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International Trade with Pensions and Demographic Shocks

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Abstract

The central question of this paper is how international trade and specialization are affected by different designs of pension schemes and asymmetric demographic changes. In a model with two goods, two countries and two production factors, we find that countries with a relatively large unfunded pension scheme will specialize in the production of labour intensive goods. If these countries are hit by a negative demographic shock, this specialization will intensify in the long run, which is contrary to the prediction of the classical Heckscher-Ohlin-Samuelson model. Eventually, these countries may even completely specialize in the production of those goods. The effects spill over to other countries, which will move away from complete specialization in capital intensive goods as the relative size of their labour intensive goods sector will also increase.

JEL Classification: E27, F16, H55, J19

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1 Introduction

Population ageing is a worldwide phenomenon, but because of regional differences, some countries age more rapidly than others. This puts pension systems under pressure, but will also affect the endowments of capital and labour, and therefore have important macroeconomic consequences that may spillover to other countries through international trade, specialization and real exchange rate changes.

According to the classical Heckscher-Ohlin-Samuelson (HOS) model (Samuelson (1948)), a country will specialize in the production of the good that uses its relatively abundant production factors. This would imply that an ageing country which experiences a shrinking labour force, will specialize in the production of capital intensive goods, and will trade with countries that are endowed with a relatively small capital stock. In this model, the amounts of labour and capital in each country are exogenously given and internationally immobile. This sounds reasonable for analyzing the short-run effects of demographic shocks. However, this assumption is not appropriate when studying the long-run effects. In the course of time, the amount of capital in an economy will adjust to its new population level. So in the long run specialization also depends on factors that determine people's desire and ability to save and accumulate capital, such as individual thriftiness and institutional arrangements like pension schemes. So far, pensions received little attention in the dynamic trade literature. In this paper, we will address the question how specialization and trade are influenced by international differences in the design of pension schemes, and how asymmetric demographic changes affect this. We find that in the long run, the relative size of different production sectors –and therefore the pattern of trade– depends on the generosity of unfunded Pay-As-You-Go (PAYG) schemes: the larger such a scheme is compared that of another country, the more the country will specialize in the production of labour intensive goods. Furthermore, the relative size of PAYG schemes is also important for the effects of a demographic shock that takes place in one country. If that country has a large unfunded pension scheme, a relative decrease in its population size may lead to a larger share of the labour force working in the labour intensive goods sector, which is opposite to the predictions of the HOS model.

Previous literature on multiple goods and trade has already emphasized international differences in saving rates as an important factor for trade flows and patterns of specialization, dating back to the seminal article by Oniki and Uzawa (1965) in which countries have fixed, but different saving rates. In Stiglitz (1970) and Deardorff and Hansson (1978), saving rates were endogenized by assuming infinitely-lived consumers whose rates of time preference differ between countries, leading to high saving countries exporting capital intensive goods. Later extensions of such Ramsey-type trade models focus on relative factor intensities (Engel and Kletzer (1989)), taxation of capital goods (Baxter (1992)), and terms-of-trade effects that influence incentives to save and convergence (Bajona and Kehoe (2010)). In another strand of literature, the overlapping-generations framework is applied which allows for analysing intergenerational issues, such as

in Fried (1980) who finds that transfers between generations are required for a production innovation to be welfare improving. Internationally different saving rates play an important role when analyzing the short-run and long-run welfare effects of free trade and capital flows (Buitier (1981), Serra (1991), Fisher (1992), Kemp and Wong (1995), Gokcekus and Tower (1998)) and also in the paper by Galor and Polemarchakis (1987) on transfers between countries, which shows that such transfers will decrease welfare in the recipient country if the marginal propensity to save in this country is lower than in the donor country. A similar conclusion was drawn by Mountford (1998), where trade may move the world toward a low-income steady state.

Some recent papers have focused on demographic factors and trade. Kenc and Sayan (2001) apply an OLG computable general-equilibrium model to analyze the effects of population ageing in the EU on Turkey's key macroeconomic variables with international trade as a transmission mechanism. They find that demographic developments in Europe magnifies the economic effects of ageing in Turkey considerably. Sayan (2005) analyzes the effects of demographic changes on the pattern of losses and gains from trade in a '2x2x2' HOS model where countries are identical except for the rate of population growth. As a lower population growth rate in autarky would imply a higher capital-labour ratio (due to less capital dilution), this leads to trade with the ageing country that is specializing in capital intensive goods. However, this trade does not necessarily lead to welfare gains for both countries. Naito and Zhao (2009) refine this result and also conclude that an ageing country will export the capital intensive good. The old generation in the ageing country gains from trade, but subsequent generations lose during the transition phase. A compensation scheme consisting of country-specific lump-sum taxes (transfers) and saving subsidies (taxes) can make free trade Pareto superior to autarky. This paper is extended by Yakita (2012) with endogenous fertility and human capital, which finds that ageing, modeled as an increase in life expectancy, does not necessarily make the country a net exporter of capital intensive goods.

The combination of international differences in pension schemes and population growth rates have been analysed in one-good models. For instance, Börsch-Supan et al. (2006) study the consequences of asymmetric population ageing in 5 regions of the world using a multi-generations simulation model. In most scenarios in this model, ageing countries export capital in the short run, and start importing capital later. Adema et al. (2008) study the spillover effects of pension schemes under symmetric population ageing in a two-country two-OLG model with perfect capital mobility, and show that a country with a PAYG pension scheme gains from the country with a funded pension scheme, because it generates larger savings. The main difference with the model developed in this paper is that we allow for two different goods, which enables us to study the effects of demographic shocks on the relative size of sectors in the countries and the characteristics of international trade flows. To the best of our knowledge, this has not been analysed before in the dynamic trade literature, with the exception of Matsuyama (1988) which analyzes the long-run effects of a higher population growth rate. If the country's citizens are relatively patient

compared to the rest of the world, this country will export capital intensive goods, but higher population growth will lead to exports of labour intensive goods in the long run. Our paper therefore adds to the previous literature in two ways. First, it focuses on the pension system as another important element for international differences in savings, and thereby for specialization and trade. Second, it studies the short-run and long-run effects of demographic developments when differences in pension systems are taken into account. In contrast to Sayan (2005), which also analyses a temporary demographic shock but without pensions, the steady state differs from the situation in autarky. In particular, the country with the larger PAYG scheme accumulates less capital and exports labour intensive goods. The distribution of labour between the sectors in the steady state not only depends on the size of the PAYG scheme, but also on the relative size of both countries in terms of population. As a consequence, temporary demographic shocks that alter the relative size of both countries may have permanent effects, also for the country that is not experiencing the shock. However, this is only the case if the size of the PAYG scheme in both countries is different.

