"The Growing Fiscal Imbalance and the Future of Monetary Policy"
David Malpass
The Cato Institute
November 16, 2006

The federal government has made commitments to increase entitlement spending rapidly in coming decades. In particular, Medicare expenditures are scheduled to balloon. My expectation is that these commitments will be met for many years by the current unfunded, pay-as-you-go system rather than being pre-funded with marketable investments -- the 2005 discussion of personal accounts for Social Security didn't make much progress, nor is any marketable funding expected for the Medicare liability.

This panel's topic is "the growing fiscal imbalance and the future of monetary policy." I'll focus my remarks on whether rapid outlay growth will affect monetary policy.

- In the near-term, the impact is limited. The Federal Reserve is powerful and independent. With the debt-to-GDP ratio at 38% or so I expect the Fed to set interest rates based on its assessments of inflation, employment and growth.

- Looking several years ahead, however, we should assume a combination of increases, relative to GDP, in outlays, receipts, the deficit and debt. This will presumably reduce the economy's real growth potential somewhat.

This structural risk creates multiple issues for monetary policy:

- The Fed will face increased political pressure to keep interest rates low in order to encourage short-term growth and to hold down the cost of funding the national debt.

- The impact of Fed or private sector errors in the cycle may be magnified. A 1% miss on the inflation rate probably poses more risk to an economy with a 75% national-debt-to-GDP ratio than it does to our present economy with half of that national debt burden.

- As the fiscal problem grows, the Fed will in some way be responsible for thinking about and commenting on fiscal trends, drawing it into a contentious political process and creating new uncertainties about monetary policy.

- Fortunately, economics is relatively clear that fiscal problems should be dealt with through fiscal tools (for example, spending restraint and a growth-oriented tax system); while monetary tools should focus on monetary issues (inflation, deflation, dollar weakness).

- I think U.S. monetary policy needs to recognize currency stability as an important ingredient of a low-inflation environment. I note that inflation problems followed the weak-dollar policies of the 1970s and the mid-1980s, a deflation problem followed the strong-dollar policy of the late 1990s, and a growing inflation problem has appeared since the dollar weakness of 2002-2004. I think the Fed should recognize the link between the value of the dollar and the resulting inflation and deflation tendencies in the economy. In my view, this change would reduce the relatively wide fluctuations in U.S. interest rates and inflation rates and thus add to average growth. As the country's potential growth rate changes, with different demographics, these fiscal challenges will provide an important opportunity for additions to the Fed's current monetary policy framework.

- As a practical matter, Europe and Japan face larger and more immediate fiscal imbalances, so the Fed will gain from their experiences dealing with it. The European Central Bank has made it repeatedly clear that it will not compromise its inflation-fighting mission in response to Europe's structural problems, growth rate or deficit-funding issues. Of particular interest to the U.S., though not an outcome we should wish on Europe, would be a European recession at a higher level of interest rates, a scenario that would create a spike in Europe's already-large fiscal deficit and debt. This would test whether the ECB's independence could be maintained under stress. If so, the euro would retain market confidence, leaving the crisis in the fiscal and political realm rather than transferring it to monetary policy.

General Government Net Debt as % of GDP

Year	Canada	United States	Japan	United Kingdom	Germany	France	Italy	G7 average
1999	53.5	36.9	53.5	39.8	45.5	33.6	104.6	45.9
2000	44.8	31.8	59.1	36.9	42.5	34.9	99.1	43.2
2001	40.5	30.4	65.1	33.5	44.2	36.7	98.9	43.3
2002	37.9	33.2	71.4	34.3	48.4	42.3	98.6	46.5
2003	34.3	35.4	76.2	34.7	53.2	44.0	97.2	48.6
2004	32.2	37.0	78.4	37.0	57.4	44.4	95.6	50.2

Source: OECD; Canadian Department of Finance; Bear, Stearns & Co. Inc.

