

Title: Public Debts: The \$36 trn Burden of coming Generations

Region: GLOBAL Date: 28th December 2009 No of Pages: 6

As the sun sets on the year of 2009, we all wish that the sunny times in the capital markets in last few quarters of 2009 world over, would continue in 2010. And the sun should never set. Well, students of geography will know that the sun never sets but the earth rotates around it. All that happens is, the sun sets in one part of the world, only to rise in another. But in 2008 financial crisis, the sun somehow failed to shine bright in any part of the world. Factually the sun did not lose any of its light, though it's not exactly close to the earth (its only about 92,955,887.6 miles away). It's the earth that stood still in the shock of 2008 financial crisis.

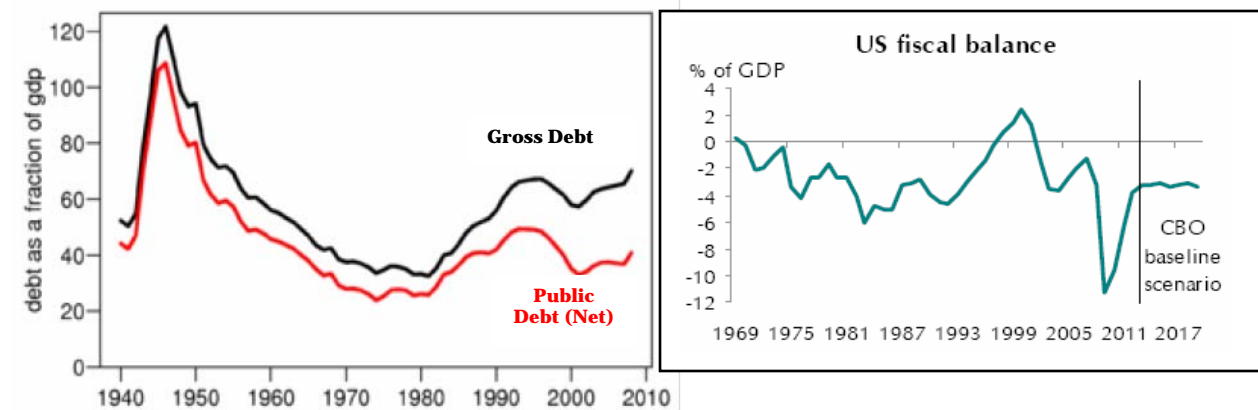
Come March 2009, the earth started rotating again, and the sun too started shining all over the world. Stocks & commodities rallied as risk & growth was back world over. And who moved the earth which according to one estimate has a mass of 5,973,700,000,000,000,000 metric tonnes? Well they are the most powerful Central Banks and Governments of the World. How did they manage to get the necessary force or the resources to set the earth rolling again? Simple: The Power of Money. Governments spent more and more than what they earn as current revenues and taxes, in order to stimulate the economies reeling under recession.

And we all know that the gap between your higher spending and revenues has to be filled in by borrowings. The Governments did borrow much more than its revenues (budget deficits), thus incurring more and more debt. In short the Governments "leveraged" and the collateral was only the "trust" in the government. And who were the financiers to the Government? Tax payers like you and me, corporations, foreign governments and others such as Central banks and fund managers who bought US bonds. Some of lenders were domestic and some international.

So we were the part lenders and the Governments were the borrowers leading to higher and higher public debt or national debt. Just like in a balance sheet, the previous years losses are carried forward to subsequent years, the burden of public debt gets carried forward too in form of net cumulative budget deficits or surpluses of previous years. A budget deficit in a year the adds to the accumulated public debt and a budget surplus in a year exactly does the opposite.

As the US Government went on a spending spree to provide the necessary stimulus to the economy and bailed out banks, its fiscal & public debt situation deteriorated sharply vis a vis its GDP, thus exerting pressure on its interest rate & currency as well as putting its top credit rating (AAA) at risk.

