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Chairman Shaw and Congressman Matsui, thank you for your leadership in highlighting the important issues raised by global aging.

The Global Aging Initiative is a project by the Center for Strategic and International Studies to examine the international implications of the simultaneous aging of the major industrial nations. Our work is being conducted under the aegis of a 75-member blue-ribbon Commission on Global Aging, headed by former Vice President Walter Mondale, former Japanese Prime Minister Ryutaro Hashimoto, and former Deutsche Bundesbank President Karl Otto Pöhl. Among its members are cabinet ministers, senior legislators, appointed officials, leading business people, economists, demographers, scientists, and experts in retirement, medicine, finance, and national security from three continents. In addition to the Chairman and ranking minority member of this Subcommittee, I am pleased to recognize three other participants in today's panel as colleagues on the Commission.

When CSIS first conceived the Global Aging Initiative in 1998, we were aware that other industrial countries either were actively debating, or had already undertaken pension reforms of the kind being discussed in America. Our initial approach was to look at how foreign governments were coping with the challenges of aging populations.

But as we explored things further, we found that there were aspects of global aging which made it more than just a matter of comparative policy. The first is that population aging in Japan and Europe is qualitatively different than our own. While America will see a greater percentage rise in the number of elderly than Europe and Japan will, our working population will continue to grow for the foreseeable future. By contrast, our major allies can expect a dramatic decline in their youth and working age populations. Under the Census Bureau's long range estimate, their combined populations could fall by nearly one-third over the next half century. This has a host of economic implications for the nations involved. Declining numbers of workers and consumers inevitably will exert a contractionary effect on their growth rates, asset values, savings rates, and currencies. If this happens, tax revenues are sure to disappoint, in turn, making it harder to fund retirement benefits without big tax increases or big budget deficits. Convulsive change in these circumstances may be hard to avoid.

This possibility suggests a second dimension to the global aging crisis, which is that the whole may be larger than the sum of its parts. That is, as we baby boomers know all too well, when it comes to aging, there is no such thing as safety in numbers. The fact that all of the rich countries will simultaneously experience a dramatic upward shift in their population age structures creates the potential for global economic and political spillovers. These factors could limit our own options for Social Security reform and impose additional burdens that are not immediately obvious when looking only at our national picture. Retirement security for Americans is probably going to require cooperation abroad. No matter what we do to shore up Social Security, our efforts could be undone by crises in other countries.

The thrust of my testimony today is that these pressures are already evident in the global economy, and they are likely to become far more powerful over the coming decades. Consider that over the last 25 years, the number of elderly in the major industrial countries rose by 45 million, while working age populations grew by 120 million. In the next 25 years, according to official projections of the various affected countries (most of which are probably optimistic), elder populations will rise by 120 million, while working age populations will rise by just 5 million.

What follows, Mr. Chairman, are only my own views, and not those of CSIS or the Commission on Global Aging. Nevertheless, they are well-supported by the facts. There are other plausible interpretations of some events and trends. But I think the general direction is clear.

The world may be on the threshold of a new period of turbulence. In recent decades, it would seem, we have banished the business cycle. But booms and busts have been the historical rule, rather than the exception. Under current patterns of work and retirement, the developed world as a whole could experience long periods of economic stagnation and decline. How serious these problems become will depend on institutional flexibility in the various countries. For Japan, Italy, and Germany, however, time is running short. I am pessimistic that they can adjust their systems of economic regulation and social provision fast enough to prevent their welfare states from plunging into crisis. Japan's extraordinary debt, now officially equal to 12 percent of world GDP, but unofficially perhaps half again higher, is the most worrisome in the short term. It is a time bomb waiting to explode.

But as bad as Japan's situation looks today, in some ways, Europe's is worse. By the end of this decade, the populations of Italy and Germany will be declining faster, and their union movements, which consist in large part of retirees, are more adamant against change. Last March, Japan quietly cut pension benefits by 20 percent for the typical 40 year old. In contrast, France's taxi drivers, who recently shut down the economy in protest over gas prices, were demanding even earlier retirement—this, in a country where the average age of retirement is 59.