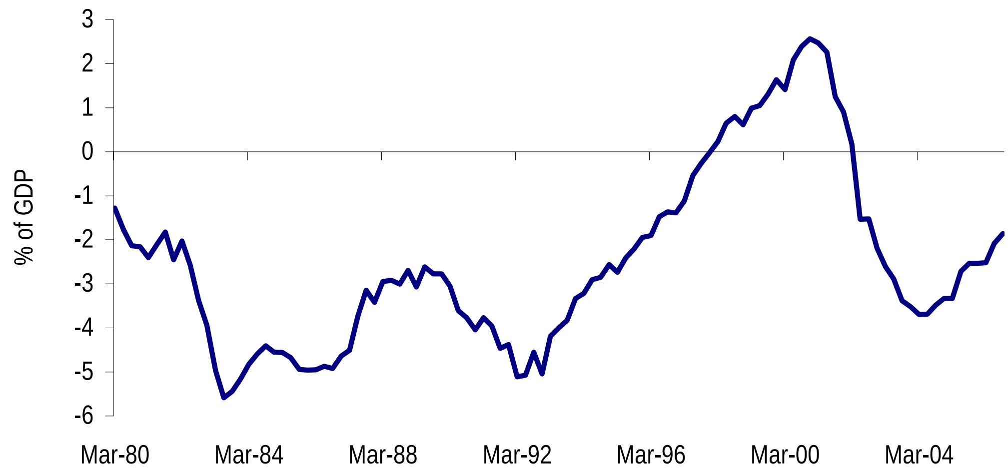
- My conclusions: U.S. monetary policy will be largely unaffected by the fiscal imbalance for several years. During that time, the U.S. will face major policy issues apart from monetary policy, including the tax challenges related to the alternative minimum tax, the 2010 suspension of the inheritance tax, and the 2011 increase in tax rates on income, dividends and capital gains. As entitlement spending expands rapidly in the 2010s, I think U.S. policy-makers will be clear throughout this process that monetary policy is required to maintain a low-inflation environment. If so, the crunch point as entitlement spending grows, and with it probably the fiscal deficit, will be met by the political system on the fiscal side, leaving monetary policy insulated.

Short-run Fiscal Outlook Improving

The U.S. is accruing a growing fiscal imbalance in the out years. This is largely the result of unfunded entitlement promises.

- The short-run outlook is actually improving, with the fiscal deficit shrinking in both dollar terms and relative to GDP.

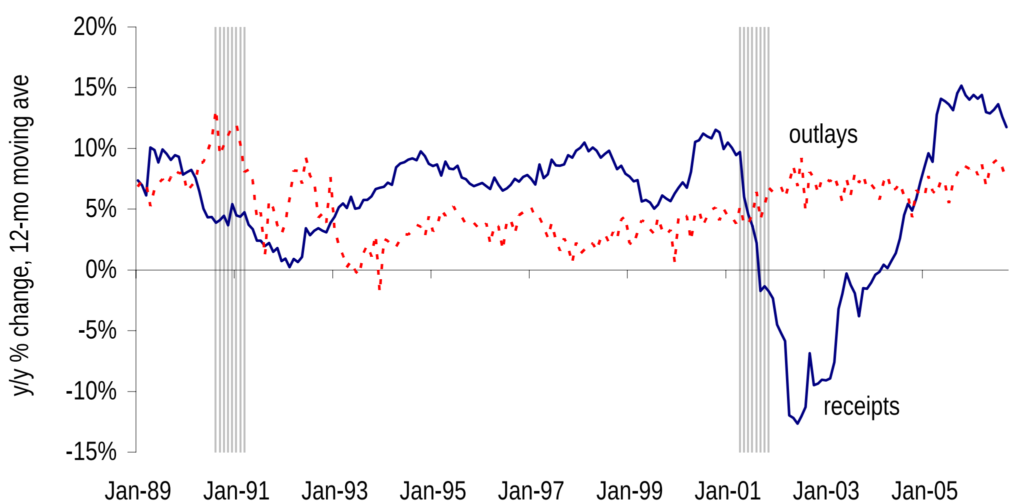
Federal Government Balance as % of GDP



Source: Haver; Bear, Stearns & Co. Inc.

