THE GLOBAL DEBT BOMB: CRISIS IN REALITY OR THINKING
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The global debt problem -- especially the global sovereign debt problem – is so pervasive and severe that we are virtually guaranteed several years of sub-par growth characterized by low employment growth, low inflation, low interest rates and low overall stock-market returns. About the only thing not likely to be low is financial market volatility. This will almost surely be our reality, given the policy responses of today's global leaders. But it is not the only possible outcome. It could be so different, so much better, if our leaders were to adopt a very different approach, which I will discuss here tonight. One warning however: while the approach I recommend should be the obvious good-news solution, the policy prescriptions are so startlingly different from current policies virtually everywhere in the Western world that they are unlikely to be championed by most politicians or electoral majorities – at least for the next while.

Austere budget policies, in the form of expenditure cuts and/or tax increases, are the near-universal response to burgeoning government debt. Look at Greece, Portugal, Spain, Italy – and virtually every other nation state in the European Union; look at the federal, provincial and municipal governments in Canada, and Federal and State & Local governments in the U.S. As many critics have pointed out, the implementation of such austere policies may actually make the debt/deficit problems worse: restrictive fiscal policies will further weaken economic growth, slow the growth of government revenues and drive up spending for unemployment insurance, welfare programs and the like. The proposed solution by those critics is clear: expand government spending and/or cut taxes to reinvigorate the economy. The problem with this view is that there are circumstances when expansionary fiscal policies will work, and other circumstances when they will not. Unfortunately, the debate over the matter almost never gets properly cast. Let me try.

Consider a hypothetical economy. It does have a fair bit of sovereign debt but it's size is widely regarded by financial markets as "manageable"; it has a balanced budget, or possibly a relatively small deficit; and, for the most part, it has been operating close to its growth potential with no worrisome unemployment problems. For one reason or another, it experiences a growth setback, producing a now worrisome unemployment problem, and causing the budget to go into deficit. Would temporary fiscal stimulus in the form of increased government spending or reduced taxes help to restore health to the economy; and restore balance to the budget once the economy is strong enough to reverse the temporary stimulus? Most theoretical and empirical studies suggest that the answer is a strong "yes". But the description of such a hypothetical economy does not bear even the slightest resemblance to the so-called basket cases that are the focus of so much global attention and worry.

Briefly consider Greece. Its government debt is over 160% of GDP. That debt has been accumulating for a great many years, the consequence of increasingly generous government programs for social security and welfare, and an extreme reluctance to

collect taxes. When the debt was relatively small, no one worried much. It was easy to borrow, and when borrowing costs ratcheted up in response to periodic credit market concerns, they could, prior to their entry into the Euro, "print" money and/or devalue the Drachma, pressure releases which they showed little reluctance to use time and time again. When they joined the Euro, they must have thought they had died and gone to heaven: sure they lost their right to "print" money and to devalue the currency, but they received a large grant of Euros and could now borrow at much lower Euro-determined interest rates, seemingly forever. How else to explain the willingness of borrowers, especially sophisticated European Banks, to continue to take on ever increasing amounts of Greek debt? As is well known, the whole thing began to unravel pretty quickly once the global financial crisis hit in 2008. And while there are some commentators – most notably, Paul Krugman – who would have us believe that, absent the U.S.-originated crisis, the borrowing spree in Greece could have merrily continued, the crisis was, in my view, only the straw that finally broke the camel's back. The chickens had finally come home to roost. As an economist friend of mine noted, "Greece had so robbed from the future that it could no longer afford the present"! Efforts by Greece to back away from its lender-imposed austerity actions would sap what little confidence remains, driving up borrowing cost dramatically, unless a "sugar daddy" can be found to pay the extra bills or provide guarantees. Less and less likely, as we have seen!

In many respects the story of Greece is not unique: lots of countries have for years been doing the same thing; maybe not to the same degree, but close. It was not long after Greece hit the proverbial fan that investors cast their eyes to other heavily indebted countries, which for varying reasons had to seek financial bailout assistance to also cope with the fallout from the 2008 crisis. With Ireland, Portugal, Spain and Italy now all under the microscope, it's no wonder that the whole European "plan" has become suspect.