Chart I: The US Debt Burdens and Mis-Fiscs Balances



Source: Wikipedia

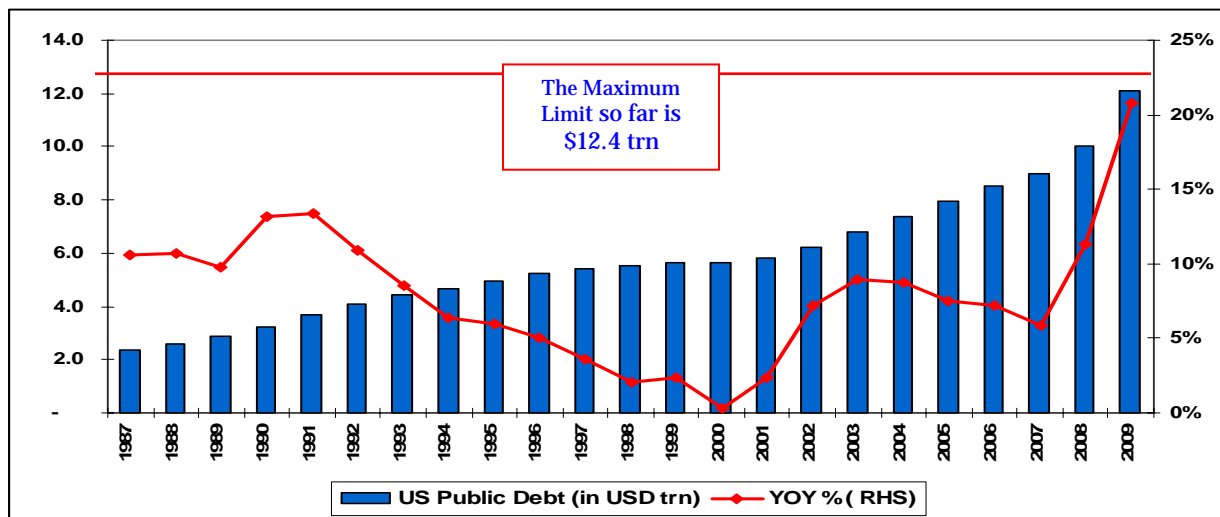
Source: CBO

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As the budget deficits in US climbed year after year, the Public Debt ballooned to trillions of US Dollars (Chart II) pushing the Senators in US to approve the raising of the maximum limit of Public Debt under the ARRA Act of 2009 many times to USD 12.4 trn as of now.

Chart II: The US Public Debt Balloon

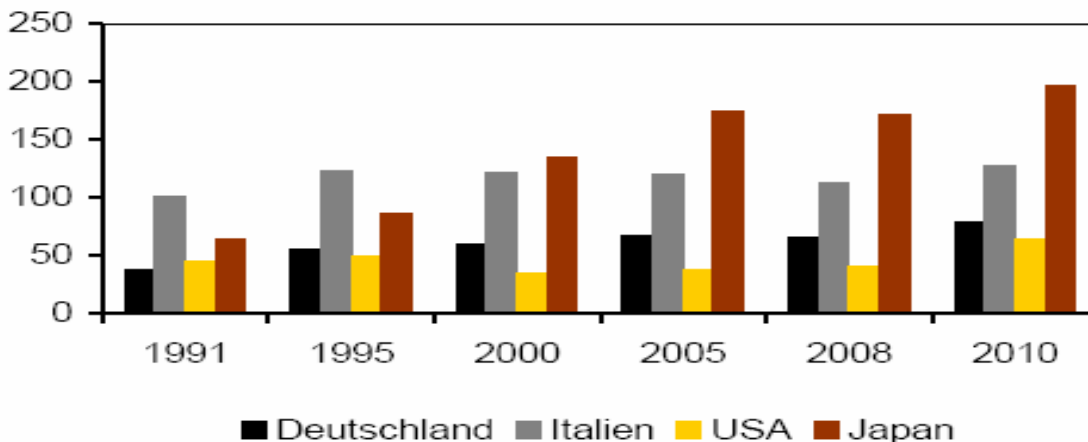


Source: www.ustreasurydirect.gov

Every US citizen's share in the public debt of US now is about USD 39,373, which the subsequent generations have to bear. Since September 2007, the US Public Debt has increased by about USD 3.79 bn per day. Since 2007, the US public Debt has jumped by about USD 3.6 trn, with the single highest rise in recent times being in 2009, viz about USD 2 trn.

And US is not the only country (Chart III) in the world which saw its public debt swelling, there are more governments globally which dolled out money to rescue there economic boat for sinking in the deep sea of recession leading to Public debt bubbles world over:

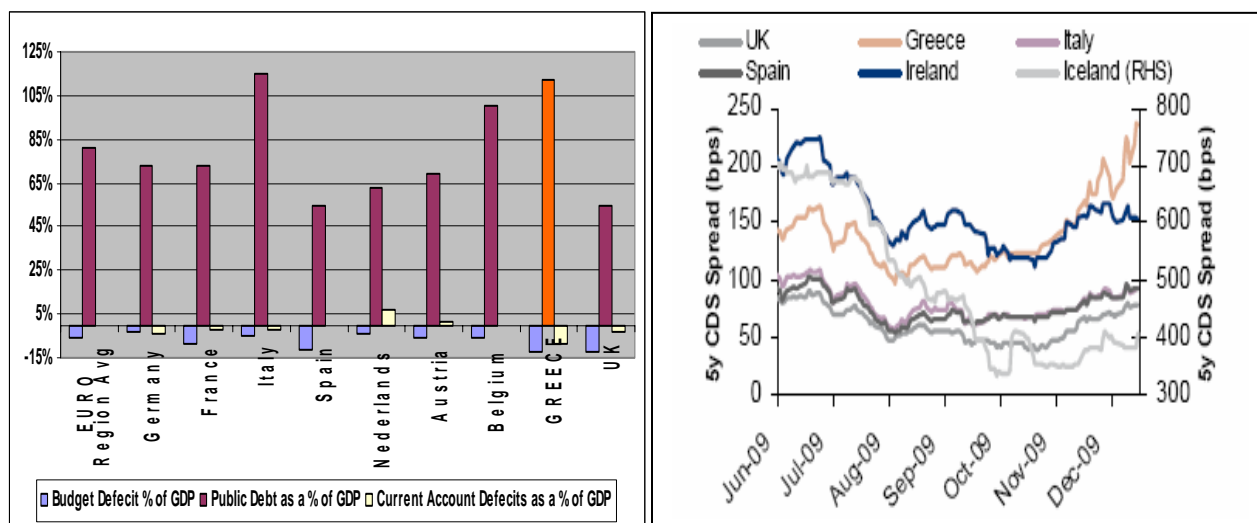
Chart III: The Public Debt Balloons all over the world



Source : Credit Agricole Perspectives & EU estimates. The figures are Public Debt as a % of GDP.

The Europe situation (Chart IV) on the Public Debt and deficits was more alarming, which resulted in rating downgrades of some of the countries such as Greece. Iceland now has a Public Debt to GDP ratio of more than 145%. The European cost of hedging sovereign risk (Credit Default Swaps) soared to record levels.

Chart IV: Europe nosedives on its Public Debt & deficits, as CDS soared



Source : Various official websites and consensus estimates

Source : BofA ML Research

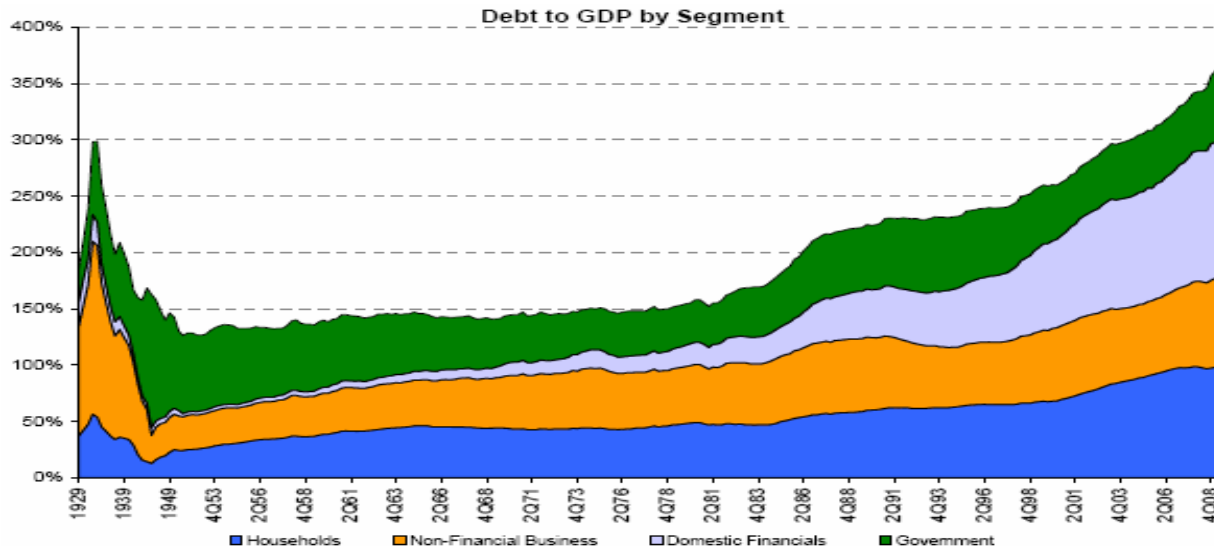
Coming back to Public Debt of US, almost 36% (as per the US Public debt website) of the public debt is payable to itself, viz the Intragovernmental Debt Obligations. And the US government pays interest on the debt held by itself. The 36% of the debt comes to around USD 4.4 trn on which the US government pays interest to itself at the average rate of 2.5-3% pa, that's around USD 220 bn every year. And moreover the US government borrows further every year to pay this interest.