Within two decades, much of the industrial world could find itself in the grip of aging recessions. Aging recessions are marked by declining asset values, falling levels of consumption, spikes in precautionary saving by aged workers, falling growth rates and hence tax revenues, chronic budget deficits, declining returns to investment, capital outflows, and currency crises. If this sounds familiar, it should. Japan, in my opinion, already is in an aging recession. Its population has leveled off and soon will decline. Consumer spending has fallen for 29 straight months. Property values have collapsed. The retail and construction sectors are on deficit-financed life support. Due to the unique characteristics of the Japan's social compact, the economy remains more or less at full employment. Yet, under these conditions, fiscal stimulus is ineffective, since you cannot stimulate an economy when there are few new workers to bring into the labor force. Monetary policy is also proving counter-productive, to the extent that lowering of rates of return merely prompts aging workers to save more. After 2010, these conditions are likely to prevail throughout much of Europe, as well.

Indeed, in its flagging currency, the euro, Europe, too, is beginning to exhibit symptoms of decline. Capital is fleeing the Continent at an unprecedented rate. Despite today's unfavorable exchange rates and the supposed overvaluation of U.S. equities, German companies announced \$94 billion in U.S. acquisitions in August alone. One reason for this is that European firms face the prospect of declining unit sales for as far as the eye can see. A real estate shakeout is also on the horizon. Italy, Germany and several smaller countries will experience dramatic declines in their household forming age groups—Italy could have 30 percent fewer persons aged 25-40 by 2020. These kinds of pressures are sure to weaken household and financial institution balance sheets, spawning weakness elsewhere.

By the 2020s, a global capital crunch could damage relations with the developing world. Rising elderly dependency is expected undermine savings rates across a band of countries that today account for almost two-thirds of global economic output. Surging retiree populations in the industrial world mean that large numbers of affluent households will be spending down their life

savings in unison. One estimate by the OECD shows that retirement alone could depress private savings rates by 8 percent of the combined GDP of the 22 OECD countries by the late-2020s. When governments run budget deficits under these conditions—for example, to pay benefits during some future slump—they will be borrowing from the third world, in the process, raising the cost of capital everywhere. It is possible that countries like China, India, and Indonesia will resist the mantle of international lender, much as America did in the 1920s. And if they opt for protectionism, as we did during the recession of 1930, a similar result could ensue.

We are sure to become militarily weaker, even as our defense needs shift from protecting borders to protecting our growth rates. We must grow steadily in order to finance our social guarantees. But these conditions require world peace. And yet, the defense programs of America and its allies will face enormous fiscal competition from old age benefits. Our combined unfunded pension liabilities are roughly equal to world GDP. And our unfunded health care liabilities may be of a similar magnitude. As these obligations come due over the next 30 years, our defense spending is likely to suffer. Our allies no longer possess first-rate militaries. Our own military faces its own aging problem. The equipment we purchased during the Cold War is wearing down. Under the current budget baseline, our armed forces will shrink to half their current size by 2010. Combined with the deteriorating capabilities of our allies, this may leave us unable to deter or resolve foreign crises that threaten global growth rates, and hence our ability to finance Social Security.

Global aging has the potential to be a first rank crisis, one that wipes out the modern welfare state, as we know it. If Europe follows Japan down the road to fiscal insolvency, the tax revenues and market returns on which America's retirees depend are sure to suffer. What would happen to our IRAs and 401(k)s if Japan were to default on its debt, or Europe were to debase the euro? These possibilities are real; and it is this fear which motivates Europe's left-of-center governments to advocate reforms that here are branded as ideologically far to the right. Whether it is the ex-Communist Massimo D'Alema in Italy or Gerhard Schröder and his Red-Green coalition in Germany, progressive governments are putting aside ideology to cut back on benefit guarantees and institute systems of private retirement provision.

There is much for America to learn from these crises. For example, our current plan for Social Security is to flood the bond markets after 2020 with trillions of dollars of our national debt. The idea is that over the next 15 years we would shift virtually all of the privately held national debt into the Old Age Insurance Trust Fund, a public agency. But then, beginning in 2017, the Trust Fund would sell this debt back to private investors at a time when Europe and Japan are no longer expected to be supplying the global capital markets. The baby boomers' retirement security might thereby hinge on heavy borrowing from the third world. This, it seems to me, is bad foreign policy, bad economic policy, and bad retirement policy.

In conclusion, Mr. Chairman, there is a new source of retirement insecurity that we must insure against. It is the growing fragility of the welfare state itself. In Europe, individuals are learning that the best way to guarantee retirement security is to own assets abroad—not only in America, but the fast-growing emerging markets. If we invest our pensions in countries with large labor surpluses and low productivity, our capital and technology can generate large returns that can be shared back with retirees in the industrial countries. In this way, the young will still support the old, but across national borders and not simply within them.