The rest of the paper is organized as follows: The next section describes the model. Section 3 presents the steady state and elaborates on the effect of the size of the PAYG schemes in the countries on the sector structure of the economies. In section 4 we analyze the effects of a temporary decrease in fertility in the Home country. First, analytical long-run results are derived, then the short-run dynamics is illustrated using numerical simulation experiments. Section 5 concludes.

2 The model

The model describes a discrete time two-country two-sector economic union where both countries have the same sectors. So, goods produced in different countries but the same sectors are identical. We assume that one sector (indicated with index C) produces goods used for consumption and the other sector (index I) produces goods that can only be used for investment. Both countries are identical with respect to the production structure and household preferences, but they may differ with respect to the size of the PAYG pension scheme. To distinguish between the countries one country will be referred to as “Home country” (H), the other being the “Foreign country” (F). We use the same notation for the variables in the Home country and the Foreign country, but variables referring to the latter are indicated by a tilde (\sim).

There are two overlapping generations in the model: young and old, and there is no population growth except for one period of temporal change in the fertility rate in one of the countries. Each person lives for two periods. The total number of young in the Home country is indicated by Λ . These young agents inelastically supply one unit of labour. We denote the number of young in the Home country working in the investment good sector in period t by $L_I(t)$, so equilibrium in the labour market implies $L_C(t) = \Lambda(t) - L_I(t)$ persons working in

the consumption good sector. Production factors are not internationally mobile. That is, agents cannot migrate and they can only invest in their Home country. However, both investment goods and consumption goods can be traded on the international market.

2.1 Firms

The firms in both countries are identical, therefore we only present the equations for the Home country. In both sectors production at time t is described by a standard Cobb-Douglas function with constant returns to scale:

$$Y_C(t) = K_C(t)^\alpha L_C(t)^{1-\alpha}, \quad 0 < \alpha < 1, \quad (1)$$

$$Y_I(t) = K_I(t)^\beta L_I(t)^{1-\beta}, \quad 0 < \beta < 1, \quad (2)$$

where $K_C(t)$ and $K_I(t)$ denote the capital stock in the consumption good sector and the investment good sector, respectively. We assume that production in the investment good sector is more capital intensive than in the consumption good sector (i.e., $\beta > \alpha$).

Capital fully depreciates in one period. In both sectors, the returns to the production factors are equal to their marginal products. Both interest rates and wages are expressed in terms of consumption goods, and the interest rates are defined as returns to investment measured in consumption goods:

$$w_C(t) = (1 - \alpha)k_C(t)^\alpha \quad (3)$$

$$w_I(t) = (1 - \beta)p(t)k_I(t)^\beta \quad (4)$$

$$1 + r_C(t) = \frac{\alpha}{p(t-1)}k_C(t)^{\alpha-1} \quad (5)$$

$$1 + r_I(t) = \frac{\beta p(t)}{p(t-1)}k_I(t)^{\beta-1} \quad (6)$$

where $w_C(t)$ is the wage rate in the consumption good sector, $w_I(t)$ denotes the wage in the investment good sector, $r_C(t)$ and $r_I(t)$ are the interest rates in consumption and investment good sector. $p(t)$ is the price of investment goods in terms of consumption goods at time t and $k_C(t) \equiv K_C(t)/L_C(t)$ and $k_I(t) \equiv K_I(t)/L_I(t)$ denote the capital-labour ratio in sector C and sector I , respectively.

2.2 Factor mobility between sectors

Agents can freely choose in which sector to work when young. After they have chosen a sector, this cannot be changed any more. As a result, expected lifetime utility at the start of the career should be equal for workers in both sectors.²

²The equations in this section are based on the assumption of rational expectations. Therefore, they may not hold in a period in which a shock unexpectedly takes place after the agents have decided in which sector to work and to invest. In the numerical simulations in Section 4, the actual return to savings in the period of the unexpected demographic shock is calculated using the assumption that all the agents have the same portfolio.

Because a larger budget allows an agent to reach a higher indifference curve, this implies equality of expected present values of individual incomes. As the pension system is organized on a national level and is identical for workers in both sectors, this boils down to equality of the wages in the sectors:³

$$w_C(t) = w_I(t) \equiv w(t). \quad (7)$$

Likewise, agents may freely choose in which sector to invest their savings, implying that interest rates in both sectors are equal as well:

$$r_C(t) = r_I(t) \equiv r(t). \quad (8)$$

Using equations (3)-(6), we can express the capital-labour ratio in the sectors as a function of the relative price of investment goods:

$$k_C(t) = \left(\frac{1-\alpha}{1-\beta} \right)^{\frac{1-\beta}{\beta-\alpha}} \left(\frac{\alpha}{\beta} \right)^{\frac{\beta}{\beta-\alpha}} p(t)^{-\frac{1}{\beta-\alpha}}, \quad (9)$$

$$k_I(t) = \left(\frac{1-\alpha}{1-\beta} \right)^{\frac{1-\alpha}{\beta-\alpha}} \left(\frac{\alpha}{\beta} \right)^{\frac{\alpha}{\beta-\alpha}} p(t)^{-\frac{1}{\beta-\alpha}}. \quad (10)$$

Note that these equations also hold for the Foreign country. That is, the capital-labour ratios in a particular sector are equal in both countries, resulting in equality of factor prices. This is in line with the classical Heckscher-Ohlin-Samuelson model. It also follows that the capital-labour ratios in both sectors are proportional to each other, i.e.:

$$k_C(t) = \kappa k_I(t) \quad (11)$$

where $0 < \kappa \equiv \frac{(1-\beta)\alpha}{(1-\alpha)\beta} < 1$.

2.3 Households

Because of the free mobility of production factors between sectors, we do not have to distinguish between households working in both sectors (except for the time of unexpected decrease in fertility). Utility functions and budget constraints are assumed to be identical in both countries, so again we only present the equations for the Home country.

