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Can Foreign Creditors Avert America's Day of Reckoning?

Most experts are moving toward the sober conclusion that America's huge current account deficit—that is, the difference between what we borrow from the rest of the world and what we lend to it—is not going away any time soon. On the fiscal front, we face an upward spiral in old-age benefit spending that threatens to widen our budget deficits, which means more dissaving by our public sector. With Washington gridlocked on entitlement reform and indeed preparing to enact new health-care benefits, there's little prospect of near-term outlay reductions. Meanwhile, neither party wants to enact broad-based tax hikes. More saving by our private sector could offset these growing fiscal deficits. But that's not likely to happen either, as millions of aging boomers prepare to cash out their retirement assets.

In 2007, the U.S. current account deficit weighed in at \$711 billion, or 5.1 percent of GDP. Over the past ten years, it has averaged 4.4 percent of GDP—a staggering rate of borrowing that many economists fear must ultimately lead to a crash in the dollar and financial markets. The growing awareness that that we are living beyond our means, both publicly and privately, may help to explain the recent negative shift in American perceptions of our nation's long-term future.

Amid this gloom, a few economists offer grounds for hope. The United States, they say, will be able to continue borrowing heavily from abroad for the next several decades without fear of a financial meltdown. They admit that other developed countries won't be in a position to lend to us, since they are aging even more rapidly than we are and will likely be running large current account deficits as well. But they argue that we can count on younger and more rapidly growing economies in the developing world to lend us whatever is needed to make what seems unaffordable affordable.

The argument has been made most forcefully by economist Jeremy Siegel, who calls it “the global solution.” Siegel acknowledges that the developed world would be in trouble if it had to rely on its own savings to finance investment and living standard growth. According to Siegel, however, it doesn't: “One future development confronts and neutralizes the age wave: the rapid economic growth in the world's developing nations... [I]he economic development of China, India, and other emerging nations can indeed provide the aging nations with the goods and services that they need to enjoy a comfortable retirement.”¹

¹ Jeremy J. Siegel, *The Future for Investors: Why the Tried and the True Triumph Over the Bold and the New* (New York: Crown Business, 2005).

At first glance, the argument seems reasonable. We don't worry when households borrow from and lend to each other. Nor do we worry when cities or regions within the same country borrow from and lend to each other. Why should we worry when nations do the same, especially when the nations doing the lending are young and rapidly growing—which suggests that they will be saving a lot just when we will be dissaving a lot? Each society will be doing the other a favor.

The closer one examines the global solution, however, the more problematic it becomes. Nations that become large and chronic borrowers in fact have plenty of reasons to worry. They will run growing trade deficits—and face a rising risk of protectionist backlash. They will incur mounting debt service costs that must be subtracted from the

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by Neil Howe and Richard Jackson

living standard of future generations. Over time, they will cede growing political influence to foreign creditors—and in the end, if the borrowing continues long enough, they will inevitably face some form of national default.

These risks alone are enough to give pause. But there is also a more fundamental problem: The developing countries simply aren't large enough economically to bail out the developed countries—and in any case, the developing countries are themselves aging rapidly and will need their savings to finance their own looming age waves. A global solution that counts on young nations to lend to old nations cannot work once there aren't any young nations left.

“Capital Flowing Uphill”

Let's start by taking a step back and looking at how we got into this predicament.

Traditionally, most countries most of the time have had to constrain their rate of investment to their rate of

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savings. When savings went down, investment had to go down as well—and, if necessary, was pulled down by skyrocketing interest rates. With the rise of modern global financial institutions in recent centuries, this constraint has weakened, especially during the various waves of globalization that have flourished in periods of geopolitical stability. One such wave began in the late nineteenth century and lasted until World War I, under a market-oriented global order led by Great Britain. Another wave has occurred in recent decades—roughly since the end of Bretton Woods in the 1970s—under a market-oriented global order led by the United States. This last wave has been the most sweeping of all. Today, to a degree having no historical precedent, a country can borrow abroad with no constraint other than its economic capacity to bear the debt-service costs and (perhaps) the political risk that it might default.