- Growth in government receipts continued to surge through October 2006, reflecting the sturdiness of the expansion and, in part, the sustained growth impact of the 2003 cut in tax rates on labor and capital.

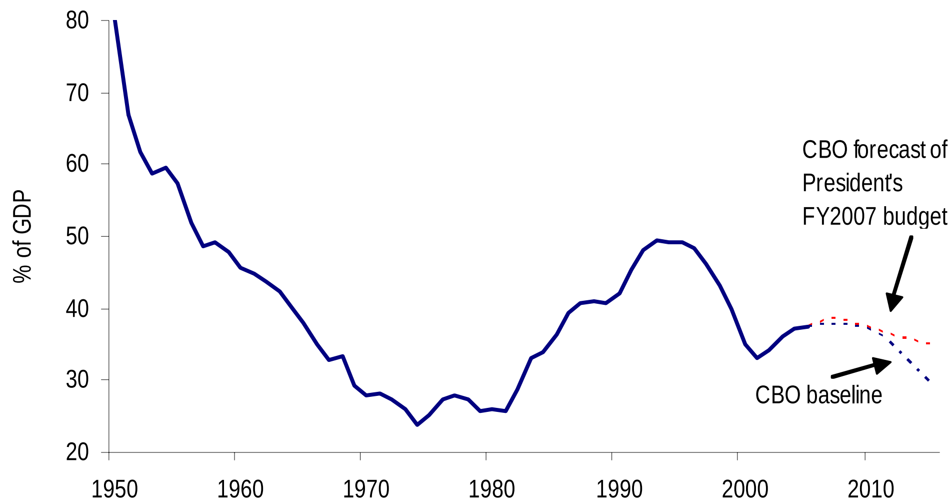
Growth in Government Receipts and Outlays



Source: Haver; Bear, Stearns & Co. Inc.

- The government debt-to-GDP ratio remains low relative to the U.S. experience of the 1980s and early 1990s. In the graph, the higher CBO forecast assumes Congressional approval of the Administration's FY2007 request to make permanent the expiring tax cuts. In the baseline forecast (in which tax rates jump in 2011), CBO uses Washington's standard static scoring assumption, meaning the same GDP growth rate whether tax rates rise or not in 2011.

Federal Government Debt as % of GDP



Source: Haver; CBO; Bear, Stearns & Co. Inc.

The lack of a near-term crisis allows Congress to avoid fiscal constraints. This argues that the spending problem will probably get worse before it gets better, especially with the economy growing strongly and bond yields low. I don't see a legislative path to the procedural changes that are needed in order to slow the government's expansion. Pro-growth structural reforms -- such as repeal of the 1974 budget and impoundment act, the line item veto, pay-go rules to require spending cuts to offset proposed spending increases, scoring reform, or a super-majority vote to pass new entitlements – are often under consideration but are unlikely to be approved.

In the coming decade, however, we expect the U.S. fiscal deficit to expand in dollar terms as revenue growth slows, especially during the next recession. Due to the low U.S. debt/GDP ratio, I don't expect a big impact in that time frame on interest rates, the dollar, the U.S. credit rating or U.S. monetary policy.

Fiscal Imbalance Is Growing Over Medium Term

The pending retirement of the baby-boom generation has raised considerable concern over the federal government's long-term fiscal health. The Fed has had considerable comment on these issues over the years. Former Fed Chairman Alan Greenspan addressed fiscal issues in his March 10, 2005 remarks to the New York Council on Foreign Relations: "We are moving to a real serious budget debate… which must halt the path which essentially becomes a significant fiscal problem in 2015 and beyond."

