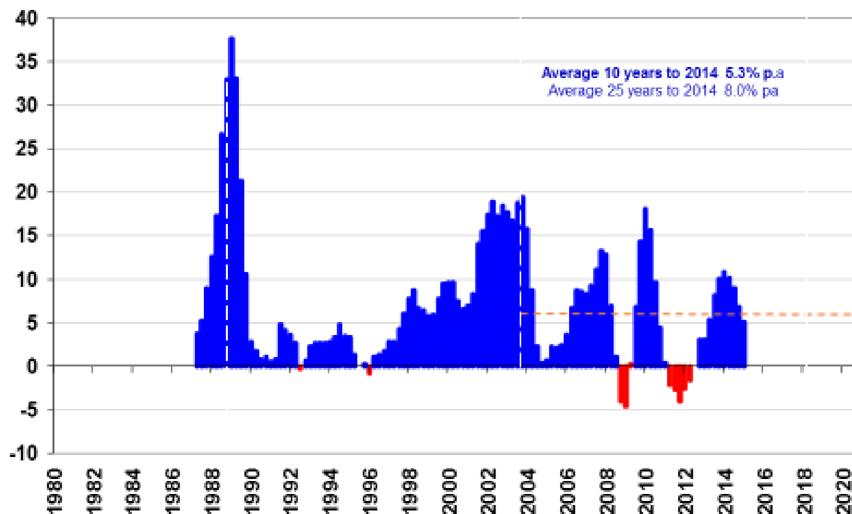
The choices at the asset class level are:

- liquids (cash, short term, long bonds)
- shares (local or foreign).
- property (owner-occupied and investment dwellings, commercial)
- commodities and collectables (gold, other metals, collectables)

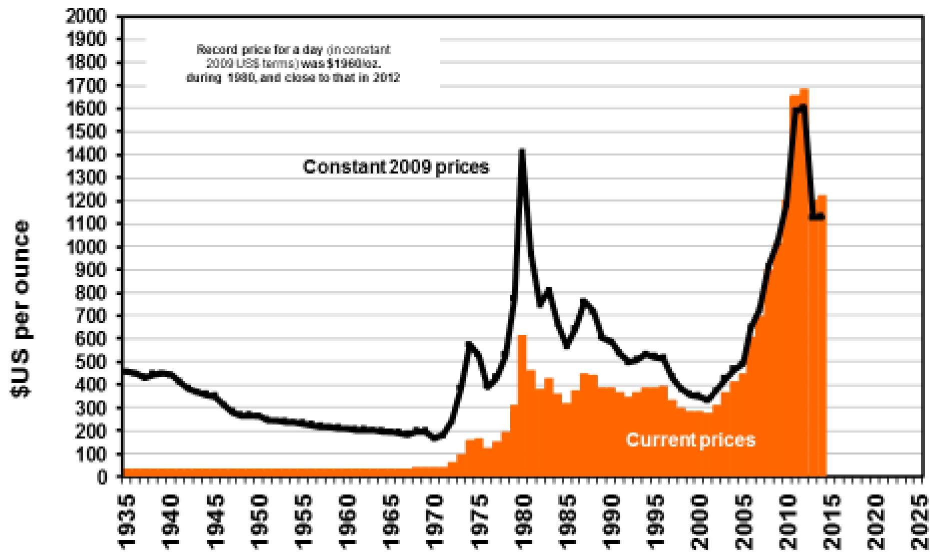
The offshore options on any of the above classes of investment introduce the exchange rate variable, further clouding the choices. As the chart below reminds us, the exchange rate is a very difficult variable to predict with any accuracy. And buying offshore assets is not as easy with a US77¢ exchange rate versus the US$1.10 of mid-2011.



Residential property values also move around, but over the medium to longer term provided capital growth of a fairly safe 5¼% pa. However prices can go negative, as seen in the second exhibit. Australia already has some of the world's most over-valued residential prices (over 3½ times average household income), kept high by record low mortgage rates at under 5% compared with the very long term average of nearer 7½%. So considerable care is needed as we head into the third decade of this 21st Century when it comes to looking for a lot of capital gain as distinct from low net rental returns in investment residential property.