This article is adapted from the authors' discussion of demographics and global capital flows in their new book, *The Graying of the Great Powers: Demography and Geopolitics in the 21st Century* (CSIS, 2008).

This regime of globalized finance, so long as it lasts, means that countries that experience a serious decline in savings due to demographic aging may be able to borrow from abroad rather than curtail domestic investment. Just as an increasing number of economists project a growing savings shortfall in the developed world, so too are they projecting a growing capital inflow occurring at about the same time. According to Matthew Higgins, the negative pressure on the developed countries' current account will start to mount around 2010 and grow explosively after 2025.² Robin Brooks identifies "...a turning point between 2010 and 2030 when North America and the EU are projected to become capital importers as rapid population aging pushes their savings below investment." As Brooks goes on to explain, "This shift will be financed by developing countries that will become capital exporters."³ Barry Bosworth likewise concludes that "all three industrial country groups [the United States, Europe, and Japan] will be experiencing large current account deficits in future decades as they sell off assets to support consumption."⁴

Only 10 or 15 years ago, it was difficult to find any economist who thought anything could push the developed world toward a long-term future of rising capital inflows and current account deficits. The natural direction of global capital flows, after all, is from richer nations with more capital per worker and lower rates of return to poorer nations with less capital per worker and higher rates of return. But today, a growing number of economists believe that the

aging-driven decline in developed-world savings will reverse the natural flow—and that in the future we will see "capital flowing uphill," as Federal Reserve Governor Randall S. Kroszner has nicely put it.

Indeed, this shift may already be under way. For most of the postwar era, the developed countries were moderate lenders to the rest of the world. Over the past decade (since 1999), however, the direction of capital flows has reversed—with the developed countries as a whole (led by the United States) recording an unbroken and increasing current account deficit for the first time since World War II, and with the developing countries (led by East Asia) exporting capital in unprecedented amounts. The net capital flow from developing to developed worlds will almost certainly exceed \$2 trillion in just the four years from 2005 to 2008.

Until recently, capital outflows from the developed countries tended to encourage excess borrowing, and then financial crises, in certain developing countries—upon which the rich countries would come to their rescue. Over the last few years, we have witnessed the reverse: excess savings in Asia and the Middle East fueling a U.S. residential property boom that culminated with a financial crisis in which Abu Dhabi, Singapore, and China have had to come to the rescue of Citibank, Merrill Lynch, and Morgan Stanley.

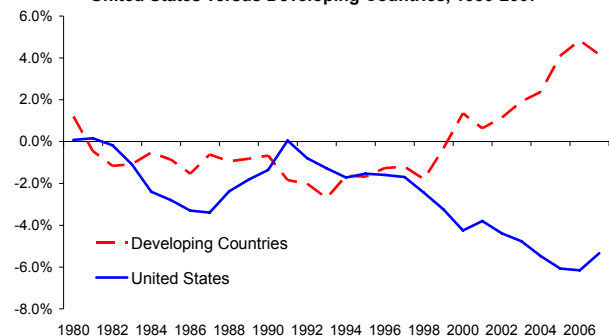
A Dangerous Proposition

According to proponents of the global solution, the unprecedented reversal of global capital flows presents a painless alternative to the economic privation that aging would otherwise impose on the United States and other developed countries. And indeed, from a certain perspective, the global solution can be seen as a "win-win" proposition: Aging developed countries will get the investment that they need to maintain or boost their labor productivity, while younger and faster-growing developing countries will get a superior return on their savings. Both sides gain.

Yet there are also some serious negative consequences which, in the real world, make the global solution a dicey—indeed, a dangerous—proposition.

First, there is the impact on trade flows. To the extent that the developed world borrows more from the developing world than it lends to it, it will, to the same extent, be importing more in goods and services than it is exporting. Moreover, because the individual developed countries are aging at different rates and are likely to respond with differ-

Current Account Balances, as a Percent of GDP:
United States versus Developing Countries, 1980-2007



Source: IMF (2008)

² Matthew Higgins, "Demography, National Savings, and International Capital Flows," *International Economic Review* 39, no. 2 (May 1998).