These debts are held in form of Intragovernmental Holdings which are mostly made up of the Government Account Series (GAS) held by government trust funds, revolving funds, and special funds, as defined by the US Public Debt website. This portion of the debt is primarily held by the medicare and social security trust funds (to which almost all the US citizens contribute regularly) in form of IOUs. These funds have liabilities in form of future payments to beneficiaries, retirees etc.

The US Government takes care of future liabilities of these funds in addition to the interest paid on the debt, in return of the debt owed. Moreover unlike the US Treasury Notes, Bonds, Bills etc which are marketable, such Intragovernmental debt is non marketable. *If at all US defaults on its debt in future, it will probably cancel this internal debt first putting all the beneficiaries and retirees at risk.*

So even with the steep rise in gross US public debt, the net figure (Chart I) remains reasonable as compared to some of the other countries such as Japan, Italy and Greece where the public debt levels have exploded. The bigger worry in US is hefty rise in the overall debt(households, corporate & governments) to GDP Ratio since the decade of 1980's. Please refer to Chart IV on the next page.

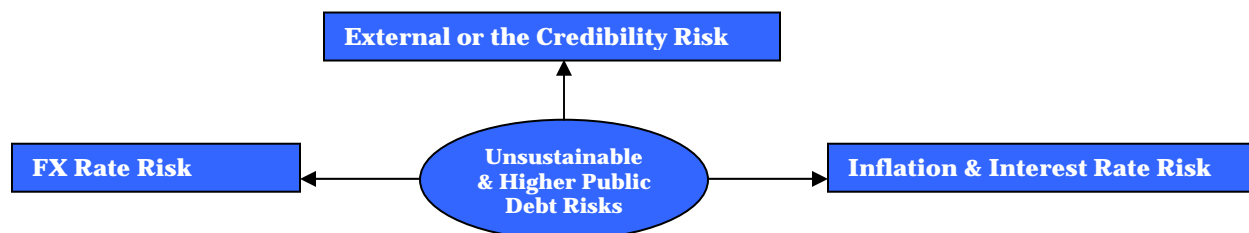
Chart IV: US Total Debt to GDP Ratio



Source : Federal Reserve and MS Research

Let’s quickly run through the ill effects of unsustainable public debt levels. A country with high debt level carries all the risks which any entity might encounter due to excessive accumulated borrowings, without sufficient means (future revenue) to repay them. And a borrower who is not able to repay its debt is termed as a “Defaulter”.

Chart V: Risks in Unsustainable Public Debt levels



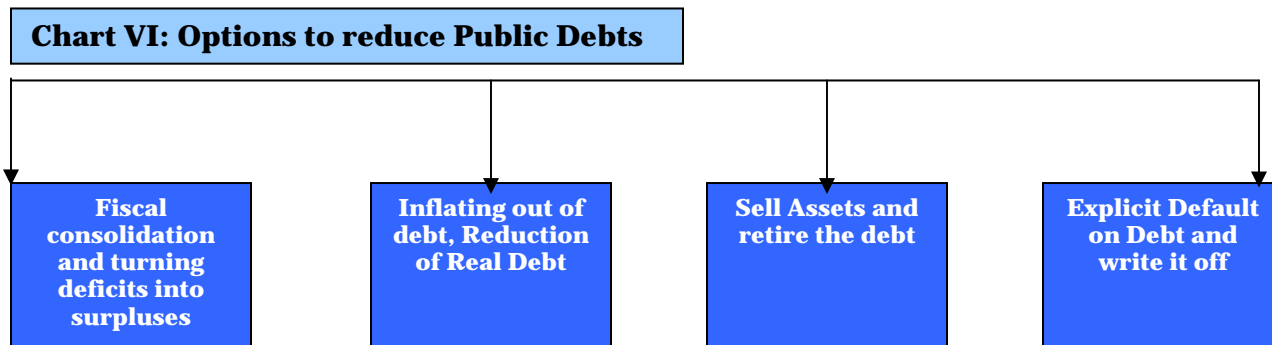
Source: Delta Global Partners Research

The largest risk that a country faces when the Public Debt goes out of control is the “loss of credibility and faith” in global markets especially on the policy makers.

This issue is more important when the public debts are financed by non domestic or international investors. A loss of credibility may result in an inability on the countries to refinance its debts in international markets resulting in cascading effects on the real economy in form of rating downgrades as well as liquidity and currency crisis. China & Japan with it’s almost USD 1.5 trn holdings of US debt are in a commanding position to make US understand this risk.

The other risks such as currency depreciation, higher inflation and crowding out effects on economy are relatively well known and well understood.