Agents are assumed to have a logarithmic utility function:

$$U(t) = \log C^y(t) + \frac{1}{1+\rho} \log C^o(t+1), \quad (12)$$

where C^y and C^o denote consumption when young and when old, respectively, and ρ is the rate of time preference. The budget constraints for the first and

³Since the same holds for both countries, we again only give the equations for the Home country. It should be noted, however, that the pension schemes are organized on a national level and PAYG tax and benefit levels in the countries may differ.

the second period of life are given by:

$$C^y(t) = w(t)(1 - \tau) - s(t), \quad (13)$$

$$C^o(t+1) = (1 + r(t+1))s(t) + \eta(t+1), \quad (14)$$

where s stands for savings, τ is the tax rate on labour income to finance the PAYG pension scheme, and η is the pension benefit. The pension system is organized on a national level and is identical for workers in both sectors. Because the PAYG tax is fixed, the pension benefit adjusts to e.g. demographic changes according to the following balanced-budget constraint for the government:

$$\eta(t+1) = \tau \frac{w(t+1)\Lambda(t+1)}{\Lambda(t)}. \quad (15)$$

Optimizing the utility function (12) subject to the budget constraints (13) and (14) results in the following expression for savings:

$$s(t) = \frac{1}{2 + \rho} \left(w(t)(1 - \tau) - \frac{1 + \rho}{1 + r(t+1)} \eta(t+1) \right). \quad (16)$$

2.4 Equilibrium

The model comprises four markets that are simultaneously in equilibrium each period. Equilibrium in the markets for consumption and investment goods implies:

$$Y_C(t) + \tilde{Y}_C(t) = \Lambda(t)C^y(t) + \Lambda(t-1)C^o(t) + \tilde{\Lambda}(t)\tilde{C}^y(t) + \tilde{\Lambda}(t-1)\tilde{C}^o(t) \quad (17)$$

$$Y_I(t-1) + \tilde{Y}_I(t-1) = K_C(t) + K_I(t) + \tilde{K}_C(t) + \tilde{K}_I(t). \quad (18)$$

We assume that savings are invested within the country of origin. Hence, the total amount of capital in the Home country in period t is equal to total savings in this country at time $t-1$, so capital market equilibrium is given by:

$$K_C(t) + K_I(t) = \Lambda(t-1)s(t-1)/p(t-1) \quad (19)$$

and equivalent for the Foreign country.

Finally, the labour market is in equilibrium if

$$L_C(t) + L_I(t) = \Lambda(t) \quad (20)$$

Defining $\lambda \equiv \frac{L_I(t)}{\Lambda(t)}$ as the share of the labour force in the Home country working in the investment good sector, this indicates the degree of specialization within the country in the production of investment goods. Using equations (15), (16) and (19) and (20), equilibrium in the capital market (19) can be written as:

$$\lambda(t) = A(t)z(t) - B \quad (21)$$

where $A(t) \equiv \frac{1-\beta}{\beta-\alpha} \frac{1-\alpha}{2+\rho} \frac{\Lambda(t-1)}{\Lambda(t)} \beta(1-\tau) > 0$, $B \equiv \frac{1-\beta}{\beta-\alpha} [\frac{(1+\rho)(1-\alpha)\tau}{2+\rho} + \alpha] > 0$ and $z(t) \equiv \frac{k_I(t-1)^\beta}{k_I(t)}$. A similar equation holds for the Foreign country.⁴

Substituting expressions (9) and (10) into (18) we get the following condition for equilibrium in the market for investment goods:

$$z(t)[\Phi(t-1)\lambda(t-1) + \tilde{\lambda}(t)] = \frac{1}{(1-\alpha)\beta} [\alpha(1-\beta)(\Phi(t)+1) + (\beta-\alpha)(\Phi(t)\lambda(t) + \tilde{\lambda}(t))] \quad (22)$$

where $\Phi(t) \equiv \Lambda(t)/\tilde{\Lambda}(t)$ is the relative population size of the Home country. Inserting equation (21) and its Foreign counterpart in (22) gives a non-linear first-order difference equation in $z(t)$ (see Appendix 1). This difference equation forms the basis of the numerical simulations of a demographic shock presented in Section 4. In the next section the steady state of this system will be discussed.

3 The steady state

In steady state, the equilibrium condition for the capital market (equation (21)) can be rewritten as:⁵

$$\lambda = Ak_I^{\beta-1} - B. \quad (23)$$

It should be noted that $A < (>)\tilde{A}$ and $B > (<)\tilde{B}$ if $\tau > (<)\tilde{\tau}$. Furthermore, the capital-labour ratio in the investment good sector is equal in both countries ($k_I = \tilde{k}_I$), which implies that

$$\lambda = \frac{A}{\tilde{A}}\tilde{\lambda} + \frac{\tilde{B}A - B\tilde{A}}{\tilde{A}}. \quad (24)$$

Both equations (23) and (24) are represented graphically as the curves indicated ‘‘Capital market equilibrium’’ in Figures 1 and 2 (for the case that the Home country has a relatively large PAYG scheme: $\tau > \tilde{\tau}$) and Figure 3 (for the case that the PAYG scheme in the Foreign country is relatively large). The downward-sloping relation between the capital-labour ratio in the investment good sector (k_I) and λ can be interpreted as follows. A higher fraction of people working in the investment good sector has two effects on the capital labour ratio of that sector. First, more people directly reduces k_I for a given capital stock. Second, for a given capital-labour ratio, total capital per worker rises if λ increases. This immediately follows from equation (19) that can be written as: $\frac{K_I+K_c}{\Lambda} = \lambda k_I + (1-\lambda)k_c = [1+(1-\kappa)\lambda]k_I$ and the fact that $\kappa < 1$ because the investment good sector is relatively capital intensive. More capital per worker will increase wages and thereby savings and capital accumulation, but less than proportional. As the first effect dominates, the curve is downward sloping. A

⁴Note that $z = \tilde{z}$.

⁵We indicate steady-state values by omitting the time index of a variable.

higher PAYG tax in the home country reduces savings and implies less capital accumulation, so for a given λ , k_I will be lower. It also immediately follows that the relative share of the investment good sector in the Home country is smaller (larger) than in the Foreign country if the Home country has a larger (smaller) PAYG pension scheme.

In order to determine the value of λ in the steady state, we also have to use the condition for equilibrium in the market for investment goods (equation (18)). Substituting the production functions and equation (10) into equation (18), and using that the fact that the capital-labour ratio in the investment good sector in both countries is equal, we find that:

$$\lambda = \frac{\alpha(1-\beta)}{(1-\alpha)\beta} \frac{\Phi+1}{\Phi+(\tilde{A}/A)} k_I^{1-\beta} - \frac{B\tilde{A}-\tilde{B}A}{\Phi A+\tilde{A}}. \quad (25)$$

