PODCAST PRESENTATION

WHICH NEWS DO YOU WANT FIRST? PART 2

Hopeful signs and hidden landmines for the global economic recovery

Presenters
Doug Holt
Senior Vice President
Northern Trust

Paul Kasriel
Chief Economist
Northern Trust

HOST: In Part 2 of our series, Paul Kasriel, Northern Trust's award-winning Chief Economist, looks ahead at hopeful signs and hidden landmines for the economic recovery.

DOUG: Paul, thanks for joining us again.

PAUL: Thanks for having me.

DOUG: Question on the financial services sector. Some banks and other financial companies are really springing back – and some recording record profits – while others continue to struggle. What is your view on the overall sector and what does that mean for the economy as a whole?

PAUL: The financial sector is out of the intensive care unit – it's not out of the hospital. And I actually see that the major headwind for economic growth this year and perhaps next year will be the financial sector. Obviously, severe losses were taken in the last couple of years. Financial institutions have gone into the market, raised capital. Some of them still have government capital embedded in them. And the financial sector as a whole is adequately capitalized today. Some institutions – don't want to name any in particular, but – are very well capitalized, others adequately capitalized – today. But the problem is, there is likely to be another wave of losses coming. And it will be led by commercial real estate. Everyone knows that there are going to be problems with commercial real estate mortgages in the next couple of years. We still have issues with residential mortgages. The worst is over, but it's not all over. With the unemployment rate likely to stay relatively high, we are going to see continued problems with consumer debt, such as credit card debt and auto loan debt. So there are more losses coming.

And what that means is that an institution that may be adequately capitalized today could find itself capital-deficient a year from now or two years from now. And without capital, financial institutions cannot increase credit. So we really have a constraint on credit creation right now. And that is constraining growth.

But really, I think it's the idea that there are more losses coming that is restraining credit creation today, and that in turn is restraining the growth in the economy.

DOUG: You mentioned the commercial real estate market. We've seen on the residential side, housing – the way that market goes can affect the entire global economy. What is your view of the housing market today?

PAUL: Well, housing had a relatively strong recovery around mid-year 2009, but of late we've seen it kind of lose momentum. It's not exactly clear why. Some of it may be weather – again, the bad weather that we had in January and February. But housing is, I think, going to continue to recover. But it's going to be a very slow and uneven recovery. The tax credits for the purchase of a house expire at the end of April. We may see some rush to buy prior to that expiration, and then some falloff after that. There is still a lot of existing houses for sale. The foreclosure process is starting up again, and that is bringing supply onto the market. So housing is going to recover, but it's not going to be a real vibrant part of the economy.

DOUG: How about in the United States, the Federal government's role in the housing market. What do you see happening there?

PAUL: Well, the Federal Reserve at the end of March is going to stop buying mortgage-backed securities. There is debate as to what effect that will have on mortgage rates. We have seen mortgage rates come down dramatically, not only in absolute terms but relative to their sort of benchmark, which is the 10-year Treasury yield. So we will maybe see some modest uptick in mortgage rates, but not enough to really hurt the economy.

DOUG: Paul, there has been a lot of concern about debt, whether referring to the debt that households are carrying, or governmental debt. What is your view on that, and what are the implications for the global economy?

PAUL: Well, household debt soared during the last boom. Household debt relative to household assets hit record highs. Borrowing relative to after-tax income hit record highs. The biggest increases occurred in the mortgage market. Either people were moving into houses with no downpayments, or borrowing against the rising equity in their houses. And these ratios were unsustainable. And now for the first time in the post-war era, we are seeing households actually pay down debt. This is going to be a long, drawn-out process. But it is occurring in a relatively benign way, orderly way. So we are going to see more of that.

Last year, U.S. Treasury debt relative to the size of the economy, or GDP, hit about 83 percent – very high. But you know, as high as that was, there are a lot of other countries out there that have much higher debt-to-GDP ratios. Japan has the highest debt-to-GDP ratio of any developed economy in the world; it is about 165 percent. We are at about 83 percent. So it is not a huge problem today. Interest rates are still very low, despite the fact that the Treasury is running a deficit in round numbers of about 1½ trillion dollars. The 10-year Treasury yield can't seem to even get up to 4 percent. And that's because, again what I mentioned, households are cutting back on their borrowing. Businesses aren't borrowing a lot right now. So total borrowing in the economy is actually slowing down. The composition is changing. But that's, again, not leading to a big increase in interest rates.

The big problem for government debt and borrowing is not this year, it's not next year. It's 10 years from now and 20 years from now. The projected deficits stay high. Projected government spending stays high. And the primary driver of spending and deficits in those out-years is really related to Social Security, but even more importantly to Medicare. The Baby Boomers are aging, and pretty soon there are going to be millions of them that are going to become Medicare beneficiaries. And the projected cost per beneficiary is going up. So this is the real driver of these out-year projections of deficits and spending.

And I want to emphasize: spending is the real issue. You see – the government always gets its money. And there are three ways the government can get its money, and all three of them are bad for the economy. It can increase taxes. It can increase borrowing, which pushes up interest rates. Or it can just print the money, which pushes up inflation and interest rates. So all of those are bad. It's the spending that's the real issue. And here's why it's an issue. With big projected increases in Medicare spending, that means that more and more resources are going to be used in the economy to take care of retirees. And that's going to leave fewer resources to make those retirees' children and grandchildren more productive. There will be fewer resources left over for businesses to invest in state-of-the art equipment, research and development. There will be fewer resources left over for educating the grandchildren of these retirees. And that means that productivity growth will be restrained, and that means that long-run growth in the U.S. economy will be restrained. So spending is the real issue that we have to tackle and Medicare is the biggest part of that.

DOUG: You mentioned some bad ways to bring down the debt. Is the best-case scenario that the global economy recovers and exports pick up?

PAUL: That's the best case, but we are not going to be able to grow our way out of this. We're going to have to face up that this projected spending on retirees, and largely Baby Boomers, is somehow going to have to be reined in. And that's why the whole issue about healthcare costs is so critical to this. Because if we can bring down general healthcare cost, cost per person, then we can turn down those projected increases in Medicare costs. And that's important. But again, the effect of it, the negative effect of it, is that it leaves fewer resources to make current workers and future workers more productive, and that slows down long-term growth.

DOUG: Well, Paul, thanks so much for your time.

PAUL: Thanks for having me.

HOST: Thank you for joining us. If you'd like to read more of Paul's commentary, please log on to northerntrust.com/econtrarian.