Monetary Policy and the Growing Fiscal Imbalance

David Malpass

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, a preferable approach, 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. Based on this assumption of a continuation of business-as-usual in Washington, this article focuses on the coming acceleration in outlay growth, in the context of rapidly growing unfunded entitlement liabilities, will affect monetary policy.

The Impact of Fiscal Profligacy on Monetary Policy

In the near term, the impact is limited. The Federal Reserve is powerful and independent. With the debt-to-GDP ratio at 37 percent 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. That combination will presumably reduce the economy's real growth potential somewhat.

Fiscal profligacy 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

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magnified. A 1 percent miss on the inflation rate probably poses more risk to an economy with a 75 percent 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.

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 2002–04. 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 (Table 1), so the Fed will gain from their experiences dealing with them. 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 United States, 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.

U.S. monetary policy will be largely unaffected by the fiscal imbalance for several years. During that time, the United States will face major policy issues apart from monetary policy, including the

TABLE 1

GENERAL GOVERNMENT NET DEBT AS PERCENT OF GDP

Year	Canada	United States	Japan	United Kingdom	Germany	France	Italy	G7 average
1999	55.1	36.7	54.1	39.9	44.8	33.6	102.2	45.7
2000	46.6	32.0	60.4	36.8	41.9	35.1	96.6	43.3
2001	42.8	30.5	66.1	33.4	43.4	36.7	97.3	43.4
2002	41.0	33.2	72.8	34.1	47.5	41.8	97.1	46.5
2003	35.3	36.1	77.3	34.7	50.4	44.2	96.2	48.8
2004	31.1	37.8	82.2	36.9	54.5	44.4	97.7	50.9
2005	26.3	38.7	86.3	40.6	58.4	44.0	98.6	52.5

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

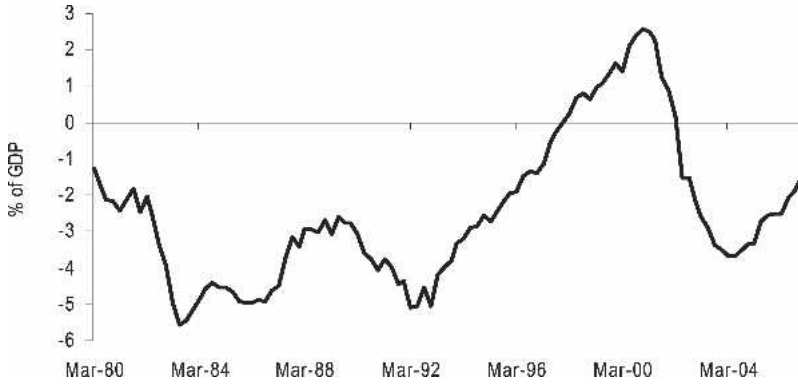
tax challenges related to the alternative minimum tax, the 2010 suspension of the inheritance tax, and the 2011 increase in tax rates on income, dividends, and capital gains. As entitlement spending expands rapidly in the 2010s, I think U.S. policymakers will be clear throughout this process that monetary 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 (Figure 1).

FIGURE 1

FEDERAL GOVERNMENT BALANCE AS A PERCENT OF GDP

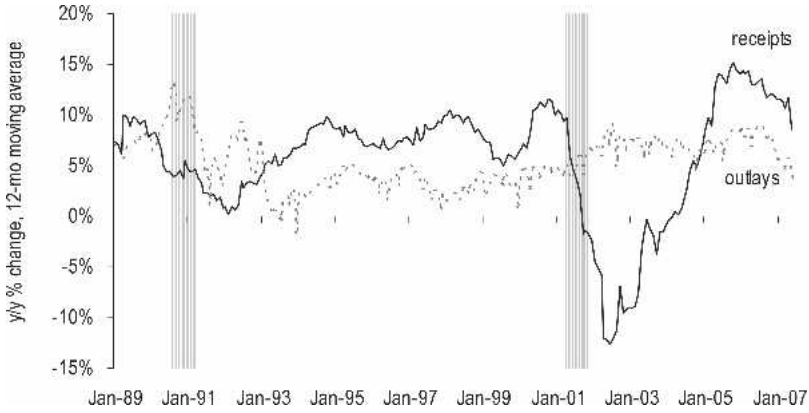


SOURCES: Haver; Bear, Stearns & Co. Inc.

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 (Figure 2).

The government debt-to-GDP ratio remains low relative to the U.S. experience of the 1980s and early 1990s. In Figure 3, the higher CBO forecast assumes Congressional approval of the administration's

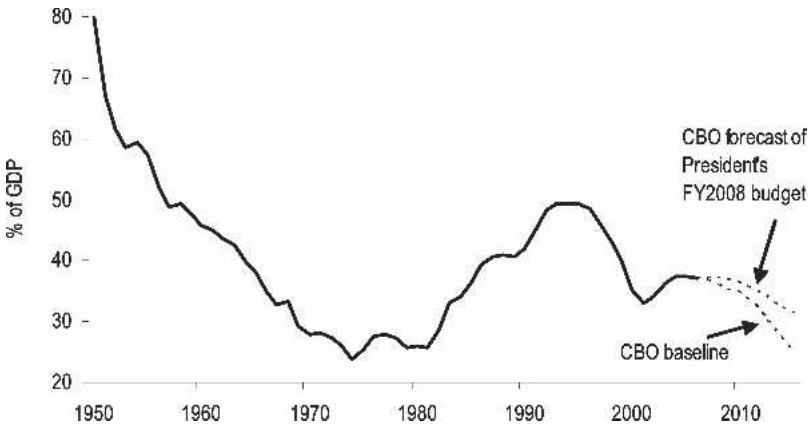
FIGURE 2
GROWTH IN GOVERNMENT RECEIPTS AND OUTLAYS



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

FY2008 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.