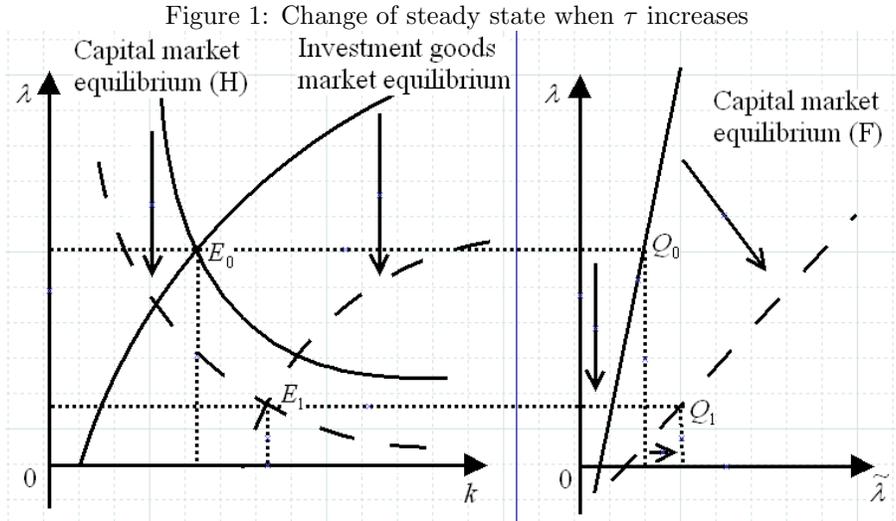
This curve is also presented in Figures 1, 2 and 3 (indicated as “Investment goods market equilibrium”). It has a straightforward interpretation: an increasing capital-labour ratio affects production in both sectors. But, in the capital intensive sector productivity of labour grows more, which attracts labour to this sector. This results in a positive relation between λ and k_I .

The intersection of both curves in the left-hand panel of Figures 1, 2 and 3 determines the steady-state values of λ and k_I .⁶ Given the value of λ , the value of $\tilde{\lambda}$ can subsequently be determined from the right-hand panel of the figure. It is immediately clear that the country with the relatively large PAYG scheme will have a relatively small investment good sector and specializes in the production of the labour intensive consumption goods, while the opposite holds for the country with the small PAYG scheme. The larger the difference in the size of the unfunded scheme, the more the countries will specialize.

This effect is presented in Figure 1. In the initial situation (E_0 and Q_0) countries have the same pension schemes. Keeping $\tilde{\tau}$ constant and increasing τ , agents in the Home country get a weaker incentive to save, hence, the amount of capital in the country decreases. As a result, the Home country specializes in the production of labour intensive goods (λ rises), as indicated by the movement to point E_1 . The Foreign country is affected as well. First, it has a relative advantage in the production of capital intensive goods, which creates incentives for the Foreign country to specialize in capital intensive goods. Second, the world demand for capital falls when τ grows, this negatively affects the share of labour in the capital intensive sector in both countries. The overall effect on $\tilde{\lambda}$ is not clear, as it depends on the exact parameter values: if the slope of the dashed line representing equation (24) depicted in the right hand panel is small enough, then $\tilde{\lambda}$ increases. Anyway, the share of the investment goods sector in the Home country becomes smaller relative to the Foreign country.

It should also be pointed out, that a further increase in τ shifts the curve and the line in the left panel of Figure 1 even more down, so if the difference between τ and $\tilde{\tau}$ gets sufficiently large, the intersection of the curves will be

⁶The analytical solution for the steady state is presented in Appendix 1.



below the horizontal axis, resulting in a corner solution in which the Home country produces labour intensive goods only.

This result coincides with what one would expect in a static HOS-model: the country with a large PAYG scheme has low savings, so capital is relatively scarce and labour relatively abundant. However, it is not completely clear if specialization of countries necessarily leads to international trade. The Home country produces less capital, but it also needs less capital. So the graphs do not provide an answer to the question whether specialization within the countries intensifies international trade.

4 An asymmetric decrease in fertility

In this section we study the long-run and short-run effects of a negative demographic shock occurring in one country. At time $t = 0$ population growth in the Home country is temporarily lower than in the Foreign country, leading to a relatively smaller labour force in the Home country, so Φ decreases. This can be interpreted as one country ageing relative to the other. This demographic shock is unexpected at time $t = -1$ when agents choose a sector to work, but they do take it into account when making their saving/consumption decisions. In subsequent periods, the population in both countries grows at the original rate again, so the relative size of the country will not change further and Φ will remain at the higher level.

Figure 2: Change of steady state when Λ decreases, $\tau > \tilde{\tau}$

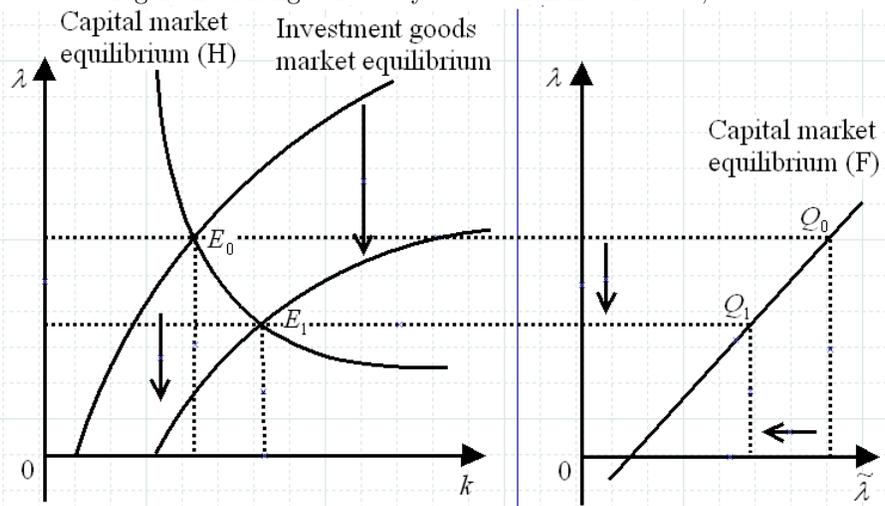
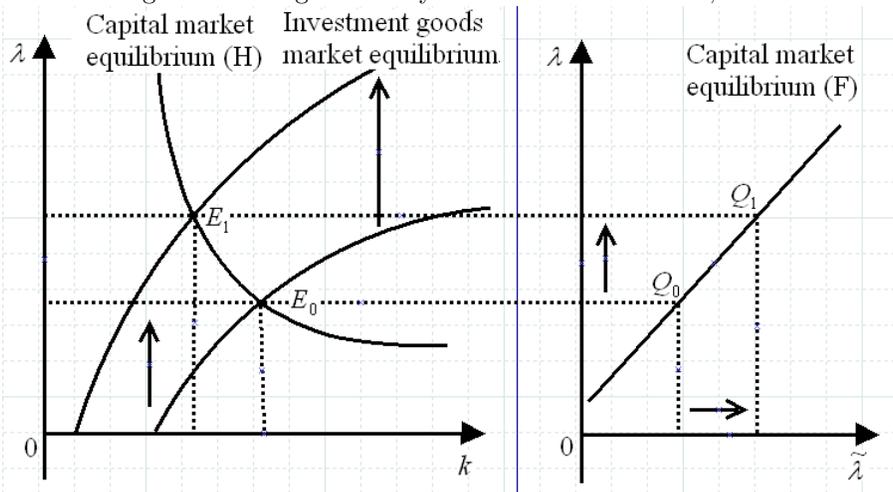