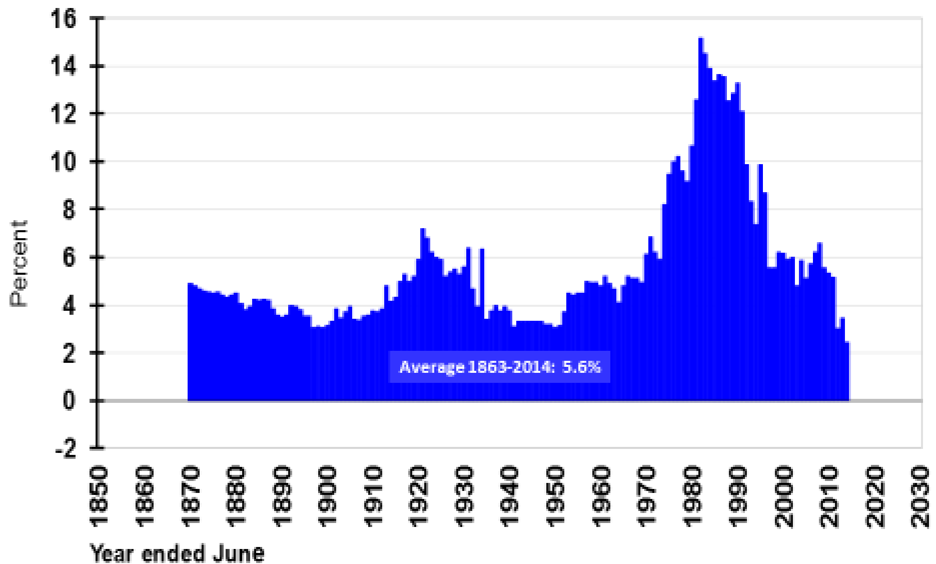


Is gold ready for another of its spectacular leaps? As we know, gold is no longer used for currency backing, the gold standard having gone almost half a century ago when President Nixon abandoned it. So these days it serves two purposes: use in jewellery and industry; and as a panic metal during financial crises. It's ever-so-obvious in the third exhibit below.

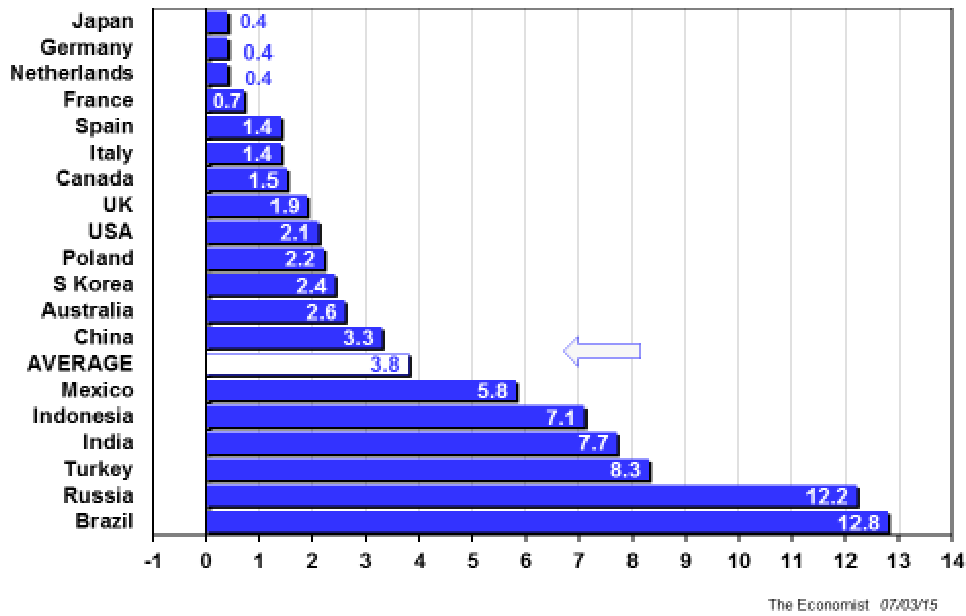


It doesn't look like the price is going to spike again in the short term, but maybe in the much longer term.

