A Dickens of a Problem: What We're Thinking

Although it is far from December, many of us may be dreaming of cooler days as we approach the summer months. With that in mind, we call your attention to Charles Dickens' classic novel, *A Christmas Carol*. In the book, Dickens takes us through the transformation of its main character Ebenezer Scrooge as he is visited by three ghosts. The specters take Ebenezer on a journey from his past through his present to his future. We will travel a similar road as we attempt to make sense of our current global debt crisis.

Before we begin our journey, it is important to note that the present issues we face on a global scale have not happened overnight nor are they a result of the Great Recession. The recent recession brought these issues to the forefront – but they have been festering for years. Chronic budget deficits have persisted for years, caused by government spending in excess of revenue. These issues can take decades to accumulate but only months to morph into a crisis. In addition, there is a distinction between short-term deficits, which are extremely useful as an auto-stabilizing mechanism during economic downturns, and long-term structural deficits. Long-term structural deficits are pernicious and often the result of countries operating under unsustainable public policies for extended periods of time.

Ghost of the Past: Finland

Our "ghost of the past" is Finland. In the early '90s, Finland went through a very painful restructuring, much like Greece is experiencing today. The country deregulated its financial markets, however the process was tainted by poor regulatory policy and it resulted in a credit boom that eventually collapsed. Its GDP plummeted by 15% over the next three years and its unemployment rate soared to almost 20%. The country recovered by adjusting its policy measures and privatizing state-owned assets. The recession lasted three years, but it took several additional years before economic growth recovered to that of pre-recession levels. Today, Finland is one of the more fiscally conservative countries with a revitalized economy. Other countries like Chile, Mexico, Sweden and Argentina have gone through similar structural adjustments to emerge as healthier countries with healthier economies.

Ghost of the Present: Greece

Not surprisingly, our "ghost of the present" is Greece. Greece's economy has been crippled by a decade of deteriorating macroeconomic fundamentals. It has a bloated public sector, rampant tax evasion and an unsustainable pension system. Its current budget deficit is 13.6% of GDP while its public debt to GDP ratio is 125%. To make matters worse, 80% of its debt is owned externally, meaning that much of the interest expense flows out of the country. Poor policy decisions have created an imbalance between what the country can afford to fund and what the country has promised its citizens. The country has just initiated a three-year austerity program aimed at reducing its budget deficit and related public debt. Greece is in the early stages of its structural changes (as the social unrest can attest to); however, it will likely emerge an improved country.

Ghost of the Future: The US

Our "ghost of the future" is the US. The Congressional Budget Office's (CBO) baseline projection of our public debt to GDP ratio will increase from its current level of 60% in 2010 to roughly 67% by 2020. Even the CBO admits that this projection may be too optimistic unless some policy changes are implemented and that the ratio could reach 100% by 2020. This is important because according to economists, a ratio above 90% results in a reduction in a country's economic growth rate. Then debt becomes a vicious cycle as slower economic growth equates to lower tax revenue, pressuring the budget deficit, which flows to increasing outstanding public debt. The director of the CBO even says, "*The country faces a fundamental disconnect between the services the people expect the government to provide, particularly in the form of benefits for older Americans, and the tax revenues that people are willing to send to the government to finance those services.*"

Additionally, Moody's, the bond rating company, has indicated that unless the US improves its structural problems it could lose its AAA credit rating, which would increase government borrowing costs and consumer borrowing rates, further stressing the budget deficit and creating a loss of international prestige. We will soon reach a point when kicking the can down the road is no longer an option and action is necessary. The US should be paying very close attention to matters in Europe as they may soon be at our door.

Like it or not the economies of the globe are interconnected and they all have a vested interest in promoting structural change. The European markets have been jittery – not because Greece is an economic juggernaut (it is only 3% of Eurozone GDP), but because many European banks hold Greek debt. This is likely why the EU in conjunction with the IMF recently pledged roughly $1 trillion dollars to Greece to avert a crisis. In the US's case, our major creditors – China and Japan – have a vested interest in ensuring our economic viability or they suffer both as a creditor and as a driver of their economic growth generated through exports to us.

Although the timing among countries will likely differ, austerity measures will almost certainly be initiated on a global basis. Some segments of the populace will be more dramatically affected than others. Over time, social order and financial market order will be restored. There is evidence that some countries are already taking corrective action – Germany is a prime example. Germany, which is Europe's largest economy, passed legislative reform in 2006 in the form of a balanced budget amendment to curtail spending (although they are one of the more fiscally sound Eurozone countries). Other sovereign debtor nations are now saying the right things and in some cases enacting legislation to curb future debt problems.

Once you escape from media sensationalism, it is not all doom and gloom. According to Federal Reserve Chairman Ben Bernanke, the current US economic expansion appears to be gaining traction. Additionally, the Organisation for Economic Co-operation of Development, an international organization representing 31 developed economies, lifted its projections for global economic growth to 4.6% in 2010 and to 4.5% in 2011. In the previous report, released in November, its growth assumptions were 3.4% and 3.7% respectively. Interestingly, the new projections are higher than the average annual rate of growth the global economy registered in the decade before the crisis.

Our Scrooge Transformation: From Generous to Sufficient

It is appropriate that we have Ebenezer Scrooge as our foil. Scrooge's transformation took him from miserly to generous, while our current required transformation must take us from being overly generous to being more fiscally prudent. On a global basis it will be necessary to both increase taxes and cut social programs. The structural changes will need to be balanced; if taxes are raised too high then economic growth can be adversely affected, dampening vital tax revenue. The more severe adjustments will need to be made on the expenditure side. The entitlement programs that worked in the 20th century apparently do not work in the 21st century. A growing population, along with changes in demographics, mandates that changes must occur. Global deleveraging may result in temporary slower economic growth in some countries; however, the deleveraging process is critical to the long-term health of the global economy as we proceed through the 21st century.

So what does all this mean for investors? Equity markets react immediately reflecting developing and speculative information into current prices. There is little question that the short-term social toll on weaker countries' citizens will be painful, perhaps for extended periods of time. Investors often overreact, especially in challenging times. However, these events, like other relatively short-term events, should have no material consequence on long-term portfolio structure. History has shown us that countries do fall into financial hardship, and after making the necessary structural changes, emerge even stronger than before. This time is no different. Fortunately, on a global scale, Greece (and Portugal and Hungary, two other countries in the news lately) are relatively small economies. If the US and others learn from their experience, it will be a small price to pay.

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