Figure 3: Change of steady state when Λ decreases, $\tau < \tilde{\tau}$



4.1 Long-run effects

The long-run effects of a negative demographic shock in the Home country are summarized in the following proposition:

Proposition 1. *A decrease in the relative size of the Home country's population:*

- *increases the capital-labour ratio in both sectors and decreases the share of labour employed in the investment good sector in both countries if $\tau > \tilde{\tau}$.*
- *decreases the capital-labour ratio in both sectors and increases the share of labour employed in the investment good sector in both countries if $\tau < \tilde{\tau}$.*
- *does not affect the capital-labour ratio and the relative degree of specialization if $\tau = \tilde{\tau}$.*

Proof. The proof is in Appendix 2. □

In case $\tau > \tilde{\tau}$, agents in the Home country save less than agents in the Foreign country. So decreasing the relative size of the Home country leads to an increase of the average amount of savings per worker in the union as a whole, which drives the capital-labour ratios up. If $\tau < \tilde{\tau}$, agents in the Home country save more than agents in the Foreign country, so if their number decreases, capital-labour ratios in the union will decrease.

This result can also be represented graphically. The decrease in the relative size of the Home country shifts the curve representing equilibrium in the market for investment goods down if the Home country has a relatively large PAYG scheme (see Figure 2), and up if this country has a relatively small PAYG scheme (see Figure 3). As the curve and the line representing capital market equilibrium are not affected, the result for the capital-labour ratio in the investment good sector and the share of labour employed in this sector immediately follows. According to equations (9) and (10), the capital labour-ratio in the consumption goods sector moves in the same direction as k_I .

The right-hand panels of Figures 2 and 3 show that λ and $\tilde{\lambda}$ move in the same direction. If $\tau > \tilde{\tau}$, the asymmetric demographic shock in the Home country causes the Foreign country to move away from the point of full specialization in investment goods. At the same time, if Λ decreases very strongly, a corner solution may result where the Home country is fully specialized in the production of consumption goods and imports all investment goods. This is opposite to the prediction of the HOS model that a decrease in the labour force in the Home country will lead to more specialization in the production of capital intensive goods. The difference comes from including pension systems, which determine savings and, hence, the relative advantage of the country in capital (labour) intensive goods production.

Figure 3 presents the case that $\tau < \tilde{\tau}$. The negative demographic shock in the Home country leads to higher shares of the labour force working in the investment goods sector. The Foreign country moves away from the point of full

specialization in labour intensive consumption goods. For the Home country it holds that if the value of λ increases very strongly, it may eventually be completely specialized in the production of capital intensive goods.

4.2 Short-run effects

In this subsection, we discuss the short-run effects of a temporary decrease in fertility in the Home country. That is, the relative size of the Home country decreases once and for all at time $t = 0$. The short-run effects will be demonstrated with numerical simulations in this section, a more technical discussion can be found in Appendix 1.

4.2.1 Calibration

The capital share for a one-sector model is usually estimated to be around 0.3. For example, Howarth (1998) assumes a share of capital income equal to 0.25, Bouzahzah et al. (2002) set it at 0.29, Kydland and Prescott (1982) choose a value of 0.36. In line with this, we chose a value that is a bit above these estimates for the capital intensive sector and a value just below these values for the labour intensive sector, i.e., $\alpha = 0.2$ and $\beta = 0.4$. As the period in the model is approximately equal to 35 years, the discount rate ρ is set at 0.42, which approximately corresponds to the 1% annual discount rate that is widely used in the literature (see for example Jermann (1998) and Börsch-Supan et al. (2006)). The tax rate is set at 0.25 for the country with the relatively small PAYG scheme and to 0.3 in the other country.⁷ Initially, the population size in both countries is equal: $\Lambda = \tilde{\Lambda} = 1$. At time $t = 0$ the population in the Home country decreases to a level that is permanently 5% lower (i.e., from $\Lambda = 1$ to $\Lambda = 0.95$).

The dynamics of this model are summarized by a first-order difference equation in $z(t) \equiv k_I(t-1)^\beta/k_I(t)$ with time-dependent coefficients. It can easily be checked that for the parameter values used this difference equation is unstable (see Appendix 1 for a more elaborate discussion).

4.2.2 Simulation results

Figure 4 presents the time path of λ both for the case that $\tau < \tilde{\tau}$ and for $\tau > \tilde{\tau}$. First consider the case that $\tau < \tilde{\tau}$. At $t = 0$ λ increases in both cases, which corresponds to the result of the static HOS model. Note that with a larger demographic shock this increase may lead to a corner solution where one of the countries completely specializes in one of the goods. Next period, λ jumps to its new steady state value. If $\tau < \tilde{\tau}$ this new steady state value is slightly larger and if $\tau > \tilde{\tau}$ it is smaller than the value in the previous steady state. In the latter case, the long-run result is opposite to the prediction of the HOS model: the Home country specializes in the production of labour intensive goods, and

⁷In fact, qualitatively the results are not sensitive to the absolute values of PAYG tax rates, but it is important that the two countries have different rates.

a negative demographic shock in this country makes it specialize even more in the production of this type of goods.

Figure 4: Share of labour in sector I of country H

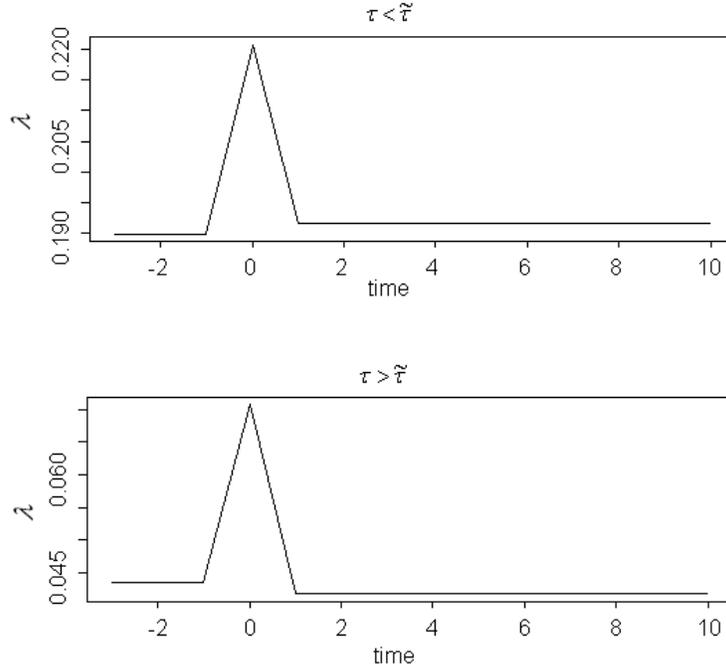
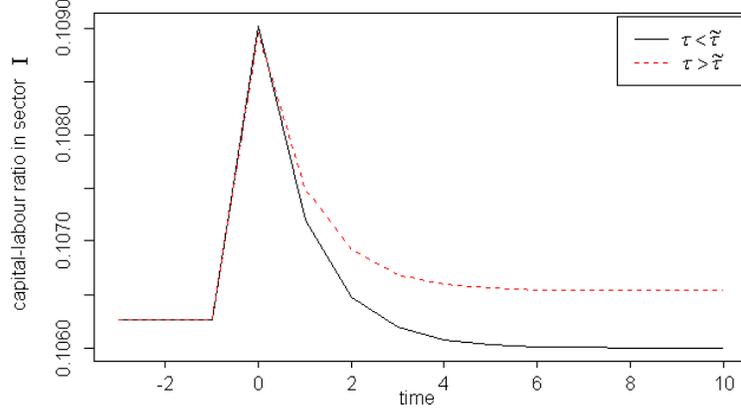


