



WEEKLY ECONOMIC COMMENTARY

- Many nations are being reminded that when times are tough, so is budgeting.
- America’s energy picture is changing for the better.
- The EU took an “extend and pretend” strategy with Greece.

The conversation at my Thanksgiving table this year touched on the hard choices faced by families enduring extended unemployment. My wife confessed to keeping a mental list of the costs that we would cut if we ever found ourselves in that situation: cable, cell plans, and Starbucks headed the list. The mention of each potential reduction brought howls of protest from our children, who have obviously become quite dependent on what we used to consider discretionary expenditures.

On a much larger scale, governments across the globe are seeking to tighten their collective belts, responding to recession’s impact on revenue, calls for structural reform, or both. In the process, though, they are discovering how deeply accustomed both bureaucrats and beneficiaries can become to the status quo.

In the US, discussions aimed at addressing the impending “fiscal cliff” resumed in earnest after the holiday recess. On the expense side, negotiators are trying to soften the trajectory of Federal spending, which has risen by more than 80% over the past ten years.

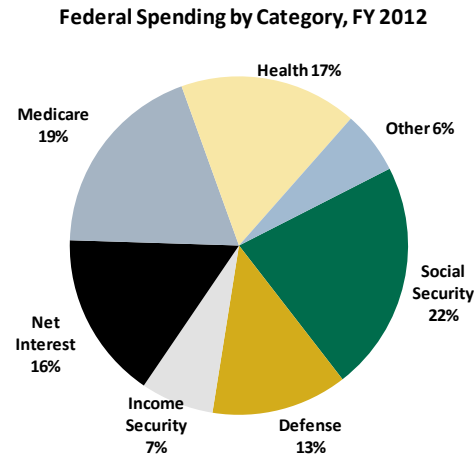
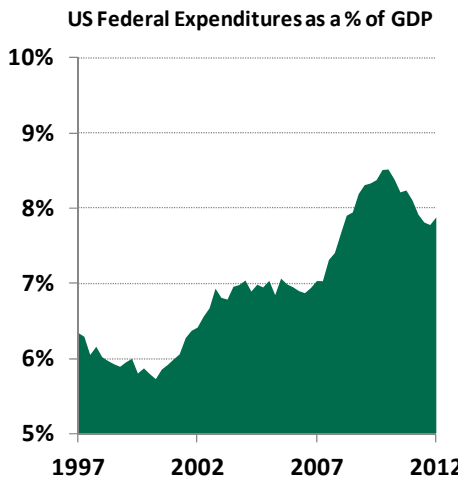
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Once initiated, government programs and the bureaucracies that administer them are very hard to dislodge.



Source: Bureau of Economic Analysis, Congressional Budget Office

An important part of this increase has occurred since the Great Recession began. Social support payments (like welfare and unemployment benefits) and the elements of the 2009 American Recovery and Reinvestment Act account for the lion’s share of the expansion. One might certainly expect that these devotions would taper off if and when the US economic recovery gains momentum.

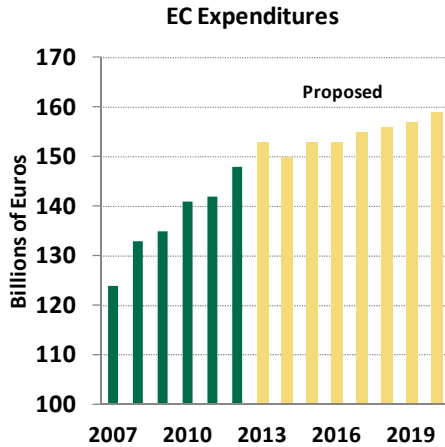
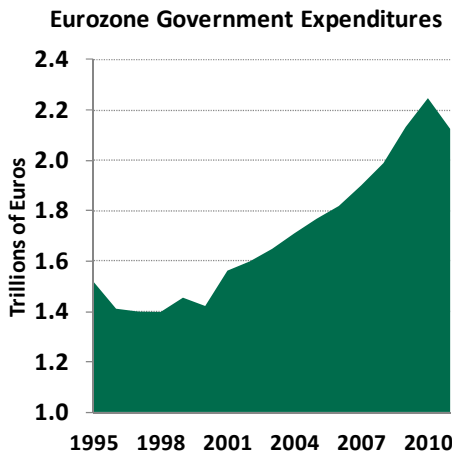
Over the longer-term, though, the cost of entitlements (such as Medicare and Social Security) is projected to place considerable pressure on the Federal budget. These categories account for a very large fraction of what the US government spends, so lasting deficit reduction must include some consideration of these areas. There have been proposals to essentially transfer funds and

responsibility for these programs to the states, but challenging fiscal conditions at many local levels would limit their ability to administer new mandates.