³ Robin Brooks, "Population Aging and Global Capital Flows in a Parallel Universe," Working Paper no. 00/151 (Washington, DC: IMF, 2000).

⁴ Barry Bosworth and Gabriel Chodorow-Reich, "Saving and Demographic Change: The Global Dimension," Working Paper no. 2007-02 (Chestnut Hill, MA: Center for Retirement Research at Boston College, February 2007).

ent policies (some more effective at keeping savings rates higher than others), it is very likely that the developed countries will begin running growing trade imbalances with each other even as they run an overall deficit with the developing world. This could inflict great harm on economically critical or politically sensitive industries in the largest deficit countries—and in turn trigger a public backlash against liberal trade policies and globalization. The economic damage and political reaction could be especially severe if, as seems likely, larger trade imbalances around the world are accompanied by larger year-to-year fluctuations in those imbalances.

Second, there is the debt-service cost. A country with inadequate savings will do better if it raises the productivity of its domestic economy by borrowing from abroad and investing than if it refuses capital inflows. All the same, borrowing is not costless. When foreign investors purchase a rising share of an economy's debt and business equity, those investors gain a rising share of its income in the form of interest and dividends. If the capital inflows continue long enough, and much of the return on domestic capital (which amounts to at least one-quarter of national income) begins flowing abroad, domestic residents may wake up to find themselves "sharecropping" on an economy owned by outsiders. They will be better off than if the investment were never made, but they will be worse off than if they had saved more and financed the investment themselves. At some point, the cost to living standards will be felt, and when it is, creeping foreign ownership of the economy is certain to become an inflammatory political issue.

If this seems overly alarmist, recall that the global solution would require decades of growing current account deficits that allow the developed world to acquire a fixed habit of overconsumption. Over time, this would lead to an enormous transfer of asset ownership from the developed to the developing countries. By mid-century, Siegel calculates, the share of global assets owned by the developing world would grow from one-third to two-thirds.⁵

Third, there is the political influence that is always ceded to the creditor. Among nations as among individuals, chronic borrowers ultimately fall under the sway and influence of chronic lenders. True, the borrower can always threaten the lender with default—but this threat can only be exercised once and, if pursued by major developed countries, would greatly damage the global economic system that these same countries have the most interest in safeguarding. As levels of indebtedness increase, the real influence would run the other way, because withholding further lending would clearly inflict more pain on the borrower (less consumption) than on the lender (more consumption). The influence would likely be exercised in many venues—from multilateral and trade organizations to alliance agreements—at first subtly and then with greater force.

The influence will be felt all the more directly if the cross-border lending in the form of sovereign wealth funds continues to grow, with developing-country governments assuming direct ownership of large shares of major corpora-

tions in the United States and Europe. In fact, these governments are already a primary driver of global capital flows: In 2005, net private-sector outflows continued to flow from the developed to developing worlds, while government investment reversed the overall direction. Already holding 75 percent of the world's \$6 trillion in foreign exchange reserves and \$2.5 trillion in sovereign wealth funds, developing-country governments may soon have the capacity to apply pressure exactly when and where they want.

Finally, there is the risk of eventual default. Liabilities to foreign owners cannot grow indefinitely as a share of GDP. If a country never enacts policies that compensate for the impact of its aging, raise its savings rate, and close its current account deficit, some form of national default is sooner or later inevitable. Most likely, markets will react (by pricing down the market value of assets) and lenders will mobilize (to try to force the debtor country to change policies) long before this moment is reached. Yet the timing of price shifts in the market and the direction of mood shifts among investors are notoriously difficult to predict. The mere threat of unsustainability in the future may create a climate of extreme volatility where even a minor event could trigger a financial cataclysm.

A More Basic Problem

That's not all. Let's assume for a moment that the risks discussed above—from the impact on trade, debt service, and political influence to the threat of eventual default—can somehow be managed or indefinitely deferred. There is still another, more basic problem with the global solution: The numbers don't add up, and the timing doesn't work.

