Discussion

Avinash D Persaud

Introduction

The most profound ideas tend to be elegant and intuitive and both of the papers presented in this session make some elegant, intuitive and profound points. At the centre of these papers is the connection between external balances, which we know reflect local saving and investment gaps, and demographic changes, which we think drive local saving and investment. It follows that demographic changes should affect current account balances and there is some evidence for this relationship over low frequencies. Obvious enough you may say, but as we will get to in a moment, the predictions and policy implications of this observation are far from the current consensus. Both papers look at a wide range of related issues such as the 'asset-price meltdown' hypothesis, the impact of pension reforms, the role of labour market flexibility and the wider economic impact of China. I will focus on just three topics: global imbalances, asset-price meltdown and labour market flexibility.

One of those surprising, yet obvious things (when you think about it), that I have learned as a practitioner in financial markets is that, most of the time, prices change without any trades. All that market chatter about prices going up because investors are buying is, invariably, what Paul Keating might call drivel. Trades almost only occur when there is a disagreement about the price. My programming is therefore to skip over points of agreement in order to get to the points of difference. So lest my remarks are misunderstood, let me say that I recommend these papers to you all and share most of their conclusions. I have three points of departure. Only one of these is really a disagreement; the other two are important implications of the papers that I believe deserve more development.

Demographics and global imbalances

My first point is this. Both papers suggest that it may be appropriate for countries on the sweet side of the demographic curve, when working-age populations are expanding, to be growing rapidly and yet have more saving than investment opportunities and so also be exporting capital. It may be appropriate for countries on the sour side of this curve, when working populations are declining, to be liquidating savings and assets and importing capital. In other words, relative demographic changes can parsimoniously explain the export of capital from young developing countries that has otherwise confused many and, to some extent, the build-up of large current account imbalances which is currently a cause of concern for many.

This of course is in sharp contrast to the presiding narrative on global imbalances, which is that the current flow of capital is unnatural, needs to be ended and is driven by unfair exchange rate arrangements in developing countries in general and China in particular. But the implication of this demographic analysis is that,

were we to remove restrictions on the movements of capital and exchange rates, we would observe similar current account positions to those we observe today. This is so important a conclusion that it is worth repeating. These papers suggest that the focus on exchange rates and competitiveness as a way of dealing with global imbalances is at best irrelevant and potentially harmful. Moreover, in the context of large divergences in the pace of demographic change, what you would expect to see, and what you would want to see, in a well-functioning financial system are ameliorating capital flows that show up as large current account imbalances.

To the extent that today's capital flows can be explained by divergences in demographic changes, we should be less worried about their size and more worried about how efficiently they are being managed. Cause for concern is that today's novice capital exporters have under-developed financial sectors. Surplus savings in developing countries are primarily invested by the public sector via central banks. But these are not the right institutions for investing national savings for the future. Central banks are, rightly, risk-averse liquidity managers. They will concentrate their investments in the most liquid, external asset – US Treasuries. This is far from the efficient frontier from a long-term investment perspective. Indeed, when viewed from all sides, it is a low-return portfolio that is dangerously concentrated.

Attention to the demographic drivers of current account imbalances recasts the problem we are facing from one of managing macro-imbalances to the macro-prudential issue of how efficiently large imbalances are managed. Instead of bullying developing countries off fixed exchange rate mechanisms that may serve them well at certain stages of development, we should be encouraging further liberalisation of trade and capital flows and the associated development of domestic financial sectors. Instead of pressuring surplus developing countries to revalue their nominal exchange rates with uncertain effect, we should take advantage of the opportunity these surpluses offer to encourage them to accept greater trade liberalisation through the Doha round of multilateral trade negotiations. Finally, perhaps prudential investment of national savings and financial sector development can be fast-tracked by outsourcing sovereign asset management to local investment institutions.