Some interesting ideas on entitlement control have been forwarded. Altering annual escalations, tying benefits and premiums more closely to means, and improved oversight all have the potential to bend long-term cost curves. But administrators and recipients have been very resistant to change, making negotiations difficult.

Across the Atlantic, the European Union (EU) meeting last week broke off without reaching agreement on the budget for the European Commission (EC). Housed in Brussels, the EC administers EU programs in a variety of areas.

**Rumors of American energy independence may be greatly exaggerated.**



Source: European Union, Haver Analytics

While spending among local governments in Europe is declining and promises to decline much further, the EC proposed steadily increasing budgets for the balance of this decade. This raised hackles from many corners, but the various EU members had very different views as to what might constitute appropriate cuts. More discussions will be required in the weeks ahead.

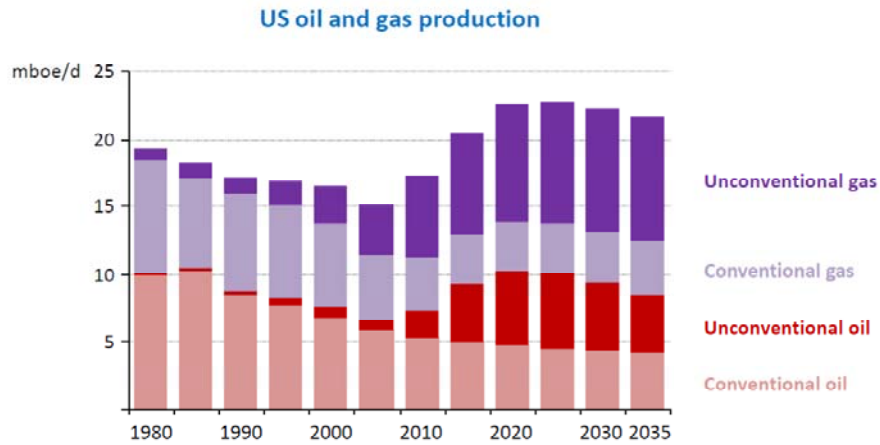
As in the US, programs which take deep root can be very difficult to unearth, even partially. When times are good, funding for these efforts is a bit easier. But when times are tough, those who coordinate the programs and those who rely on them often undertake a spirited defense...like a coffee addict facing separation from Starbucks.

**Are We Heading for Energy Independence?**

In 1973, President Nixon’s announced “Project Independence” in response to the OPEC oil embargo, setting the US on a quest for energy self-sufficiency. Nearly forty years later, the International Energy Agency (IEA) projected in its latest outlook that the United States will be almost self-sufficient by 2030. Shall we place an order for champagne? Not quite yet.

The IEA’s breakdown of the sources of oil and gas production is a good starting place to understand the situation. The chart below shows that a sizable portion of the increase in supply of oil and gas in the future is from “unconventional oil and gas production,” whereas the share derived from traditional methods is projected to shrink in the years ahead.

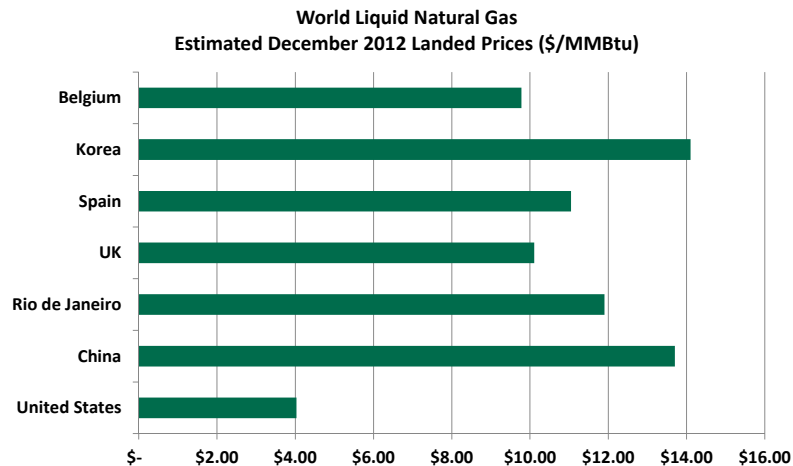
As often happens, energy and environmental policy may be on a collision course.



Source: [World Energy Outlook, 2012](#)

Production of oil and gas through unconventional methods has advanced through recent breakthroughs in technology. The extensive utilization of horizontal drilling and hydraulic fracturing (or “fracking”) has resulted in a significant increase in the estimated US natural gas resource base. Based on this development, the IEA predicts that the United States will surpass Russia as the largest producer of natural gas in the near term.

These improved technologies are also used to extract oil from previously unproductive rocks, which should raise the quantity of oil production in the US. The IEA forecast reflects a significantly optimistic outlook which rests on these new technological developments. Some think that cheaper US energy may offer a competitive advantage.