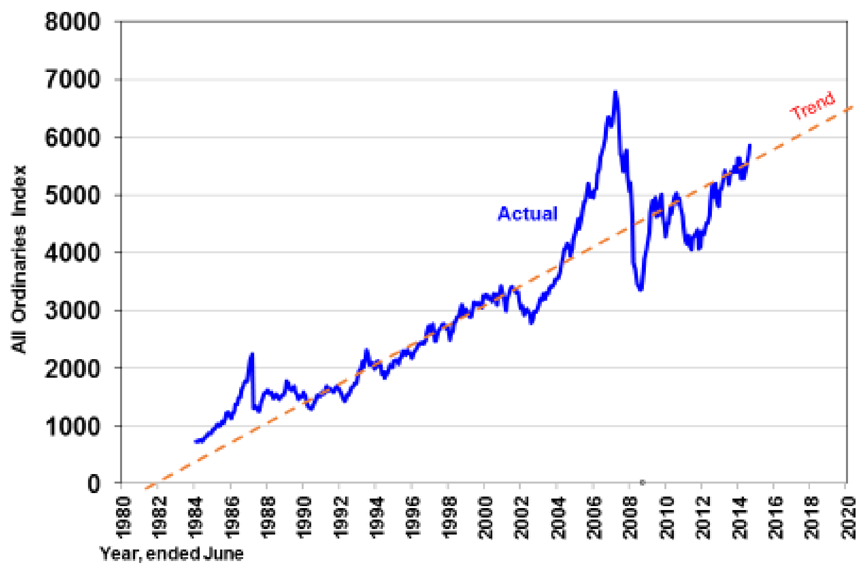
Are government bonds better? Hardly, when one looks at the fourth exhibit and its record low yield in March 2015 of 2.6%.



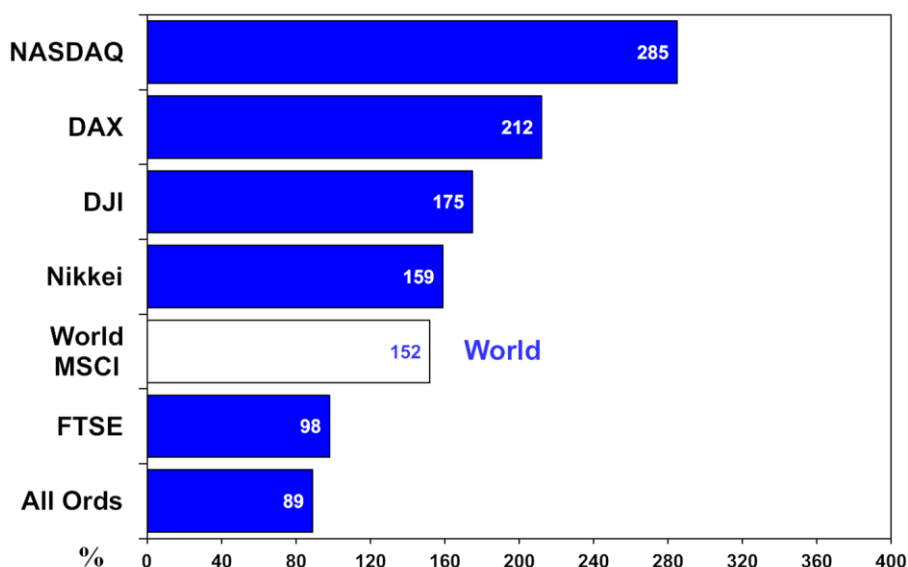
If we think that level of yield is unacceptably low to an investor, we could spare some compassion for investors in other large economies as seen in the fifth exhibit below.



Which leads to shares. They are rising lately as much by default (unattractive yields in other classes of investment) as due to other fundamentals (rising profitability and dividends) as we see below in the sixth exhibit. So far into 2015, the All Ordinaries Index does not appear to be wildly over-trend.



The final exhibit suggests that we can over-react to steep falls such as occasioned by the GFC. The recovery across the world's major indices ranges from the mind-boggling (NASDAQ and DAX) to sort of reasonable (All Ordinaries).



So what does all this mean going forward from 2015?

Basically, that returns are not as good as they have been over recent decades, whether they be liquids, property, commodities or shares, where rising P/E ratios are lowering yields in response to record low interest rates. Then again we aren't experiencing another GFC either which would be a much greater worry. Inflation is very low in most developed economies, and some are experiencing *deflation*, not seen since the Great Depression. This points to slightly better *real* returns than the nominal rates might suggest.

It is also very encouraging to see the USA and UK climbing out of their six-year long GFC, although we could be less sanguine by the almost motionless Japanese economy and the slowing Chinese economy – both big export destinations for Australia, accounting for well over half our trade.

Some forecasters are predicting apocalyptic troubles arising from world debt levels, but not this author, as yet. Government indebtedness is not yet back to the immediate post WWII levels (with some exceptions such as Greece and Japan). Yes, household debt is huge in many countries, especially Australia, but still manageable in terms of debt servicing costs as our RBA reminds us from time to time, while warning us of stupid dwelling prices and the long term dangers involved.

And business debt in terms of debt/equity ratios are generally prudent.

If all this tells us anything, it is don't retire too early! Supplement any low investment returns with working income, be it on a part-time or casual basis if you can. We will probably live longer anyway by doing that.

