Waiting for Something to Turn up: Europe's Looming Pensions-based Sovereign Debt Crisis

Edward Hugh | Mar 18, 2010 7:15PM

As Irwin Stelzer argued in a recent opinion article in the Wall Street Journal, Spain's Prime Minister José Luis Rodríguez Zapatero seems to be an admirer of Charles Dickens's character Mr. Micawber. When asked what he plans to do about Spain's 11.4% fiscal deficit, first he promises to extend the retirement age, only to later tell us the measure may not be necessary. Then he promises a public-sector wage freeze, only to have his Economy Minister, Elena Salgado, say he really doesn't mean exactly what he seems to say. And in any event, we shouldn't worry too much, since given that Spain is a serious country, somehow or other the fiscal deficit will be cut to 3% by 2013, even though most serious analysts consider the economic growth numbers on which the budget plans are based to have their origins more in the dreams of an Alice long lost in Wonderland than in any kind of sobre analysis of real possibilities. "We do have a plan," deputy prime minister, Maria Teresa Fernandez de la Vega assures us, but to many that plan now seems to be little better than hoping, like the proverbial Mr. Micawber, that "something will turn up."

The lastest to draw attention, to the problematic nature of this "wait and see" approach - and to the gaping hole which is now yawning in Spain's national balance sheet - is the credit ratings agency Fitch, who only last week warned that many Western governments now face unsustainable debt dynamics following measures taken to address the financial crisis.

The agency singled out Britain, France and Spain as being in special and urgent need of outlining plans to strengthen their public finances if they don't want to risk losing their current highly prized AAA ranking.

This strong and direct warning was issued by Brian Coulton, Head of Global Economics at Fitch, who said "High-grade sovereign governments need to articulate more credible and stronger fiscal consolidation plans during the course of 2010 to underpin confidence in the sustainability of public finances over the medium-term and their commitment to low and stable inflation. The UK, Spain and France in particular must outline more credible fiscal consolidation programmes over the coming year given the pace of fiscal deterioration and the budgetary challenges they face in stabilising public debt."

Yet, while criticising Portugal's gradual approach to fiscal consolidation as a matter of "concern" Fitch senior director Paul Rawkins also argued that the Spanish govenment had acted swiftly in announcing plans to consolidate public finances. Nonetheless he did still warn that the economic risks facing Spain remain very high, especially since the pace of decline in tax revenues is dramatic enough to be preoccupying, while continuing "labour market inflexibilities could well prolong the economic adjustment".

The current problem facing Spain (and other similarly affected countries) has its roots in two quite distinct sources. In the first place measures taken to counteract the impact of the financial crisis have been inadequate and have simply produced large short term deficits. However to this short term liquidity and adjustment problem must now be added the further dimension of longer term impacts on public finances which have their origins lie in ageing populations, and the effect on economic growth of having older and smaller working-age populations.

Regarding the first, as Willem Buiter, now chief economist at Citi has pointed out, more than 40 per cent of global GDP is currently being produced in countries (overwhelmingly advanced economies) running fiscal deficits of 10 per cent of GDP or more. Over most of the last 30 years, this level fluctuated in the 0-5 per cent range and was dominated by debt form emerging economies. So the crisis marks a watershed, from which there will likely be no turning back, and in many ways could not have come at a worse moment for those countries who still have to undertake substantial pension reform to put their nation finances on a solid footing when faced with the unprecedented ageing which lies ahead.

Indeed, to take the Greek case, while the short term fiscal deficit has been the focus of most of the press

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attention, the longer term problem associated with the funding of Greek pensions far outweighs issues associated with the falsifying of national accounts in the early years of this century. A recent report by the European Commission found that Greek spending on pensions and health care for its ageing population, if left unchecked, would soar from just over 20 percent of GDP today to around 37 percent of G.D.P. by 2060. And Greece is simply an early warning indicator of troubles to yet to come, in larger countries like Germany, France, Spain and Italy who have all relied for decades on pay as you go type state-financed pension schemes. Now, governments across Europe are being pressed to re-examine their commitments to providing generous pensions over extended retirements because fiscal issues associated with the downturn have suddenly pushed at least part of these previously hidden costs up to the surface.

In fact, unfunded pension liabilities far outweigh the high levels of official sovereign debt. According to research by Jagadeesh Gokhale, an economist at the Cato Institute in Washington, bringing Greece's pension obligations onto its balance sheet would show that the government's debt is in reality equal to something like 875 percent of its gross domestic product. That would be the highest debt level in the 16-nation euro zone, and far above Greece's official debt level of 113 percent. Other countries have obscured their total obligations as well. In France, where the official debt level is 76 percent of economic output, total debt rises to 549 percent once all of its current pension promises are taken into account. Similarly, in Germany, the current debt level of 69 percent would soar to 418 percent. Of course, these numbers are arguable, and may well be in the excessively high range, but the fact still remains: outstanding and unfunded liabilities are huge, and would have been difficult to honour even without the present crisis. As it is, we are now in danger of spending the seedcorn which could have been harvested later on down the road.

Public opinion has yet to assimilate the seriousness of the issues involved here. As Pimco Chief Executive Mohamed El-Erian said in a recent FT Opinion article, the importance of the shock to public finances in advanced economies is not yet sufficiently appreciated and understood. With time, this issue will prove to be highly consequential. The latest Fitch report is simply another warning shot. The sooner we all recognise the, the greater the probability of our being able to stay ahead of the disruptions this adjustment to reality will cause. It is time to stop simply waiting around to see what is going to turn up, since if we do continue like this we won't like what we eventually find.

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