Source: [Federal Energy Regulatory Commission](#)

As natural gas does not travel very well, current price differentials may persist for quite some time. This might lead manufacturers to consider “re-shoring,” bringing production back in this direction. The caveat is that the durability of this price advantage is subject to change, depending on competition, regulation, and efficiency.

Production of oil and natural gas through unconventional technologies entails the use of large quantities of water. Energy producers could be competing with farmers for water in the years

ahead. Also, some think fracking may contaminate ground water in the underlying areas. Environmental groups have warned about the danger fracking poses to rare and endangered species. And some significant reserves lie below Federal land, which the Administration has been reluctant to open for exploration.

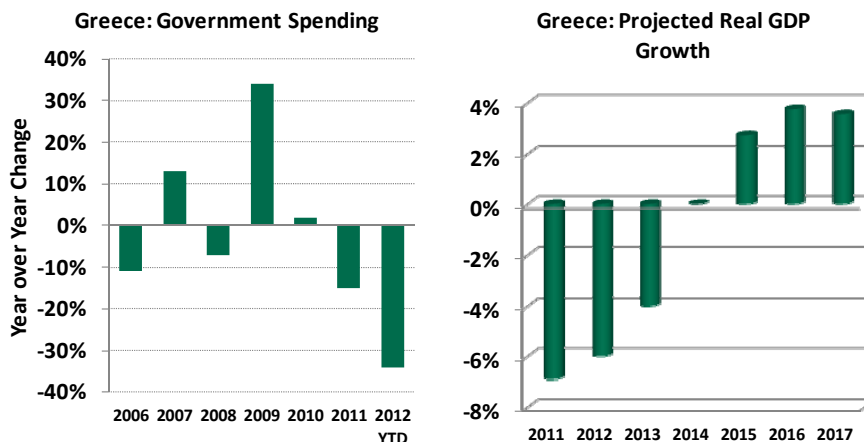
It may be important to keep in mind that unconventional methods of oil and gas production are in their formative stage. It is not certain that initial success will persist in terms of productivity and efficiency and mature to become the huge transformation that IEA envisions.

Energy independence is essentially a race between demand and supply. Depletion of energy resources, renewable energy sources, and new technology are constantly shaping the supply side of the energy market. Conservation programs, technology, efficiency of energy usage, regulation and awareness of renewables influence demand for energy. Anticipating how these forces will play out in the marketplace is a challenge for market participants and policy makers.

### More Fuzzy Math

Last year, the author Michael Lewis put out a book entitled “[Boomerang](#).” The book explores the roots and ravages of the financial crisis. The chapter on Greece is entitled: “And They Invented Math,” which plays on the irony of Greek struggles with government accounting.

Last week, Greece received some international aid...in their long-running efforts to obscure the true nature of their national finances. Facing a deadline to establish a credible plan for Greek debt reduction, the “troika” of the EU, the ECB, and the IMF produced an outline that was long on bookkeeping magic and short on real progress.



Source: IMF, Haver Analytics

Greece has made substantial reductions in its public spending, and deepened its recession in doing so. Yet even these cuts have not been enough to put the country on a path to a “sustainable” fiscal position. Long-term projections still showed frighteningly high levels of national debt.

IMF Managing Director Christine Lagarde had therefore called for additional debt forgiveness as the only true way to place Greece on a credible track. Instead, the most recent negotiations resulted in a combination of interest rate reductions, loan extensions, rebates, and a plan for the Greeks to repurchase their own debt at a discount. When pushed through a long term projection, these elements appear to bring the Greek debt to GDP ratio below 120% over the next ten years.

There are several reasons to be very cautious before embracing this outcome.

- a) The outcome rests critically on a ten-year economic forecast for Greece. Past attempts to project Greek performance have invariably been too optimistic.
- b) The details of the debt repurchase program are not entirely clear; neither are prospects for its success.
- c) The practice of lowering interest rates and extending maturities for a struggling debtor is typically frowned upon by accountants and supervisors. If Greece were a private sector borrower in the US, for example, the recent accord would be classified as a troubled debt restructuring, and lenders would be required to write down a portion of the principal.

Most expect another round of debt restructuring before too long. This round will likely include write-downs from “official” holders of Greek debt: European governments and central banks. The timing, however, seems tied to the calendar of regional and national elections, most prominently the German balloting set for next September. Until then, it would be politically difficult for Chancellor Merkel to accept German losses that benefit Greece.

The markets initially took news of the Greek accord well, but stepped back after the details received a bit more scrutiny. The irony is that the new outline rests heavily on somewhat questionable accounting, the same problem that initiated the Greek crisis in the first place.

At what point will investors tire of intermittent and incomplete solutions and demand something more lasting? Many Western nations might be challenged to answer this question. But just as they were the first to establish a modern democracy, the Greeks shall be the first called to account for their fiscal frailties.

**Greece remains critically reliant on overly hopeful projections and policies.**