Figure 5 presents the time path of the capital-labour ratio in the investment good sector. As the amount of investment goods produced in period $t = -1$ cannot be changed any more when it becomes known that the population in the Home country will shrink in period $t = 0$, capital is abundant at $t = 0$. That is, the capital-labour ratios in both sectors and both countries at $t = 0$ are high. As the low interest rate is already anticipated at $t = -1$, savings and thus the demand for investment goods change at $t = -1$ in both countries. A lower interest rate, and higher wages, affect agents in both countries.⁸ In the Home country, this is counteracted by the decrease pension benefits due to the negative demographic shock at $t = 0$, which raises savings at $t = -1$ in that country. For the given parameter values, the negative effect via interest rate and wages dominates when $\tau < \tilde{\tau}$, implying that the demand for investment goods falls, leading to a decrease in the relative price of these goods already at

⁸Note that the decrease in savings in reaction to the lower interest rate and higher future wages is due to the presence of a PAYG pension. Given that we have assumed a logarithmic utility function, the income effect and the substitution effect of a change in the interest rate on savings would exactly cancel out if there was no PAYG scheme. This does not hold with a more general utility function as well as in our model due to the presence of PAYG scheme.

Figure 5: Capital-labour ratio in sector I



$t = -1$ (see Figure 6).

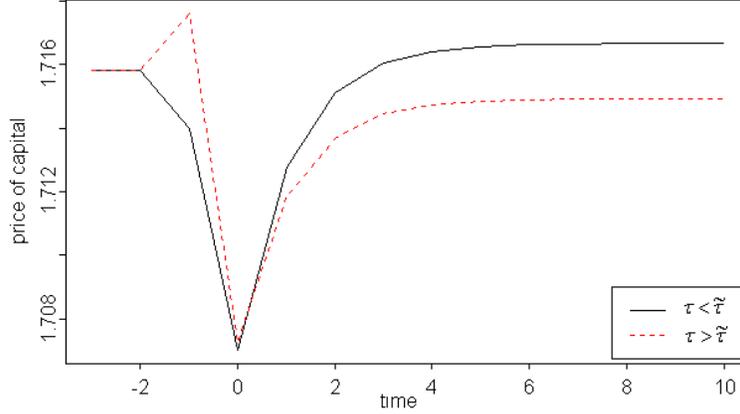
The abundance of capital at $t = 0$ stimulates production in both sectors, but more in the capital intensive investment good sector. Furthermore, workers move from the consumption good sector to the investment good sector. Thus, the production of investment goods will be relatively high at $t = 0$ leading to a fall in the price of investment goods that is even lower than at $t = -1$.

The high supply of investment goods in period $t = 0$ affects capital-labour ratios in the subsequent period that is lower than at $t = 0$ but still above the new steady-state value. The abundance of capital leads to the same effects as at $t = 0$, but the size of the effects is smaller. This development continues, leading to a gradual decrease in the capital-labour ratios along with a gradual increase in the price of investment goods. As discussed above, in the long run, this results in a capital-labour ratio that is below the initial steady-state value and a price of investment goods that is higher than it initially was.

In case the Home country has a relatively large PAYG scheme, the short-run results are analogous to the ones presented above, the only difference being that in that case, the interest-rate effect on savings at $t = -1$ is dominated by the effect of the decrease in the PAYG benefit due to demographic shock, so that the relative price of investment goods slightly rises at that time.

Figure 7 shows the effect of the demographic shock on international trade. It presents the difference between the amount of investment goods produced in country H and the actual amount of savings in country H in that period. This difference is equal to the amount of investment goods sold to (bought from) country F, if the value is positive (negative). The demographic shock at $t = 0$ leads to a relatively higher demand for capital goods in country H at $t = -1$ compared to country F, because pension benefits in country H are directly affected by the demographic shock. This leads to a smaller export of investment goods from the Home country when $\tau < \bar{\tau}$, or a larger import if $\tau > \bar{\tau}$ at

Figure 6: Price of capital



$t = -1$. At $t = 0$ there is relatively more capital in the country affected by the demographic shock, so it starts exporting more capital (or importing less). At later stages the volume of trade decreases in both cases compared to their initial equilibrium, because of a smaller total number of agents in the world.

Figures 8 and 9 show the effect on lifetime utility of the generations in both sectors and countries when $\tau < \tilde{\tau}$. As the case $\tau > \tilde{\tau}$ is very similar, we omit it. The time on the horizontal axis corresponds to the period of birth of a generation. The decrease in the price of investment goods at $t = -1$ leads to lower wages in that sector and hence negatively affects the PAYG benefits of the generation born at $t = -2$. Furthermore, the lower price reduces the interest rates in the investment good sector at $t = -1$ and thus the return on savings of generation $t = -2$. These effects are the same in both sectors and both countries. However, they are very small. So, the utility of generation $t = -2$ slightly decreases. At $t = 0$ the number of agents in the world is smaller and capital is abundant, which drives interest rates down. Smaller interest rates imply a lower return to savings for the generation born at $t = -1$ in both countries. In the Home country, the decrease in the PAYG benefit caused by the rise in the dependency ratio adds an additional negative effect on utility of this generation. Finally, the members of this generation that work in the investment good sector experience a third negative effect as the decrease in the price of the investment good at $t = -1$ implies a lower wage when young. Note that this is the only generation for which the effects of the shock differ for workers in different sectors. All subsequent generations can take the effects of the shock into account when deciding in which sector to work. Hence, for these generations utility for workers in both sectors must be equal.

