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What does preparing for old age have to do with the global economic crisis?

(Frank Eich)

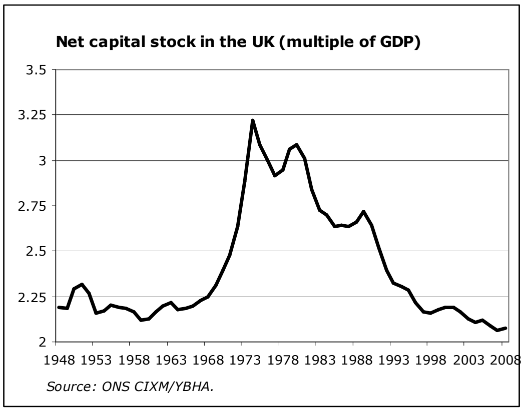
- **The policy response of record low interest rates and quantitative easing by central banks, and massive fiscal stimuli and bank support by governments appears to have helped avoid a depression but it has come at the price of deep fiscal imbalances and rapidly rising debt in most countries.**
- **Much of the blame for the crisis has been put on the "excessive surplus" countries such as Germany and China, which saved at home and relied on exports for growth. Little effort has been made to understand why they have behaved in such a way.**
- **One reason is that these countries prepared for the financial consequences of their rapidly ageing societies. China is growing old before it has grown rich, with millions of Chinese without access to state pensions or health care provision. Rapidly ageing Germany has tried to make their welfare state future proof before the baby boomers retire. As long as societies have different saving cultures there is a risk that these global imbalances will continue to exist.**
- **There are also lessons for the "excessive deficit" and "surplus" countries. The former could have used the period of cheap money to add to their stock of productive capital rather than finance consumption; for example the UK's net capital stock in relation to the size of the economy is now the lowest since the end of the Second World War. The latter should not necessarily assume that their savings will be used more productively abroad than at home and should therefore explore more creatively investment opportunities at home.**

Having just gone through the deepest recession in living memory, the world economy is slowly stabilising and countries are returning to growth. It appears that the policy response of record low interest rates and quantitative easing by central banks, and massive fiscal stimuli and bank support by governments has paid off after all.

This policy response did come at a price though: in almost all countries the public finances have fallen off the cliff; in some countries so much so that the financial markets are increasingly losing confidence in governments to turn the situation around. Greece might be an extreme example but the situation is severe in other countries too, including the US or the UK. What many of those countries with severe budgetary imbalances now have in common is that they did not use the good times to prepare for an inevitable eventual economic downturn. More importantly, most also put little effort into preparing adequately for the fiscal consequences arising from population ageing. Instead of households putting away some money for retirement or governments reducing their debt burdens to create urgently needed fiscal space in the future, they enjoyed a long consumption spree, much of it met by imported goods and services. Welcome to the "excessive deficit" countries.

When the crisis erupted much of the blame was put on the "excessive surplus" countries, which saved at home and relied on exports for growth. China and Germany were singled out as major culprits but were obviously not the only ones. Rather than blaming these countries for not consuming enough themselves, it might be worth asking why they were such keen savers in the first place. Part of the answer is that they tried to prepare for the financial consequences of their rapidly ageing societies. China is growing old before it has grown rich, with the legacy of the one-child policy and the collapse of the traditional ways of looking after the old requiring millions of Chinese to fend for themselves now. With less than a third of society entitled to any form of public pension, from their perspective it is just common sense to put a fair chunk of income away for the future, be it for a pension or to pay for health care provision (though admittedly their efforts are not being helped by an anachronistic domestic capital market). Rapidly ageing Germany has the privilege of having grown rich before growing old so they tried to make their welfare state future proof before the baby boomers start retiring. Encouraging the take up of personal pensions and reducing the government's deficit – both raising national savings – were two important responses to this challenge. The stories are similar in other "excessive surplus countries", whether it is the Netherlands or Sweden.

There are some lessons to be learnt. First, as long as societies have different saving cultures – perhaps because they are ageing at different speeds - there is a risk that these global imbalances will remain for many years to come. Over the long term though, many of today's "surplus countries" will become "deficit countries" as they will eventually consume more than their ageing and declining workforces can produce. Policy makers and the financial markets would be well served to think long term. Second, "excessive deficit countries" should perhaps ask themselves whether they could have used all that cheap money coming their way more intelligently than to support consumption and finance housing booms. Were there really so few attractive opportunities to invest in productive capital? In the UK, for example, the net capital stock dropped sharply in the 1980s and 1990s in relation to the size of the economy and is now the lowest since the 2nd World War. The drop is even more pronounced once residential housing is excluded.



Third and related, "surplus countries" probably ought to take a greater interest in what their savings are used for. One should not assume that capital is necessarily flowing to more productive uses abroad. If it is consumption or housing booms abroad, then one might as well keep the money and do the same at home. Better still: invest in productive capital or in infrastructure, which could help to meet the needs of an ageing population.