Phil Ruthven AM is Chairman, IBISWorld and Australia's leading futurist. Repeating, he is not a licensed financial advisor, and opinions are given as personal conviction and as a futurist, not advice to investors. The article is written for general information and investors should seek their own professional advice.

A super consensus needed before the demographic tsunami

Pauline Vamos

Last week's release of the Intergenerational Report showed there will be an increase in the number of people retiring over the next few decades, and they will live longer in retirement than ever before. These changing demographics will create challenges for any government that is in power over coming years.

Reading through the pages of the Report, it is clear that policymakers recognise the important role superannuation plays in the Australian economy. Not only does it provide benefits to individuals by delivering extra income in retirement, it also benefits the community, by decreasing reliance on the age pension and therefore alleviating pressure on government finances.

Rise in number of fully self-funded retirees

ASFA estimates that at present, around 32% of retirees aged 65 or over have accumulated enough superannuation and private savings to be fully self-funded. As the system matures, the benefits will broaden and increase, with the number of fully self-funded retirees rising to 40% by 2023.

Retirees at age 65

Source: Department of Social Services and ASFA Research Centre

Superannuation is working on a number of levels to alleviate demographic-related fiscal pressures. People who have private savings are more likely to fully or partially self-fund healthcare, aged care or other age-related expenses.

Super tax concessions will change

While this is a good news story for superannuation, there are other parts of the system that are not working as well as they could. You only need to glance at the newspapers over the past few weeks to see that the equity of superannuation tax concessions is continuing to be challenged. This is a debate that ASFA welcomes, but it's essential that it be based on facts and not media hysteria.

The $32 billion dollar figure that is often quoted as the 'annual cost to revenue' of superannuation tax concessions is arguably inflated for two key reasons. It does not take into account the savings the government makes on pensions and other age-related government expenditure as a result of people having super. It also does not take into account what alternative vehicles people will seek particularly those with high net worth, if super becomes less tax-effective. The search for a better deal, for example into geared property or shares, means they end up trading one concession for another.

However there's no doubt that as the system matures and account balances get bigger the cohorts that benefit from tax concessions in super will change.

Last year ASFA conducted an analysis of the flow of superannuation tax concessions by taxable income bracket. Parts of the analysis are somewhat different to what you often hear in the media. It found that around 90% of employer contributions to super go to individuals paying less than the top marginal tax rate, with 57% going to those paying a tax rate of 30% or less. This means the bulk of tax concessions applied to contributions flow to those paying either the 30 or 38% marginal tax rate. This is a large part of the Australian workforce and shows that the lower concessional contribution caps are doing their job.

However, the analysis also found that when it comes to tax concessions on earnings, the benefits are skewed towards middle-high income earners, who generally have a higher superannuation account balance, some in the millions. Given the demographic fiscal pressures, it's appropriate to question whether it's fair for future generations of taxpayers to fund generous tax concessions on earnings for older Australians who have accumulated these very high account balances.

As stated in the Financial System Inquiry (FSI) final report, the overarching goal of the superannuation system should be to allow people to accumulate private savings that deliver an income in retirement to substitute or supplement the age pension. It is therefore fair to say that tax concessions should start to fall away once a person has accumulated enough superannuation savings to generate an income that enables them to have a comfortable retirement.

How much is enough superannuation?

So how much is enough, and how much is too much? At a bare minimum, the superannuation balance required to live at the ASFA Retirement Standard 'comfortable' level should continue to attract the same tax concessions that are currently in place. Taking into account the fact that many people will continue to live in private rental accommodation during their retirement, and the financial risks associated with increased longevity and future medical and aged care expenses, ASFA estimates a balance of $2.5 million is sufficient to support a lifestyle in retirement which is comfortable for the great bulk of the Australian population. This could potentially be the 'ceiling' where the tax rules change.

Most people will never be able to accumulate an account balance anywhere near $2.5 million, so aiming tax changes above this amount will limit community reaction. It is also fair to say that most individuals who have super above this amount should have limited objections to paying a small amount of additional tax, particularly when they have received considerable tax concessions in the past on the contributions and investment earnings that enabled them to build such a large pot of savings.

These are discussions that will be had during the Tax White Paper process, and the FSI consultations. What's important is that we all reach a consensus on what changes need to be made to our system to ensure it remains equitable and sustainable when the baby boomer tsunami reaches our shores.

Pauline Vamos is Chief Executive Officer of The Association of Superannuation Funds of Australia (ASFA).

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