To begin with, the developing economies (including China) are not yet large enough to make up for more than a small share of the savings shortfall projected for the developed economies by the 2020s or 2030s. The proponents of the global solution acknowledge this, but argue that these economies' high rates of growth ensure that they will become large enough in the future. Perhaps they will. Yet if poor developing countries are to maintain high rates of growth, they will have to undertake vast additional investments within their own domestic economies. It seems heroic to presume that they can save enough to do this while also financing retirement consumption in the rich countries.

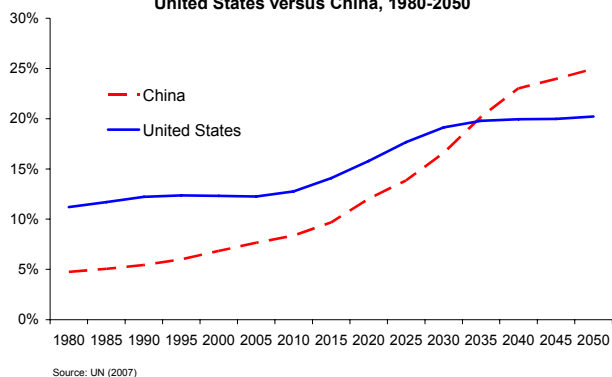
Then there's the matter of the developing world's own demographic transformation. Although the developing world is still much younger and faster growing than the developed world, fertility rates have plunged and life expectancy has soared almost everywhere over the past few decades. By the 2020s and 2030s, much of the developing world will itself be growing old. Like the developed countries, the regions that are expected to finance the global solution—especially East Asia, but to a lesser extent the Middle East, South Asia, and Latin America—also face looming age waves and will eventually need to divert a rising share of their production toward the consumption of their own growing elderly populations.

China, in particular, is due to age dramatically beginning in the 2020s. Virtually every study confirms that the

⁵ Jeremy J. Siegel, "Impact of an Aging Population on the Global Economy," *CFA Institute Conference Proceedings Quarterly* 24, no. 3 (September 2007).

classic lifecycle motivation for savings—accumulating assets during the working years to be drawn down during retirement—functions even more powerfully in East Asia than in the developed countries, perhaps because social insurance systems are not yet well developed and because families are experiencing a significant erosion of the Confucian ethic that traditionally allowed elders to rely on their children for support in old age. This means that savings in East Asia, which has risen dramatically in recent decades as youth dependency has declined and the share of the population in the working years has surged, could fall just as dramatically once elder dependency begins to climb. Indeed, from the perspective of China, much of the current capital outflow is clearly motivated by the desire, both by government and within families, to prepare for the future aging of the population. When that aging happens, it would be strange indeed if China did not reduce the outflow—and maybe even attempt to cash in on what it has invested abroad.

**Elderly (Aged 65 & Over), as a Percent of the Population:
United States versus China, 1980-2050**



In other words, by the time the developed world is fully dependent on developing-world savings, the fastest-growing—but also by then fastest-aging—nations in the developing world may be cutting off the flow. Robin Brooks predicts “a dissaving shock” when Asia ages. “In one fell swoop,” he says, “[it] is going to eliminate the low global interest rate environment.”⁶ Economist Alan Taylor makes this argument even more forcefully: “The predicted demographic shocks are so closely synchronized across rich and poor countries that we cannot expect very significant differences in demographic structures to open up and induce large and persistent capital movements.” As Taylor goes on to note, “Only in Africa is it significantly later (much later), but Africa is, sadly, likely to continue to have such a trivial GDP weight in the world economy that it cannot possibly sustain large capital outflows to finance everybody else’s retirements.”⁷

⁶ Robin Brooks, “Will There Be an Asset Meltdown?” (presentation delivered at the conference on Global Aging and Financial Markets co-hosted by Macroeconomic Advisers, Council on Foreign Relations, and CSIS, Washington, DC, September 7, 2006).

⁷ Alan M. Taylor, “Commentary: Demographic Changes and International Factor Mobility,” in *Global Demographic Change: Economic Impacts and Policy Challenges*, ed. Gordon H. Sellon Jr. (Jackson Hole, WY: Federal Reserve Bank of Kansas City, 2004).