Asset-price meltdown

My second point relates to the asset-price meltdown hypothesis. Axel Börsch-Supan describes his disagreement with this hypothesis as his paper's most controversial position. I think he is being more controversial than he realises in other areas. I also think he dismisses the asset-price meltdown hypothesis too readily. This hypothesis suggests that when baby boomers retire, roughly at the same time as each other, and start cashing in their investments in order to spend, there will be a collapse of asset prices. There are two related conditions for this hypothesis to hold: a strong concentration of retirees must exist and they must hold assets that are unattractive to others. Axel argues persuasively that international capital mobility and differing demographics internationally makes these conditions unlikely to hold. If all Italians were to retire at the same time and cash in their Fiat shares, and the share price were

to begin falling, this would merely bring out young investors, from China and India say, looking for a bargain.

But suppose that a major part of the pension portfolio of soon-to-be retirees was made up of owner-occupied property, and that they all planned to downsize when they retire. It is not clear that Chinese and Indian investors would want a portfolio of Italian property in an environment where Italians were trying to be net sellers and the Italian population was falling relative to the stock of property. Of course, we have not seen any substantial downsizing as yet. But the essential point is that the asset-price meltdown story is a genuine problem, even in a world of international capital mobility, *if* the value of the assets of the soon-to-be-retired depend on local investment and consumption. Let me put this another way. International capital mobility does not improve the value of an investment in a hairdresser specialising in purple Mohicans in a country that is ageing and balding fast.

International discussions of pension systems are illuminating, but one of their problems is that most of us think our experiences are general. Most German residents, for example, would consider the asset-price meltdown story an odd one because property represents only a modest proportion of individual savings in Germany. But it represents an important and rising proportion of gross savings in many countries including Italy, the United Kingdom, the United States and Australia. Part of the explanation for the low personal saving rates in the US and UK is the widely-held belief that largely owner-occupied property assets can be transformed into high cash flows at retirement. But if property prices can rise as a result of an increase demand for property as a pension asset, making investors feel so wealthy that they decide to save less, why can they not fall when this demand reverses, leaving savers with a lower-than-expected pool of savings.

Often in finance, common buying behaviour, caused by some investment fashion, creates wealth that many hopes and futures are built upon. But this wealth proves to be ephemeral when its owners all try to realise its value at the same time. This type of illusory value and safety in financial markets is an area of my own research. To avoid pension or other assets disappearing down a liquidity black hole, investors should hold assets where there is a strong heterogeneity in the sources of demand as a result of there being investors with different investment horizons, strategies and risk management. International capital mobility can improve that diversity. But it is likely that property is the kind of asset that has too much homogeneity in the sources of demand in a country with a large cohort of soon-to-be-retired.

The interesting implication is that pension funds in countries should be encouraged to hold assets with more internationally heterogeneous demand. Assets where demand is overly dominated by local savings and investment trends include property and, to a lesser extent, domestic government bonds (partly due to regulatory reporting requirements). Yet, in some countries there are proposals to actually encourage property and government bonds being held as pension assets. For whatever reason these assets have increased their share of total pension assets.

Labour supply

For my third point let me say that Axel, Larry and others make the interesting observation that the impact of demographic changes depends in part on the elasticity of labour supply. In Europe that is seen as the substitution between leisure and work. In the United States and other places it would be seen as a question of immigration.

Clearly there are serious political issues at work here and the appetite for immigration in our currently troubled world is weak. The recent treatment of asylum seekers is a sad reflection of current populist concerns. It may be that in this case the European Union provides a model, where international migration is modest, but regional migration in accordance with regional rules is substantial. There are tough restrictions on labour mobility from outside the EU to inside, but substantial mobility within the EU. Perhaps the social problems of increased migration are partly addressed by the lengthy consensual process of joining the EU.

It is said that there are now one million more Poles living in the UK than there were just five years ago. Most people in the UK view this as a positive development. Perhaps the case for EU enlargement should partly be made in terms of how increased regional mobility moderates the demographic challenges facing Europe.

Let us not forget that the enlightened civilisations of our past were partly built on an easy flow between peoples born in different places and that concepts of sovereignty and citizenship are fairly recent, especially in the time frame of demographic change. The so-called demographic time bomb is partly a product of a relatively recent form of autarky.