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Dissecting emerging market demographics

Judging by some of our politicians' rhetoric, an outsider might be forgiven for thinking that Australia is teetering on the precipice of a looming debt crisis, severe infrastructure shortages, environmental catastrophe and a wave of illegal immigration.

The rather more mundane reality is that Australia's problems are negligible compared to the scale of problems confronting many emerging market countries.

For instance, demographics, often touted as one of the attractive long term characteristics enticing investors to emerging market countries, present extraordinary challenges to countries like India and China – suggesting their evolving demographic structures may become pitfalls and snare unwary investors.

Across emerging markets, improved healthcare, sanitation and diet, amongst other things, have resulted in changing demographic structures. Although different countries are at varying stages of this evolution, there is a general trend towards a growing proportion of the population who are of working age.

The consequences are that a growing workforce will positively contribute, other things being equal, to household savings rates, productivity and economic growth. Often the economic benefit is called the demographic dividend. Conversely, other things being equal, as the population grows older and as the bulge in the workforce declines, consumption is likely to rise.

The working-age population typically swells as life expectancy increases, but shrinks as fertility rates decrease. The proportion of working age population can rise by extending the retirement age.

Every emerging market country displays a different demographic structure leading to varying expectations of savings rates, consumption, productivity and economic growth.

India has a very young population and as the workforce bulge expands, savings rates are likely to rise, leading to greater investment in infrastructure and gains in productivity and economic growth. In contrast, China already has a relatively high proportion of elderly and is likely to experience a decline in savings rates, but there will possibly be an escalation of consumption over the long term.

Although favourable demographics can bestow interesting investment opportunities at a macro level over the long term, how a country adapts – by its ability to absorb and productively employ a growing workforce or by its ability to provide social security and welfare for the elderly – is critical.

Also, the pace at which the proportion of the working-age population in emerging markets is growing, or, retirees' rising poses risks. Rapid change means they will have less wealth and time to encourage and build necessary employment industries and social security systems.

Again, these potential problems vary significantly across countries. UN projections suggest that Brazil, Mexico and even Vietnam will have an equal or higher percentage of elderly than the United States by 2050. China, South Korea and Singapore will have an equal or higher percentage of elderly than Europe by the same year.

But emerging markets are actually in worse shape than the United States or Europe in dealing with the problem; the United States and Europe had a comparable working-age population 65 years ago, but a per capita income around 300% and 150% greater, respectively.

Investing in countries with rapidly growing workforces or ageing populations also requires an assessment of whether emerging markets are implementing sound public policy and building quality institutions.

By way of a well known illustration, an emerging market investor would have done much better investing in East Asia than Latin America since the 1970's. However, East Asia and Latin America had similar demographic structures and wealth at the beginning of that period.

It is generally accepted that East Asian countries were better able to exploit their attractive demographics, comparatively speaking, as a result of stronger governance, sturdier legal institutions and stronger macroeconomic and social policies.

India is a perfect example of a country which could potentially squander its favourable demographics. Poor public policy and inefficient institutions could hinder it attempts to grapple with the financial and administrative challenges of rising income inequality, rapid urbanisation, educational underdevelopment and environmental degradation.

Perhaps India's greatest obstacle, as it tries to leap from an agrarian to a service-orientated economy, is that it lacks manufacturing industries, which are typically more highly labour intensive.

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By way of comparison, Australia will probably need to find employment for around 90,000 new people every year for the foreseeable future representing about 0.4% of people in employment. India will have to employ around 11 million annually , representing slightly less than 2.5% of the current labour force.

Tellingly, Australia's wealth is over 11 times that of India, suggesting that Australia has the capacity to integrate people into the workforce as required. Even more challenging for India, public policy and institutions related to employment, unemployment, industrial relations, education and provision of public goods are in most cases lagging well behind Australia.

In contrast, countries such as China are likely to confront a different problem. Although China has been reaping a demographic dividend, it is now in the process of dealing with a rapidly ageing population. But despite growing briskly, its means to confront the problem are still significantly more modest – its current GDP per capita is six times less than the United States.

Consequently, large companies are increasingly re-locating inland to avoid rising wage pressures on the coast. Although there are over 200 million rural workers China can draw from, the supply of cheap labour will be increasingly difficult to come by.

And in regards to provisioning for the burgeoning number of retirees, the Chinese government has recently attempted to increase payments and enlarge social security coverage. However, healthcare and social security systems are still grossly inadequate – state pensions are only half of average wages, but only 20% and less than 10% of urban and rural workers are covered, respectively. This escalates the probability of dissatisfaction, of an already fraught relationship, with the government.

Although the favourable demographics of emerging markets constitute an important long term benefit for investors, significant variability and changes in demographic structures suggest they should not invest indiscriminately. Additionally, without sound public policy and dependable institutional infrastructure (as highlighted in the challenges faced by India and China), the demographic dividend and the assumed benefits of ageing on consumption may not eventuate. **FS**