The developed countries are thus heading down a perilous road. They may be able to import lots of capital from developing countries now and in the near-term future (until roughly 2025), as the negative impact of aging on their savings rates begins to be felt in earnest. But just when they have become dependent on this source of capital, and just when their needs are deepening (from roughly 2025 on), the developing countries may have to shut off the spigot and reverse the direction of the flow of savings.

No Global Free Lunch

This scenario is particularly worrisome for the United States. Since America is due to age less than Europe or Japan, we might expect, all other things being equal, that its projected savings shortfall would also be less severe. But all other things are not equal. The United States begins with a relatively low private savings rate and a relatively large and growing fiscal deficit. Its net national savings rate—just 1.3 percent of GDP in 2007 and near absolute zero in the first quarter of 2008—will surely sink beneath zero in the decades to come without a major shift in policies.

Back in the 1990s, many hoped that the United States would run large near-term budget surpluses while the boomers were still in the workforce. The idea was to build up assets that could later be drawn down to finance their retirement. Alas, that never happened. Instead, the United States faces the coming demographic gauntlet with the lowest national savings rate of any major developed country and a current account deficit that is already at record highs.

We are thus moving toward a future in which the health of our economy—and indeed, our national destiny—may depend as much on what foreign creditors do with their dollar holdings as on our own policy decisions. If that fact bothers us, we should have given it more thought years ago when we first embarked on a long-term path of falling national savings and rising federal deficits. Given that path, the birth of a large current-account deficit—the federal deficit’s “twin”—was almost inevitable. Fifty years ago, our nation was the largest net lender on earth. Twenty-five years ago, our global assets still exceeded our liabilities. Today, our net investment position is minus \$2.5 trillion and falling.

The global-solution optimists to the contrary, this trend cannot continue indefinitely. It can, however, continue for a long time—and that’s precisely the problem. Indeed, the most serious downside to effortless global borrowing is how it allows a nation to put off needed policy reforms, thus making the ultimate adjustment more painful, when it would otherwise have to take action and raise savings rates early on.

There are no free lunches, even in a global economy. Sooner or later the United States, along with other aging developed economies, will need to bring consumption in line with savings. With boomers poised to begin retiring en masse over the next decade, the hour is already late. But if we face the difficult resource trade-offs now, there may still be time to change course. If we don’t, we will meet a day of reckoning. In the end, the future we bequeath to our children will be one of both diminished economic expectations and declining influence in world affairs. ■

Federal Budget: Debt & Deficits			Fed Outlays: FY 2007		
	Bil \$	% GDP		Bil \$	% Budg
Gross Federal Debt: End of May 2008	\$9,389	65.9%	Social Security	\$581	21.3%
Statutory Debt Limit	\$9,815	NA	Medicare	\$436	16.0%
Publicly Held Debt: End of May 2008	\$5,279	37.1%	Medicaid	\$191	7.0%
Debt Held by Foreigners: End March 2008	\$2,520	47.2%*	Other Entitlements	\$420	15.4%
			Domestic Discretionary	\$493	18.1%
Budget Balance in FY 2007	-\$162	-1.2%	Defense	\$549	20.1%
Budget Balance in FY 2008: CBO Estimate**	-\$357	-2.5%	Net Interest	\$238	8.7%
Budget Balance in FY 2008: Concord Estimate†	-\$398	-2.8%	Offsetting Receipts	-\$178	-6.5%
10-yr Balance (FY 2009-18): CBO Projection**	\$270	NA	TOTAL OUTLAYS	\$2,730	100%
10-yr Balance (FY 2009-18): Concord Projection†	-\$6,460	NA	TOTAL REVENUES	\$2,568	NA
Budget Balance in FY 2018: CBO Projection**	\$202	0.9%	TOTAL DEFICIT	-\$162	NA
Budget Balance in FY 2018: Concord Projection†	-\$973	-4.3%			