Fed Chairman Ben Bernanke gave substantial insight into his fiscal views in answering a question during his March 20, 2006 address to the Economic Club of New York:

> "There are really two key variables that one must think about when thinking about federal budget activity. One is the deficit, but the other is the share of GDP that's devoted to federal spending. The share of GDP devoted to federal spending is the fundamental measure of the amount of resources that is being taken out of the economy by the government, as Milton Friedman taught us many years ago. The deficit, by contrast, basically tells us who's going to pay for that spending. Is it going to be us, or is it going to be our children?
>
> "There's a big difference between having a balanced budget where spending and taxes are 15 percent of GDP and having a balanced budget where spending and taxes are 25 percent of GDP… Congress needs to look very hard at the size of the government, because the resources extracted to fund government spending really have more than a one-for-one cost. Let me explain what I mean. If you spend a dollar on government spending, that costs a dollar in terms of the resources being drawn from the economy, but in addition there's what economists called a dead weight loss, or an excess burden. Higher taxes do create inefficiencies in the economy and do have effects on growth, (so) there's an extra cost that goes beyond the simple direct cost of the government spending.
>
> "Now in the long run, and perhaps even in the intermediate run, taxes and spending have to be commensurate. That doesn't mean exactly equal, but they have to be at roughly comparable levels. Otherwise you run into exploding debt problems and the bond market will let you know about that.
>
> So, really there are two coherent positions that one can take. (The only law here I'm defending is the law of arithmetic -- I hope that's not too controversial.)
>
> "One is to say: 'I think government spending has a very high value. I think that an extra dollar of government spending justifies not only the dollar I'm taking out of the pocket of someone, but the additional cost associated with the inefficiencies of higher tax rates on the economy, and I make that judgment. I think the worth - the value of that spending is worth it, and I'm willing to do that.' That's one possibility.
>
> "The other possibility is to say: 'I value low taxes because low taxes maintain higher levels of efficiency, they promote growth.' But if you take that view, which is a respectable view, of course, you also have to say: 'I agree that the consequence of that is, at least somewhere down the road, government spending commensurate with that level of taxes.' And so they are different positions.
>
> "Ultimately, of course, you can't make that choice without a liberal dose of values of your own personal judgments about the relative value of different spending programs, for

example, and different tax cuts. And that, I am happy to say, is not my responsibility. That is the responsibility of our elected representatives in Congress. And I will urge them not necessarily to choose high or low spending, or high or low taxes, but only to make sure that the choices they make are internally consistent, and consistent with long-term responsibility in our - in our fiscal finances."

In an effort to analyze the long-term fiscal outlook, CBO has adopted a set of assumptions to create six scenarios, on which I will draw.

- Long-term deficit and debt projections are very sensitive to relatively modest changes in the assumptions: economic growth, demographic variables like immigration and the average retirement age, and medical cost and usage.

- For this exercise, CBO's spending assumptions are divided into high, intermediate and low spending outlooks. Revenues are projected under two scenarios, high and low.

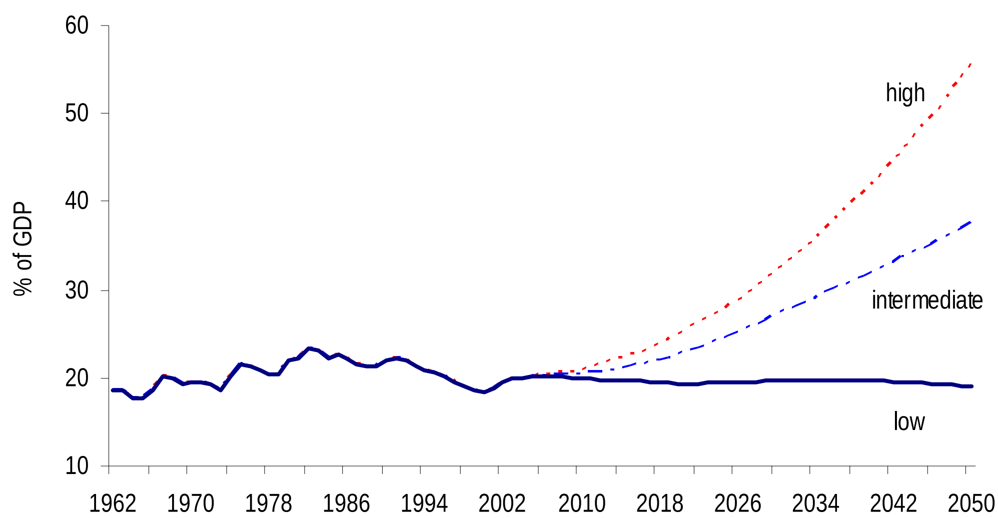
CBO Assumptions Behind Long-Term Budget Projections