The generation born at $t = 0$ enjoys the large capital stock that results from the investment of their parents, so their utility is affected positively. In subsequent periods, the capital-labour ratio gradually decreases and the same

Figure 7: Net exports of investment goods by the Home country (total volume)

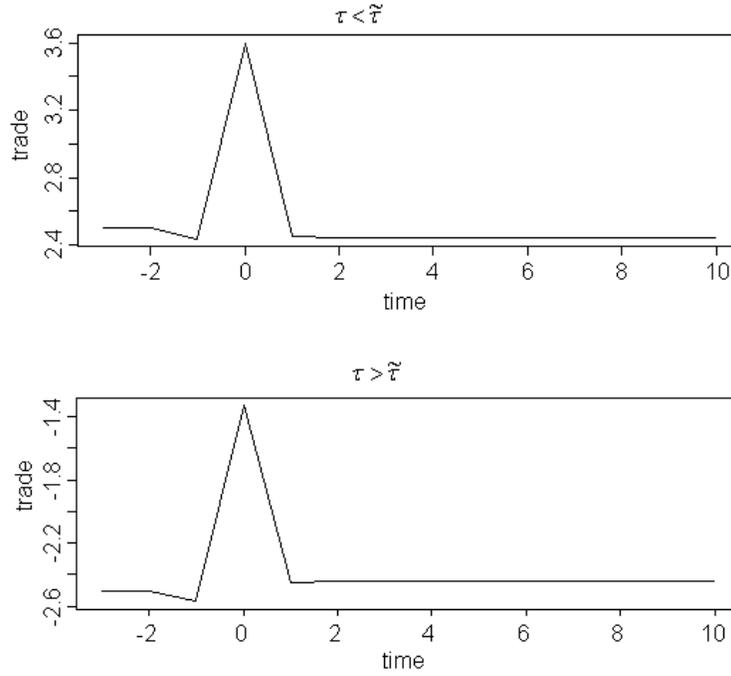


Figure 8: Utility in the Home country when $\tau < \tilde{\tau}$

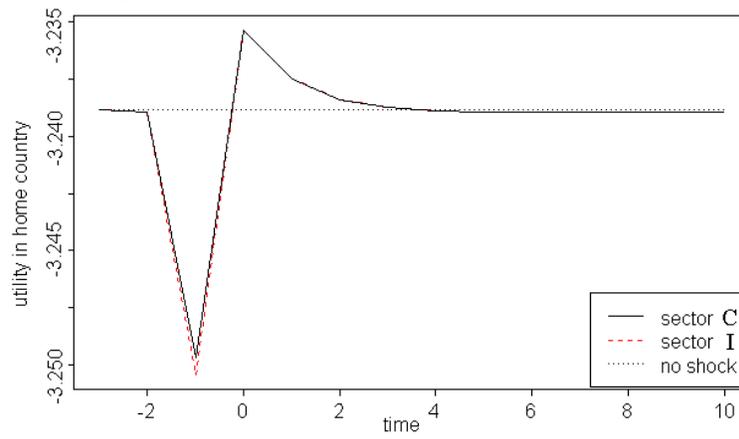
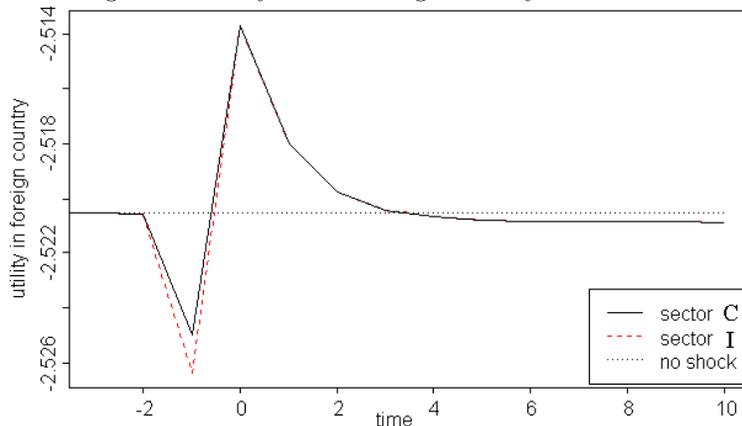


Figure 9: Utility in the Foreign country when $\tau < \tilde{\tau}$



holds for utility. Initially, it is still larger than in the original steady state, but in the long run it falls below that level. This time pattern is the same for both countries. However, absolute utility levels differ due to the difference in the size of the PAYG scheme between the countries. Without such difference, there would be no long-run effects of a temporary demographic shock. Furthermore, these differences also imply that the effects of the shock in one country spill over to the other country: as the economy is dynamically efficient, the Foreign country (which has the largest PAYG scheme in this example) has lowest utility.

5 Conclusions

This paper analyzed the effects of demographic shocks in a discrete time dynamic model with two countries, two sectors, two-period overlapping generations and PAYG pensions. We showed that in the long run, the relative size of the sectors in both countries (and therefore the pattern of trade) depends on the relative size of the PAYG schemes in the countries. A smaller PAYG pension scheme leads to higher savings, which gives a country an advantage in the production of capital intensive goods, leading to specialization in these goods. The other country specializes in labour intensive goods. We also showed that, while the short-run effects of demographic shocks are not affected by the presence of PAYG schemes and coincide with the predictions of the classical HOS-model, the long-run effects can be different. Due to the fact that PAYG pensions affect the incentive to save and accumulate capital, the long-run consequences of demographic shocks in the dynamic model with unfunded pensions may be opposite to the predictions of the classical HOS model. So, a temporal decrease in fertility leads to specialization of the country in capital intensive goods in the short run, but in the long run, specialization of the countries depends on the

relative size of the PAYG scheme. Comparable results are likely to hold in the presence of other factors that affect the desire or ability to accumulate capital like, for example, differences in the rate of time preference and government debt.

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Appendix

Appendix 1: The dynamic system

Inserting equation (21) and its Foreign counterpart in (22) gives a non-linear first-order difference equation in $z(t) \equiv \frac{k_I(t-1)^\beta}{k_I(t)}$:

$$z(t)[\Phi(t-1)(A(t-1)z(t-1) + B) + \tilde{A}(t-1)z(t-1) + \tilde{B}] = \frac{1}{(1-\alpha)\beta}[\alpha(1-\beta)(\Phi(t)+1) + (\beta-\alpha)(\Phi(t)(A(t)z(t) + B) + \tilde{A}(t)z(t) + \tilde{B})]. \quad (26)$$