So what are the options with the government to lower the Public Debts? A few are as follows:



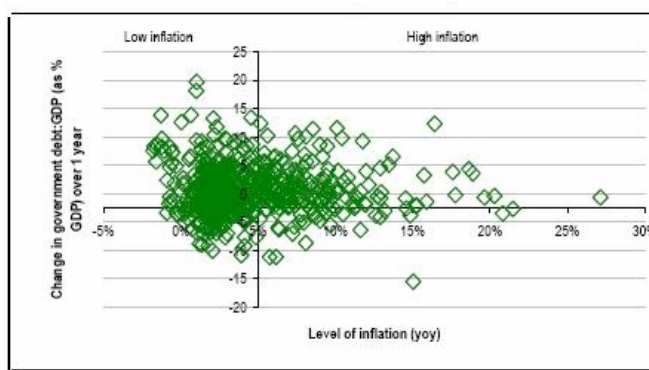
Source: Delta Global Partners Research

Well the easiest but the most risky option is the one to the rightmost in the above Chart VI. And the most desirable option is the one to leftmost in above Chart VI. Fiscal consolidation in form of either increasing the revenues or cutting the outlays would be the most natural way to unwind large public debts. This requires firm and harsh policy actions such as higher taxes for trimming deficits on a sustained basis and results are only visible over a period of time. Political will is essential here to implement a sustained fiscal tightening.

Selling assets owned by the Government such as holdings in listed or unlisted companies, can help to reduce public debts though on a one off basis. Though one has to understand that assets are always a finite number and selling them can't be taken as a sustained strategy to reduce public debt. India is looking to do this in form of selling off stakes in state owned enterprises and the 3G auction.

“Inflating your way out of Debt “is nothing but the strategy to simply print more and more money to repay your public debt. This strategy debases the domestic currency bringing in higher inflation (and so higher interest rates) and some times even hyperinflation. Higher inflation makes the debt repayments easier, since it lowers the “Real Debt (net of inflation)”. The drawback of this is the rising cost of refinancing your debt rollovers in form of higher interest rates or even inability to refinance it. Imagine China refusing to buy fresh US treasuries as current holdings mature.

Chart VII: Higher Inflation has not always reduced the public debt



Source: OECD,Haver,UBS

The strategy of inflating your way out of debt has hardly worked in the past. Periods of high inflation have not coincided with lower debt to GDP ratios in next one year (Chart VII). But the risks are high in terms of hyperinflation, currency depreciation, debt spirals and loss of credibility for the government. Zimbabwe is a classic example.

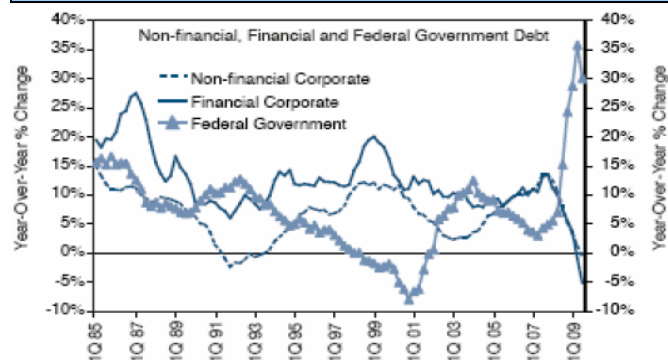
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And the last option, which is the least desirable for any government in the world, is an outright default on the debt. Declare yourself as a Defaulter and you can write off the necessary debts. We all by now know the repercussions of the sovereign debt defaults on the global credit markets as well as on the economies. No one will ever forget the USD 95 bn default by Argentina in December 2001 and the ripple effect of the same all over the world on credit markets.

To conclude, the year 2010, will be the testing time for the Governments who have overrun their capacity on creating more public debt. And the path to return to fiscal profligacy will have land mines on the way, including the political ones. These governments would necessarily need the support of higher economic growth and thus higher revenues to “mean revert” to their normal public debt levels. Some tough measures from the governments will be indispensable.

Chart VIII: The Risk Swap of the decade in US



Source: Federal Reserve & PIMCO

What did the economic crisis and the government response to it did in 2008 was to deleverage households, banks, corporate balance sheets and re leverage the government balance sheets. It was the biggest swap (Chart VIII for US) of trillions of dollars of private risk with public or government risk, in turn creating the new monster of ‘Sovereign risk “ which will usher us into the year of 2010. The banks were bailed out by the Governments, but who will bail the governments out?

And on a foot note: The global public debt as calculated by The Economist magazine now stands at USD 36 trn, which is around 60% of the estimated Global GDP.

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