	High	Intermed	Low
Spending			
Social security	under current law	under current law	under current law
Medicare/medicaid	costs per beneficiary increase 2.5 pp > GDP growth	costs per beneficiary increase 1.0 pp > GDP growth	costs per beneficiary increase at rate of GDP growth
Other mandatory	stabilize at 2005 % of GDP	stabilize at 2005 % of GDP	decline by 1% annually as % of GDP
Defense	follow President's long-term plan to 2024 and then grows at rate of CPI inflation	gradually falls to 20-yr ave by 2024 and then grows at rate of CPI inflation	gradually falls to 20-yr ave by 2024 and then grows at rate of CPI inflation
Nondef discretionary	falls to 20-yr ave in 2007 as % of GDP and then = GDP growth	falls to 20-yr ave in 2007 as % of GDP and then = GDP growth	falls to 20-yr ave in 2007 as % of GDP and then = CPI inflation
	High	**Low**	
Revenues			
Individual income taxes	current law	rise as % of GDP by 2014 and then adjusted so that total revenues remain at 18.3% of GDP	
Social Security/ Medicare	current law	current law	
Other taxes	stabilize at 2014 as % of GDP	stabilize at 2014 as % of GDP	

Source: CBO; Bear, Stearns & Co. Inc.

- In CBO's intermediate spending scenario, federal budget outlays are projected to grow much faster than the economy beginning in roughly 2015, causing outlays as a percentage of GDP to expand rapidly. Total federal outlays are projected to be 21% of GDP in 2015, rising to 25% (exceedinge previous postwar peak) by 2025.

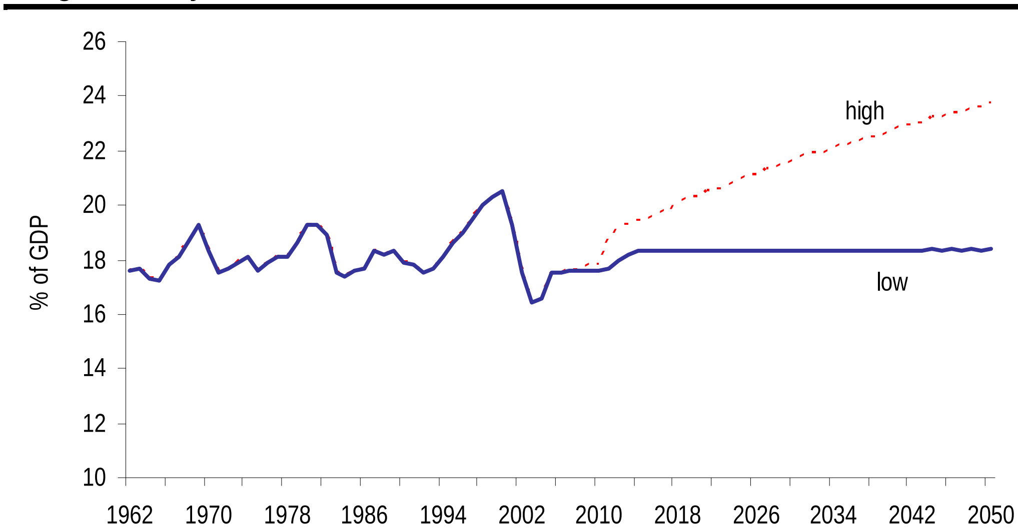
Long-term Projections of Government Spending



Source: Haver; CBO; Bear, Stearns & Co. Inc.

