

The Private Sector Crisis Is Going Public

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May 2010

The red ink of crisis-induced government deficits is bleeding into the enormous out-year liabilities that have been looming on the horizon but are now hurtling toward us as the population ages and birth rates decline.

A version of this article first appeared on www.top1000funds.com, the news and analysis site for the world's largest institutional investors.

During the recent financial crisis, governments across the developed world stepped up their spending dramatically to compensate for the pullback in private spending. But this vast expansion in government spending, deficits and guarantees for faltering financial institutions has now shifted concern from the tattered state of private-sector balance sheets to the ballooning debts on sovereign balance sheets. Last year every developed country except oil-rich Norway ran a deficit, with Iceland, Greece, the United Kingdom, Ireland and the United States having the deepest deficits.

While the huge increases in annual operating deficits in many developed countries as a result of the recession are troubling, it is the tidal wave of long-term healthcare and retirement liabilities threatening to engulf those same countries that is the far greater—and largely overlooked—problem. Just as the off-balance sheet obligations contained in banks' special investment vehicles (SIVs) went largely unnoticed until they nearly toppled some institutions, sovereign states have tried kicking the can of these long-term liabilities as far down the road as they could manage.

But now demography is catching up with them. As the baby boomers begin to retire in greater numbers, the financial implications of their demographic bulge will become more dire as fewer younger workers remain to support those costs. The red ink of crisis-induced government deficits is bleeding into the enormous out-year liabilities that have been looming on the horizon but are now hurtling toward us as the population ages and birth rates decline.

This unprecedented accumulation of operating deficits and long-term debts from pay-as-you-go health and retirement systems in the developed world could be setting the stage for the next financial crisis. Without meaningful reform, that debt could have catastrophic implications for government credit premiums, higher real interest rates and currency declines.

While an economic recovery will bring some rebound in government revenue, government financing needs will likely grow because of the long-term liabilities coming due. A modest economic recovery and increase in private credit demands may conflict with governmental deficits and could risk substantial yield increases. It is not difficult to imagine what the ripple effects could be across global financial markets.

While Greece has dominated headlines, it is by no means alone in its balance sheet problems. Many European countries, including the U.K., are running annual budget deficits close to or in excess of 10% of GDP. Despite the European Growth and Stability Pact meant to keep explicit public debt under 60% of GDP, many EU members have total cumulative debt and out-year liabilities that could reach 300% (and by some estimates 500%) of GDP by 2050 on the current trajectory.¹

In the U.S., the focus has also been on the annual budget deficit and the public debt outstanding. While the U.S. is not experiencing the same declining birth rates as many European countries, it still faces massive out-year liabilities. Experts have estimated the present value of these out-year liabilities as between \$70-100 trillion, roughly five to seven times GDP.² Put differently, that debt load alone amounts to an additional liability of \$200,000 to \$300,000 for each U.S. citizen on top of other debt.

The largest liabilities in the U.S. are from Medicare and Medicaid, followed by Social Security, which will pay out more than it takes in this year, seven years sooner than predicted. Healthcare costs already comprise 16% of GDP and could rise by another 8-10 percentage points if left unchecked.³ The current health care legislation appears to be slightly deficit positive but puts only a small dent in the out-year liabilities over the next twenty years. Other substantial long-term debt includes the unfunded liabilities of state and local pension plans (many of which use unrealistically high assumed returns); state and local post-retirement healthcare liabilities; the financial guarantees extended to Fannie Mae, Freddie Mac and other financial institutions; and the Pension Benefit Guaranty Corporation deficit. Meanwhile, the Federal Highway Trust Fund has exhausted its surplus, while the Federal Housing Authority has run out of money. The American Society of Civil Engineers estimates that the U.S. should spend an additional \$2 trillion in the next five years to upgrade aging infrastructure. This is an imposing list that does not even include the ultimate cost of two wars and the potential expenses to address climate change.

How can the U.S. possibly finance all of this? Trying to inflate its way out of the problem will create problems of its own for the U.S. Foreign appetite for U.S. debt, which made our 20-year spending spree possible, has diminished. Annual foreign capital inflows have nearly halved from close to \$800 billion in 2006 to \$400 billion in 2009.⁴ Chinese purchases of U.S. Treasuries have slowed considerably as the Chinese focus on spurring domestic demand. Meanwhile, other foreign buyers seem increasingly reluctant to buy U.S. government issues out of concern they could be paid back in devalued dollars if the U.S. debt continues to expand.

While current account deficit dollars can be recycled, the buyers may be unwilling and prefer other assets. There is clearly a risk for the U.S. in being dependent on external capital, especially when many of our liabilities are short term.

1 Stephen G. Cecchetti, M.S. Mohanty and Fabrizio Zampolli, "The Future of Public Debt: Prospects and Implications," BIS Working Papers, Bank for International Settlements, March 2010, p. 10.

2 Eurostat figures, Jagadeesh Gokhale, senior fellow at the Cato Institute, U.S. Government Accounting Office, U.S. Bureau of Economic Analysis. For summary statistics, see "In Greek Pension System, Signs of Troubles to Come Elsewhere," The New York Times, March 12, 2010.

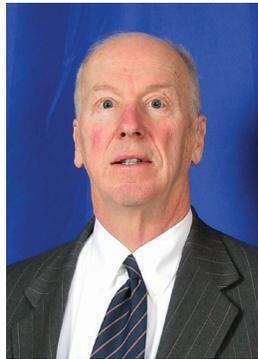
3 U.S. Centers for Medicare and Medicaid Services, http://www2.cms.gov/NationalHealthExpendData/03_NationalHealthAccountsProjected, February 4, 2010.

4 U.S. Department of Commerce, Bureau of Economic Analysis, National Income Accounts, <http://www.bea.gov/national/index>.

If the U.S. runs large governmental deficits, the long-run requirement will be either reduced domestic productive investment or a higher level of domestic savings. Making that happen will probably require materially higher interest rates.

While an economic recovery will bring some rebound in government revenue, government financing needs will likely grow because of the long-term liabilities coming due. A modest economic recovery and increase in private credit demands may conflict with governmental deficits and could risk substantial yield increases. It is not difficult to imagine what the ripple effects could be across global financial markets.

There is no precedent for the scale of these liabilities as a proportion of economic activity and there are no easy answers. Raising awareness of the potential global financial market fall-out from inaction should galvanize public and private industry leaders to address a gathering crisis that has often been dismissed as too far out to matter. There is an inevitability of either reducing government obligations or raising government revenues to meet those obligations. In any event, those obligations are coming due sooner than we think and could destabilize government finances and societies across the world for many years to come.



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Ted's distinguished career began at Standish, Ayer & Wood in 1962, and he was named Chairman in 1989. He became Chairman of Standish Mellon Asset Management in 2001 and Chairman Emeritus in 2004. He is a Director of the Conservation Law Foundation, Land Trust Alliance, A Better City, The Trustees of Reservations, and The Boston Company Asset Management. Ted is Chair of the Board of Trustees of the Beth Israel Deaconess Medical Center and a Trustee of Wheelock College. Ted is also Chairman of the Boston Committee on Foreign Relations, a member of the WGBH Board of Overseers, and Vice Chairman of the Massachusetts Taxpayers Foundation. He is a former Director of Citizens Financial Group, Harvard Management Company, and the Federal Reserve Bank of Boston. Ted has an M.B.A. from Harvard Business School and a B.A. from Yale University, holds the CFA® designation and has 47 years of investment experience.

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