What was lost in all of this tumult – and which is still not understood by a great many commentators, including, I am sorry to say, by a number of economists – is that each of these countries had violated the most fundamental law of macroeconomics**: it is not possible for any economy to sustain a level of total economy-wide spending larger that its total economy-wide income. It can be done for a while – by borrowing or by printing money – but even those avenues have their limits: in the case of borrowing, the ultimate loss of confidence of lenders; and in the case of printing money, inflation, or in the extreme, hyperinflation.**

We all need to be reminded of one of the first lessons we were taught in Economics 101: **the total of a nation's income is the same as the total value of its production of goods and services. Thus, the total income available for distribution, or redistribution, is no more or less than the total value of its production of goods and services. If fiscal actions undertaken by government – and here I include all of those actions that either enrich recipients of government largesse, or restrict the production of additional goods and services, however well intentioned those actions might have been -- have the consequential effect of causing total national spending to exceed total national income, the outcome will not be sustainable. As I noted a moment**

ago, borrowing, or, where available, printing money, are stopgap measures only. Either national spending has to be reined in, or total income increased in ways that are sustainable. In some cases, to right the balance, there will need to be a major restructuring of numerous social welfare programs. In other cases – and I suspect this will be true for Greece – nothing short of a wholesale dismantling of the social welfare state as currently constructed will suffice. Remember, the issue before the Greek government – and before virtually all of the other EU governments – is the adoption of a long-term plan to bring about revenue increases and/or spending cuts sufficient to produce a budget that is sustainable. So what sort of things do I have in mind? Well, for starters, what about setting the retirement age at, say, 75. What about means-testing payments for health care and social security, focusing not just on income but also on – however imperfectly measured – wealth? What about serious tax reform (which in the case of Greece might begin with the simple action of actually collecting the taxes that are owed!) where the focus of reform is, in part, on increasing the total production of goods and services (and hence total national income) rather than the protection of particular political/social groups? What about serious labour market reforms, where again the focus is on the increased production of goods and services? What about the dismantling policies aimed at the protection of certain groups (like agriculture) at the general expense of other goods and services production? This is only for starters. As I said at the beginning of this talk, such policy reforms are not likely to be championed by many politicians (unless they want to eliminate any chance of being elected), or by electoral majorities. Too bad, because those reforms are going to take place at some point in time, however reluctantly. Depending on whether "credible" long-term plans are put in place to significantly raise revenues relative to outlays rests the question of the survival of the Euro and the European Union.

I am led to one ineluctable conclusion: ***Governments and their leaders can never see the writing on the wall until their backs are to it?*** Maybe that's just human nature.

But why all this talk about Europe and the Euro? Is not the U.S. in more or less the same boat? After all, they have a debt/deficit problem that by numbers is as bad or worse than several EU members who are under intense global pressure to reform their ways? The simple answer is no. First, no one doubts that the U.S. has the capacity to readily deal with its debt/deficit problem: both taxes and government spending are a much smaller proportion of GDP than is true of Europe. Are we to conclude then that the U.S. government is therefore completely dysfunctional by its apparent inability to deal with the problem? Again, I would argue, no. What is taking place is one of the messiest fights ever over the proper role and size of government – a debate that has never really taken place in Europe, and I dare say, in Canada. The U.S. tax code is a mess, and so are the Medicare and Medicaid programs. But don't doubt that they can be fixed in ways that are much easier than in Europe. Second, the U.S. has the ability to print money – the most popular means these days being called "quantitative easing" (QE) – a tool that the U.S. Federal Reserve has been using liberally since the beginning of the 2008 crisis. Indeed, since quantitative easing is all about the purchase of assets – toxic and otherwise – by the U.S. Fed in exchange for "money", the U.S. Central bank has accumulated a

huge portfolio of securities in the past few years. And while the creation of money in that way was essential to the rescue effort following the 2008 crisis, there will come a day with the return of more normal financial market conditions when the Fed will have to unload its portfolio of securities which will present its own challenges, as we will see in a moment.

Notwithstanding the extensive use of quantitative easing, and major fiscal stimulus at both the end of the Bush term and the beginning of the Obama years, the U.S. economy has been performing sub-par. In part this has to with the fact that the 2008 crisis hit the economy so hard that all these measures provided only partial offsets. In addition, state and local governments were forced to severely cut their own spending and raise taxes to deal with the revenue losses associated with the same 2008 crisis. In fact, the contraction at the state and local level came close to negating the entire fiscal stimulus at the federal level. Monetary policy, in the form of near zero interest rates and quantitative easing, has been the only policy tool holding the whole thing together.

