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Could the US policy of quantitative easing be too reliant on consumers conforming to the life-cycle hypothesis?

Political challenge

We need a new policy framework to reflect major changes in the global economy

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Politicians are floundering for solutions as the West swings between austerity and economic stimulus.

Which is the better route to growth? Cut spending to bring budgets back into balance, as has been the case in Europe, or pump money into the economy via quantitative easing, as has been the policy of the US government? These are the questions being posed, time and again, in private policy debates and in the public arena.

But in Chapter 10 of our e-book, *Boom, Gloom and the New Normal – How Western Baby Boomers are Changing Western Demand Patterns, Again*, we argue that policymakers are on the wrong track. The first challenge is to get over their adherence to an economic theory – the life-cycle hypothesis.

The theory holds that we are, on the whole, rational beings, meaning that most of us save enough money for our retirements.

Policymakers are therefore convinced that the total volume of spending will not decline when populations age, even though the nature of spending might undergo radical changes. The over-65s are, for example, going to buy fewer sports cars, but the economy will be compensated by an equal amount of spending on Zimmer frames and, for the more able, sedate walking holidays in the countryside, they believe.

What about the effect on pensions of the recent collapse in equity and housing markets? No problem, say policymakers in the US. All we have to do is reinflate stock and housing markets with a few hefty doses of fiscal stimulus to enable everyone to rebuild their savings for retirement.

In Europe, too, although the debate continues to rage over austerity versus stimulus, politicians and central bankers are in agreement that the life-cycle hypothesis holds true. They are therefore convinced that once this current economic sticky patch is over, demand will come roaring back.

WE ARE NOT RATIONAL

But we argue that people are far from rational, making life very difficult for policymakers and economists, who like nice, neat models to explain where things are going. This helps keep them in jobs. Lending decisions by institutions and borrowing decisions by individuals are, of course, often irrational. Take, for example, the dot-com bubble. People were desperate to rebuild their savings after the bubble burst in 2001, thus taking more big risks, this time on property rather than equity.

The psychology of any bubble can be reinforcing. People tend to believe that "this time it will be different" – that a particular bubble

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Companies such as Hyundai now form a world-class manufacturing sector in South Korea

» will go on forever, rather than believing in the inevitable, eventual end of all bubbles.

The influence of the media, and of the "Hollywood effect," on people's lifestyle choices is also important. We are constantly bombarded with images, through TV and magazines, of the seemingly wonderful lives of the rich and famous, and so can be tempted into taking on too much debt in futile efforts to emulate those we envy.

This was the case during the subprime mania, with average-income earners further lured into high debt levels by the failure of politicians to issue warnings about the risks ahead. Why on earth did we expect anything better of the average guy or gal when political leaders, as well as most economists and other "experts," failed to see this coming?

Once politicians get over their belief in the life-cycle hypothesis, they can then begin to come to grips with the need to retool Western economies to take advantage of the changing nature of demand.

DEALING WITH SKEWED INCENTIVES

The right products need to be made, at the right cost, for the aging baby boomers – who are spending less and saving more – and for younger people struggling with reduced employment and income prospects.

Manufacturing industry also needs to be reconfigured in order to tap not only into demographics, but also into the other megatrends such as carbon footprint and scarcity of food and water.

We argue that companies cannot do this alone. Public investment in research and development, and in industry-focused education programs, is needed so that both the young and old are given new opportunities to find work that is both meaningful and financially rewarding.

Picking the right industries to support, and avoiding waste often associated with government involvement in industry, will be the obvious challenges. But the opportunities are enormous for governments and for companies, in home and export markets. Incentives, which have become badly skewed in the West as a result of the growth in importance of the financial sector, also need to be adjusted.

> **"Now, South Korea has some tremendous brands, including Samsung and LG..., and Hyundai Motors"**

Young engineers and scientists, who would be much better employed in industry, prefer to work in the financial sector where salaries are far higher. The size and rewards of the financial industry are way out of line with the needs of society, and are distorting Western economies. It needs to be reformed and we suggest how this might be done.

In the Middle East and in China, major debate is already underway about the role that manufacturing can play in stabilizing societies through job creation. China has created hundreds of millions of low-paid manufacturing jobs, but now faces an enormous challenge in successfully moving on to the next phase of its development.

We explore how China's highly ambitious 12th Five Year Plan is at risk of failure. The plan defines a clear path towards a new, sustainable growth model. But can the reforms work if China fails to become more open and more democratic?

China is very good at copying – and sometimes improving on – Western technologies. But without more creativity and innovation, it might struggle to produce the original designs and brands necessary to justify rising wage costs. Can the right levels of creativity and innovation occur without its society becoming more open and democratic?

South Korea serves as a good example of a country that has successfully made the transition from developing to developed status. From 1961 to 1979, when it was run by the military dictator Park Chung-hee, the focus was on rebuilding the country through low-value manufacturing after the devastation of the Korean War.

In 1987, it became a democracy and, as wage costs rose, it shifted to shipbuilding, steel, chemicals and basic electronics manufacturing. The 1997–1998 Asian financial crisis exposed flaws in the economy, most notably overcapacity in steel and chemicals as a result of the over-dominance of the Chaebol, the country's industrial conglomerates.

Thanks to the election of the first president from an opposition party, Kim Dae-Jung, which occurred shortly after the Asian financial crisis, the Chaebol and the financial sector were restructured and corporate governance improved. Now, South Korea has some tremendous brands, including Samsung and LG, which dominate the LCD TV business, and Hyundai Motors.

It is the job of politicians everywhere to be frank and open about the challenges ahead. They also need to encourage and inspire companies and individuals to benefit from the transition to the New Normal, while creating the policy framework to make this possible. ■

THE NEW NORMAL

Chapter ten of *Boom, Gloom and the New Normal – How Western Baby Boomers are Changing Global Chemical Demand Patterns, Again* is now available free to download at **icis.com/NewNormaleBook**. It is co-authored by Paul Hodges, chairman of International eChem, and John Richardson, director, ICIS training Asia, who both blog for ICIS at **icis.com/blog**