- In the "low" revenues assumption, total government receipts are limited to their longer-term average of 18.3% of GDP, while no limit is assumed for federal outlays. This implies a reduction in tax rates from current law, which, if unchanged, would cause receipts to rise to 24% of GDP by 2050. (I note again the use of the static model, which assumes GDP growth doesn't slow no matter the size of government.)

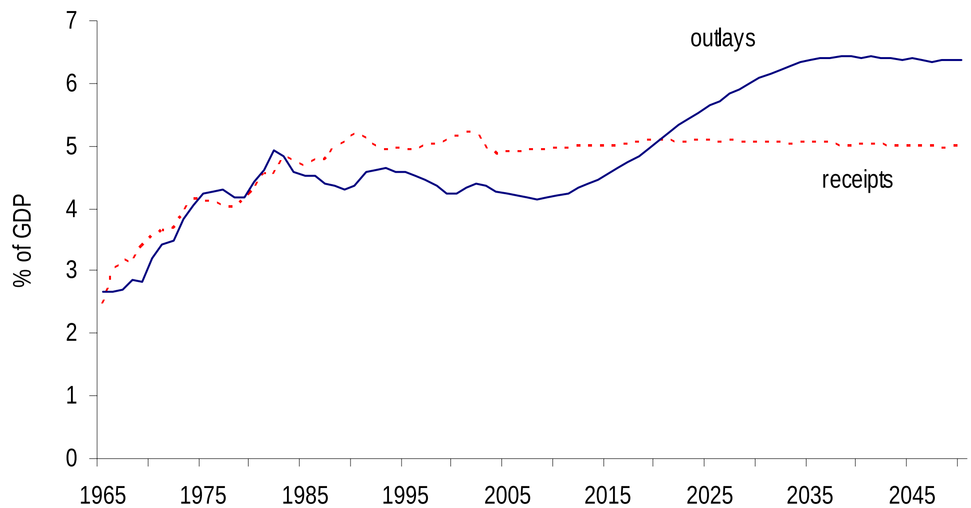
Long-term Projections of Government Revenues



Source: Haver; CBO; Bear, Stearns & Co. Inc.

- Under the intermediate assumptions of the Social Security Trustees, which are incorporated into all of CBO's spending scenarios, Social Security spending will grow to over 6% of GDP. The demographic assumptions are a fertility rate of 2 children per family, a steady decline in the death rate and immigration patterns similar to recent trends. The economic assumptions are average CPI inflation of 2.8%, an average unemployment rate of 5.5%, and productivity growth of 1.6%, the average from 1966 to 2000. While we think several of these assumptions are conservative, the impact of changes is not material compared to the uncertainties in the Medicare assumptions.

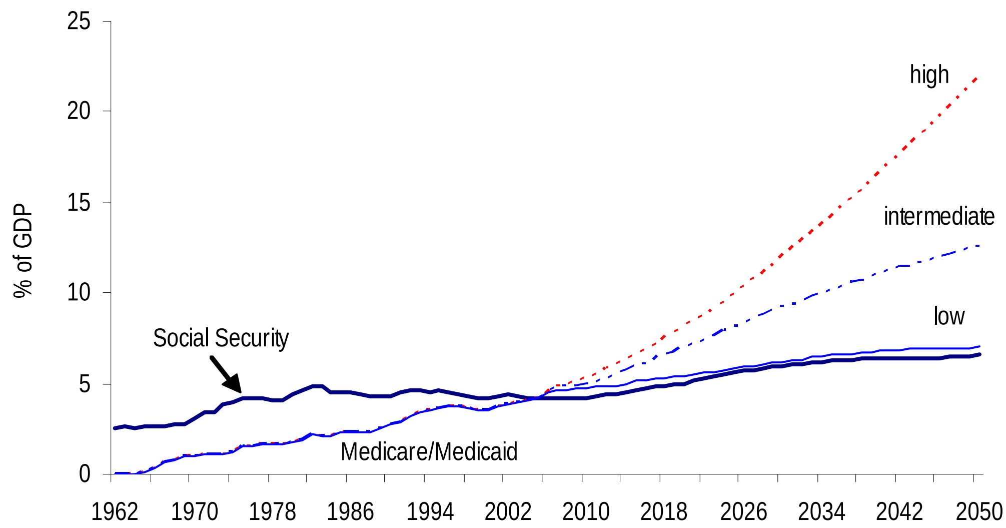
Long-term Projections of Social Security Receipts and Outlays