And what about Canada through all the mess elsewhere in the global economy? It would appear that Canada has fared quite well by comparison, the result in part of a more conservatively managed and regulated financial sector that has stood up well against the onslaught, and a good bit of luck, most notably the strengthening in commodity prices that provided much welcome offsets to the weaknesses taking place elsewhere in the economy. Canada was also well served by the timely introduction of fiscal stimulus at the beginning of the 2008 crisis, even if its timely occurrence was also more by luck than design. And, yes, the Bank of Canada was strongly supportive throughout, providing, like the U.S. Fed, generous doses of liquidity as needed. But to acknowledge this good fortune, it would be wrong to conclude that all is well. When one looks at the combined Federal, Provincial, Municipal debt/deficit totals, there is not a lot to brag about: as percentages of GDP, both are not much different from the U.S., and by further comparison with the U.S., we have a lot less tax wiggle room. And given the recent weakness in commodity prices, there will be much to be concerned about for Canada if those recent price trends continue.

Which of course brings us to one of the main worries facing the world economy today, namely, the slowdown in world economic growth that is the principal reason behind the recent price weakness in commodities that are so critically important to Canada. Even China and India are in the midst of a material growth slowdown. How can this be happening? Weren't these two countries supposed to be beacons of light in an otherwise bleak world? Yes, but that did not mean – except to a number of bleary-eyed observers – that they were insulated from what was going on in the rest of the world. Europe and North America were and are India's and China's major customers. The world is not de-linked, but rather hyper-linked!! And the slowdowns in Europe and North America are as worrisome to India and China as their slowdowns are to Europe and North America. It's not surprising then that both India and China continue to engage in their own forms of monetary and fiscal stimulus to offset the growth weakness elsewhere in the globe. Nor should it be so shocking that the rating agencies currently have grave concerns about the solvency status of India.

It should be apparent from this discussion that the task facing the world economy of righting the ship listing under the weight of global debt is indeed daunting. But in truth, that is only the half of it!! The globe not only must struggle with burdensome sovereign debt matters, it has to do it at the same time as it tries to meet the crushing new demands being imposed by the relentless aging of populations. We are daily witness to the struggles on that front coming from Japan, a country whose debt already exceeds 200% of its GDP and whose population is in absolute decline. The challenges posed by aging populations are also well advanced in Europe. They are beginning in earnest in Canada and the United States only now. Interestingly, China, a country with a very young population (on average overall) is also witness to the most rapidly aging population almost anywhere – the direct consequence of its ongoing one-child policy. Some have wondered in consequence whether China will become old before it becomes rich!

The challenges posed to policymakers by aging populations are double barreled. To meet the needs of the elderly, whose average life expectancy keeps advancing, ever greater resources must be provided by those who are producing the country's goods and services – in other words, from those who are working. However, over time, and at an increasingly rapid pace, the percentage of the population made up of workers will be shrinking. To illustrate, Canada this year, for the fist time, is experiencing more exits from its workforce than entrants. And although today there are about 4 workers per 2 retirees, by 2030, the numbers will be 2 to 2.

Why are these ratios so important? Because meeting the resource demands of the elderly – for health care, for social security, and for the myriad other programs for the aged – must come from each country's national income; that is, from the employed population. The alternative? To pare back the support for the elderly: cut social security payouts; cut health care benefits; cut other elderly programs; impose or expand inheritance taxes. Do you see a problem here? This would be construed as an assault on hard-earned entitlements. And guess who currently has the most political power? You know who: the elderly and the near-elderly because they vote, in contrast to the dismal electoral turnout of those aged 35 or less. And as the elderly continue to make up an increasingly large percentage of the eligible voters, this concentration of political power is unlikely to change dramatically even if the young get out to vote.

This has all the markings of a potential intergenerational war. It's not difficult to see the resentments that will boil up from young people who will be handed the bills for past government debts that were not of their making, all the while trying to cope with the new and rising bills being presented to meet the needs of the aged. As an important aside, it is worth noting that the shoe was very much on the other foot during the sixties and seventies. Numerous stories were regularly reported in the press about the dire financial straits of the then elderly. Stories of how many elderly people were forced by dint of their inadequate incomes and savings to eat cat and dog food; of the disproportionate number of elderly living in poverty. That is when the fixes were put in – in the form of enriched social security and elderly welfare programs. But those fixes occurred when we could easily afford them. Because of the baby boom, labour force growth was rapid. In

addition, the labour force numbers were swelled even further because of a new social phenomenon – the increased labour force participation rate of women. And finally, productivity growth – which constitutes further growth in income -- was strong.