The steady state

We first solve the steady state of this system. In the steady state, equation (26) is equivalent to:

$$aq^2 + bq + c = 0, \quad (27)$$

where $q \equiv \frac{1}{z} = k_I^{1-\beta}$, and

$$a \equiv \frac{(1+\rho)(\tau\Lambda + \tilde{\tau}\tilde{\Lambda})}{\beta} > 0 \quad (28)$$

$$b \equiv -\frac{(\Lambda + \tilde{\Lambda})(\beta + \alpha + \alpha\rho) + (1 + \rho - \alpha\rho - \beta)(\tau\Lambda + \tilde{\tau}\tilde{\Lambda})}{\beta - \alpha} \quad (29)$$

$$c \equiv \frac{\beta(1-\alpha)(\Lambda(1-\tau) + \tilde{\Lambda}(1-\tilde{\tau}))}{\beta - \alpha} > 0. \quad (30)$$

The solutions to this quadratic equation are:

$$q_1 = \frac{-b - \sqrt{b^2 - 4ac}}{2a}. \quad (31)$$

$$q_2 = \frac{-b + \sqrt{b^2 - 4ac}}{2a}. \quad (32)$$

Because $0 < \alpha < \beta < 1$, $0 < \tau, \tilde{\tau} < 1$ and $\rho, \Lambda, \tilde{\Lambda} > 0$, the variables a, b and c are positive. The obvious question arises whether the discriminant is positive and the solutions have real values. This can be checked numerically. We fix τ at 0.25 and set Λ equal to 1 in order to reduce the excess of degrees of freedom, and employ a L-BFGS-B (Limited memory Broyden-Fletcher-Goldfarb-Shanno) algorithm allowing for box constraints to minimize the discriminant with respect to $\alpha, \beta, \rho, \tilde{\Lambda}$ and $\tilde{\tau}$. As the constraint $\alpha < \beta$ is not a box constraint, we implement the algorithm in two steps. The first step minimizes the discriminant with respect to α given all the other parameter values, with the constraint $0 \leq \alpha \leq \beta$, and the second step minimizes the value of the discriminant received in the first step with respect to all other parameter values. The initial starting value for parameter β is taken from the uniform distribution in the interval (0.01, 1). The lower range is not 0 so as to leave some “space” for α , which

is taken from the uniform distribution on the interval $[0, \beta]$. $\tilde{\tau}$ is taken from the uniform distribution $(0, 1)$ and $\tilde{\Lambda}$ from the interval $(0.2, 5)$ in order to avoid cases where one country is incomparably larger than the other country. ρ is taken from the standard lognormal distribution. In order to be sure that we achieve the global minimum and not a local one, we repeat the procedure for 1000 different initial parameter values. The minimal value of the discriminant is received to be equal 0, which is achieved in a number of points, for example $\alpha = 0$, $\beta \approx 0.6385$, $\rho \approx 0.705$, $\tilde{\tau} \approx 0.316$, $\tilde{\Lambda} \approx 0.5102$. Indeed, the minimum is achieved not only at this point, but in a set of other parameter values, which is determined by a nonlinear dependence. But a further reduction of degrees of freedoms increases the chance that the global minimum is not found.

This is enough to show that $q_2 > 0$. The fact that $q_1 > 0$ comes from $-b > \sqrt{b^2 - 4ac}$, which holds due to the negativeness of b and $-4ac < 0$. So we get two possible equilibrium points. Indeed, substituting the value of k corresponding to q_2 into equation (21) with most reasonable parameter values, the labour share of sector I becomes negative. So we will consider equilibrium q_1 only.

Linearizing difference equation (26) around the steady state $z = 1/q_1$ shows that the eigenvalue of this equation is larger than one for reasonable parameter values, so that we can conclude that the difference equation is unstable.

Short-run effects of a demographic shock

Assume that decrease in fertility is completely unexpected. Because difference equation (26) is unstable, the system should be in its new steady state at time $t = 1$ (when the coefficients of the difference equation do not change any more), i.e. immediately after the shock in period $t = 0$, otherwise it will never stabilize. Given that z attains its new steady-state value at $t = 1$, the value of this variable at the time of the shock ($t = 0$) can easily be calculated using the difference equation. So z goes to the new steady-state in two steps. The same holds for the share of the labour force working in the investment good sector λ (see equation (21)). Given the initial value $k_I(-1)$ the time path for k_I can easily be derived from $z(0)$ and $z(1)$. Note that the definition of $z(t) = k_I(t-1)^\beta / k_I(t)$ implies that the capital-labour ratio does not go to the new steady-state in two steps, but jumps to a new value at $t = 0$ and then gradually converges to its new long-run equilibrium. All other variables can then easily be derived.

Appendix 2: Proof of Proposition 1

Proof. Consider the long-run effects of Λ on the equilibrium point k_I . As k_I is a strictly increasing function of q_1 described by equation (31), the sign of the derivative of k_I with respect to Λ is equal to the sign of the derivative of q_1 with respect to Λ at the point $\Lambda = \tilde{\Lambda}$, which is for simplicity set to 1.

$$\frac{\partial q_1}{\partial \Lambda} = -\frac{\partial b}{\partial \Lambda} \frac{1}{2a} - \frac{1}{2a\sqrt{b^2 - 4ac}} \left(b \frac{\partial b}{\partial \Lambda} - 2c \frac{\partial a}{\partial \Lambda} - 2a \frac{\partial c}{\partial \Lambda} \right) - \frac{q_1}{a} \frac{\partial a}{\partial \Lambda} \quad (33)$$

Derivatives $\partial a/\partial \Lambda$, $\partial b/\partial \Lambda$, $\partial c/\partial \Lambda$ can be easily found from equations (28)-(30). Substituting a , b , c , their partial derivatives and q into equation (33) and making a number of algebraical manipulations the expression simplifies to:

$$\frac{\partial q_1}{\partial \Lambda} = \Omega(\tilde{\tau} - \tau) \quad (34)$$

where

$$\Omega = \frac{1}{2(\beta - \alpha)(\tau + \tilde{\tau})} \left(\beta + \alpha\rho + \alpha + \frac{1}{(\beta - \alpha)\sqrt{b^2 - 4ac}} \left(2\beta^2 + 2\alpha^2 + 2\alpha^2\rho^2 + 4\alpha\beta + 4\alpha^2\rho + 4\beta\alpha\rho + (\tau + \tilde{\tau})(-\beta - \beta^2 - 2\alpha^2 + 3\alpha - \rho\beta + \rho^2\alpha - \alpha^2\rho^2 - 3\alpha^2\rho + \alpha\beta + 4\alpha\rho) \right) \right)$$

Numerically, with the same two-step L-BFGS-B algorithm as in Appendix 1 we checked that for parameter values $0 < \alpha < \beta < 1$, $\rho > 0$, $0 < \tau + \tilde{\tau} < 2$, Ω can get nonnegative values only. Hence the sign of $\partial k_I/\partial \Lambda$ in equilibrium depends on the sign of $\tilde{\tau} - \tau$: if $\tau < \tilde{\tau}$, the dependence is positive. \square