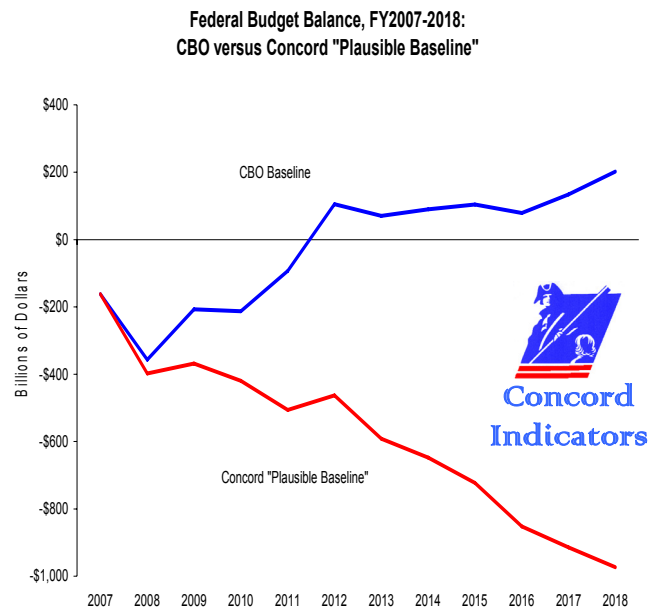
*Percent of publicly held debt. **March 2008 CBO baseline. †Concord's "plausible baseline" assumes discretionary spending grows with GDP, operations in Iraq and Afghanistan are gradually scaled back to about one-third of today's level, and all expiring tax provisions are extended with AMT relief.

GAO's Long-Term Budget Scenario* (% GDP)					
	1962	1980	2000	2020	2040
Discretionary	12.7%	10.1%	6.3%	7.7%	7.7%
Entitlements*	4.9%	9.6%	9.8%	13.1%	18.2%
Net Interest	1.2%	1.9%	2.3%	2.7%	8.5%
Revenue	17.6%	19.0%	20.9%	18.4%	18.6%
Budget Balance	-1.3%	-2.7%	2.4%	-5.2%	-15.7%
Pub Held Debt	43.7%	26.1%	35.1%	60.8%	188.4%

*GAO April 2008 update. Assumes discretionary spending grows with GDP and all expiring tax provisions are extended; entitlements are net of offsetting receipts.

National Savings (% GDP)		
	2007	1st QTR 2008
Personal Savings Rate*	0.5%	0.6%
Net Private Savings	2.9%	2.7%
State & Local Savings	-0.1%	-0.4%
Federal Savings	-1.6%	-2.2%
Net National Savings	1.3%	0%
Current Account Balance	-5.1%	-4.7%
Intl Investment Position**	-19.2%	NA

*Percent of disposable income. **2006 data.



Note: Concord's "plausible baseline" assumes discretionary spending grows with GDP, operations in Iraq and Afghanistan are gradually scaled back to about one-third of today's level, and all expiring tax provisions are extended with AMT relief.

Social Security & Medicare*	Social Security	Medicare HI	Medicare SMI	Social Security & Medicare
Payroll Cost Rate in 2008	11.2%	3.2%	2.7%†	17.1%†
Payroll Cost Rate in 2040	16.8%	7.4%	7.6%†	31.7%†
75-Year Liability (PV \$)**	\$6.6 TRILLION	\$12.7 TRILLION	\$23.6 TRILLION	\$42.9 TRILLION
Infinite-Horizon Liability (PV \$)**	\$15.9 TRILLION	\$34.7 TRILLION	\$51.2 TRILLION	\$101.8 TRILLION
Date of First Cash Deficit	2017	2007	NA	NA
Date of Trust-Fund Insolvency	2041	2019	NA	NA
Cash Deficit in Year of Insolvency (2008 \$)	-\$337 BILLION	-\$76 BILLION	NA	NA

*Data are from 2008 Trustees reports. **Unfunded liabilities are not offset by trust-fund assets. †Figures for Medicare SMI are net of beneficiary premiums. Although SMI is not financed with payroll taxes, net expenditures are shown here as a percent of payroll to facilitate comparison.