Source: Haver; CBO; Bear, Stearns & Co. Inc.

- Much attention has focused on the retirement of the baby boom generation. CBO expects spending on Social Security to increase from 4.2% of GDP currently to 6.2% of GDP in 2050. The real budget buster is the expected increase in federal spending on Medicare and Medicaid (which CBO says may increase from 4.2% to 12.6% of GDP, using its intermediate spending assumptions defined below).

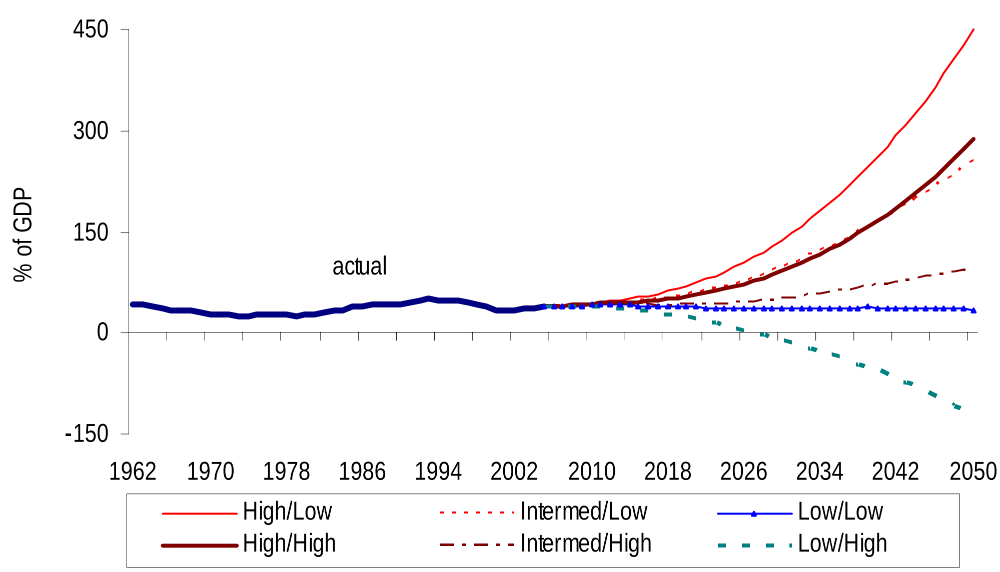
Long-term Projections of Social Security and Medicare/Medicaid Spending



Source: Haver; CBO; Bear, Stearns & Co. Inc.

- Combining the spending and revenue assumptions, federal government debt rises in an uncontrolled fashion in some of the scenarios. I think the private sector will grow faster than the more pessimistic scenarios assume and the public sector's expansion as a share of the economy will face more restraints. Thus, I think the key fiscal issues, rather than the deficit itself, are restraint on entitlement growth, particularly Medicare, and the growth orientation of the tax system. Unfortunately, neither has much prospect for reform.

Long-term Projections of Government Debt (Under the Various CBO Scenarios)



Source: Haver; CBO; Bear, Stearns & Co. Inc.