The shoe on today's foot looks very different. Virtually every major country is drowning in debt. Debt service costs eat up huge amounts of the budget, a situation that can only get worse once interest rates move from their current emergency low levels to more normal levels as the economic picture stabilizes and then improves, as it most assuredly will – maybe four to five years down the road. Because of a double whammy effect – continued sluggish growth as the world economy struggles to bring debt down to more manageable levels resulting in only a slower pace of sovereign debt growth, not a decline; and the gradual increase in interest rates as world growth strengthens, carrying with it further increases in sovereign debt to meet higher debt service costs – the overall debt burden has little or no prospect of being much lighter four or five years from now, unless economic growth were to speed up significantly.

So what is the prospect of a sharp advance in global growth in the years and decades ahead? At first blush, the answer would appear to be a resounding no. The maximum speed an economy can grow over time is determined by two factors: growth in the workforce; and growth in productivity. Oh sure, the economy can grow faster for a while as it extricates itself from recession or sub-par performance, but once it reaches its max growth path, potential growth thereafter will be driven by labour force growth and productivity.

As far as labour force growth is concerned, the numbers almost everywhere promise to be low. For decades the birth rates in most of the so-called developed world have been well below the 2.1 rate needed to replace the population. In Canada, the birth rate is below 1.7; Germany's rate is 1.4, Italy's is 1.3 and Japan's is 1.2. The U.S. is almost alone in having a birth rate at its replacement rate, 2.1. Thus, in sharp contrast to the baby boom years, the growth of new entrants to the workforce has fallen significantly, a trend that promises to continue in the years to come. In Canada, the best we can probably hope for is a labour force growth rate of 1.2-1.4 percent per year. This could be augmented by sustained flows of new immigrants; it could be temporarily buoyed by increases in effective retirement ages. In any event, the point to be made is abundantly clear: if labour force growth is all we can rely on, then we are in for some very challenging times. Bluntly put, it will not be possible to both service significantly larger amounts of government debt and meet the needs of an aging population without very material increases in taxes and/or sharp cuts in program spending. And you can bet that this prospect will not be welcomed by the young. The same story – perhaps in spades—awaits most of the countries of Western Europe.

This of course leads naturally to the discussion of productivity. Simply put, improving productivity is, in my view, the only reliable and sustainable way of getting out of the mess we find ourselves in. To get to 4% real growth in the economy year after year – which is what I estimate is necessary to throw up the revenue needed by government to meet current program requirements and service the debt -- means compound growth in

labour productivity of almost 3% per year. To achieve anywhere near that rate will be judged by some as near impossible given that, notwithstanding a great many government initiatives in that direction, including material cuts in corporate taxes, we in Canada have been able to eek out productivity gains of barely 0.5% annually for a long time.

I acknowledge that we do not have a complete understanding of all the factors that determine growth in productivity, but that does not mean we are in the dark. We had productivity growth rates in the sixties that averaged near 3%. We have seen two decades of near 3% productivity growth in the U.S. And several of the European countries, most notably Germany, have much better productivity records than Canada.

A great many things can be done to improve production efficiency. At the top of the list has to be business investment, the well-documented source of strong productivity growth over time and across countries. Why business investment in Canada has been so weak in the past few years is a mystery to me, even after taking account of the uncertainties created by the financial crisis in 2008. The strong Canadian dollar combined with the notable improvements in many business balance sheets should have been a much stronger spur to investment. But it did not happen.

There is also much more that Government can do. But in order to justify the more it could do, there first has to be a better acknowledgement of the magnitude of the daunting tasks we face to meet both the debt/deficit challenges and those of our aging population. Only then could we set about the task of rooting out inefficiencies wherever we find them. Let's try on the following for size: phasing out supply management in the dairy and poultry sectors; dismantling interprovincial barriers to the movement of goods and workers; eliminating most regional development programs; seriously reforming the EI program; forcing government unions to compete with private sector providers for contracts. You get the idea. It would not take long to generate an almost endless list of possibilities.

The point of the whole exercise to improve productivity is that there will result a higher level of national income, and we are all aware that higher incomes generate higher tax revenues.

Sticking with the revenue theme, there is much more that governments could do to generate savings that could be used to meet the needs of the elderly and debt service/retirement. Consider major reform of public sector pensions and benefits that have been talked about ad nauseum in the press; significantly raising the age of eligibility for CPP/QPP and OAS to possibly 75; rewriting the Canada Health Act to permit private enterprise. Easy stuff, right? No, but no one should kid himself that anything less than draconian measures will bring about the conditions necessary to meet the needs of current and future generations. And as draconian as the measures must be here, rest assured they will be more gut-wrenching overseas in Europe.

BOOK RECOMMENDATIONS:
Why Nations Fail by Daron Acemoglu and James Robinson
While America Aged by Roger Lowenstein