FIGURE 3
FEDERAL GOVERNMENT DEBT AS A PERCENT OF GDP



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

The lack of a near-term crisis allows Congress to thwart fiscal restraint. This argues that the spending problem is almost sure to persist, especially with the economy and tax receipts growing strongly and bond yields relatively low. I don't see a legislative path to the procedural changes that are needed to contain the government's expansion. Pro-growth structural reforms—such as scoring reform, the repeal of the 1974 budget and impoundment act, the line item veto, modified PAYGO rules to require spending cuts to offset proposed spending increases, or a super-majority vote to pass new entitlements—are often under consideration but are unlikely to be approved.

In the coming decade, however, I 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-to-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 deadweight 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 (Table 2) 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

TABLE 2

CBO Assumptions behind Long-Term Budget Projections

	High	Intermediate	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	follows 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
Nondefense 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
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

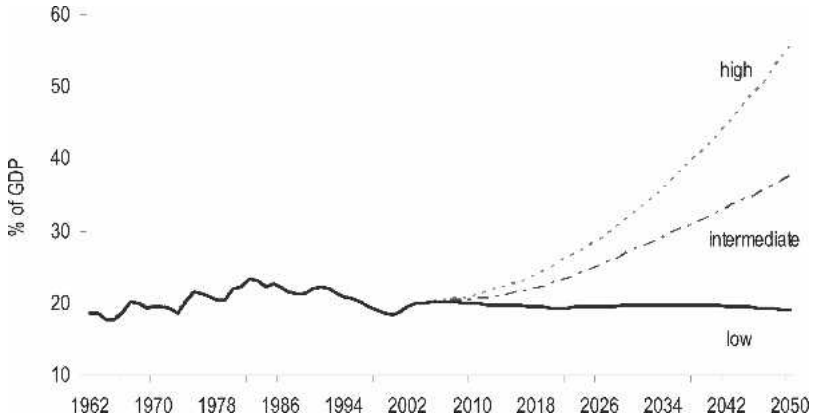
Sources: CBO; Bear, Stearns & Co. Inc.

spending outlooks. Revenues are projected under two scenarios, high and low.

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 (Figure 4). Total federal outlays are projected to be 21 percent of GDP in 2015, rising to 25 percent (exceeding previous postwar peak) by 2025.

FIGURE 4

LONG-TERM PROJECTIONS OF GOVERNMENT SPENDING



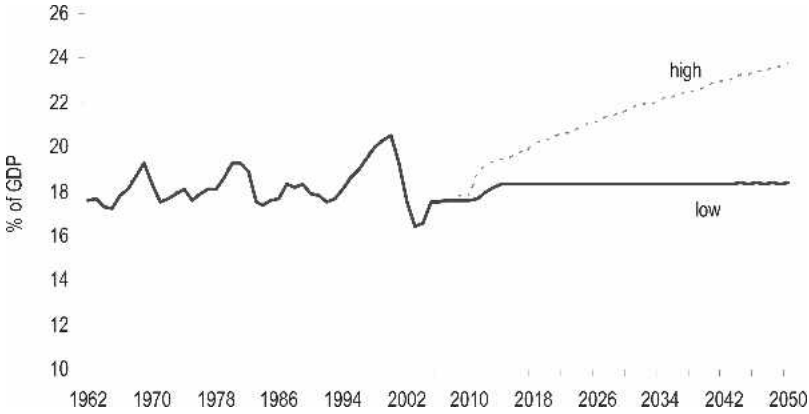
SOURCES: Haver; CBO; Bear, Stearns & Co. Inc.

In the "low" revenues assumption, total government receipts are limited to their longer-term average of 18.3 percent 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 percent of GDP by 2050 (Figure 5). (I note again the use of the static model, which assumes GDP growth doesn't slow no matter the size of government.)

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 percent of GDP (Figure 6). The demographic assumptions are a fertility rate of two 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 percent, an average unemployment rate of 5.5

FIGURE 5

LONG-TERM PROJECTIONS OF GOVERNMENT REVENUES

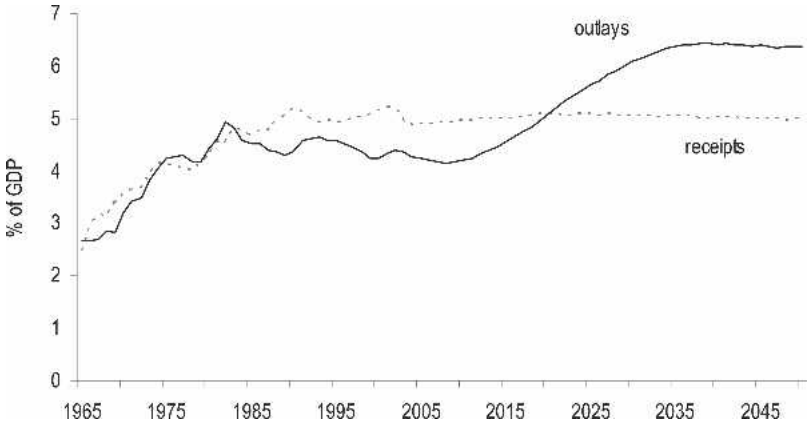


SOURCES: Haver; CBO; Bear, Stearns & Co. Inc.

percent, and productivity growth of 1.6 percent, 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.

FIGURE 6

LONG-TERM PROJECTIONS OF SOCIAL SECURITY RECEIPTS AND OUTLAYS

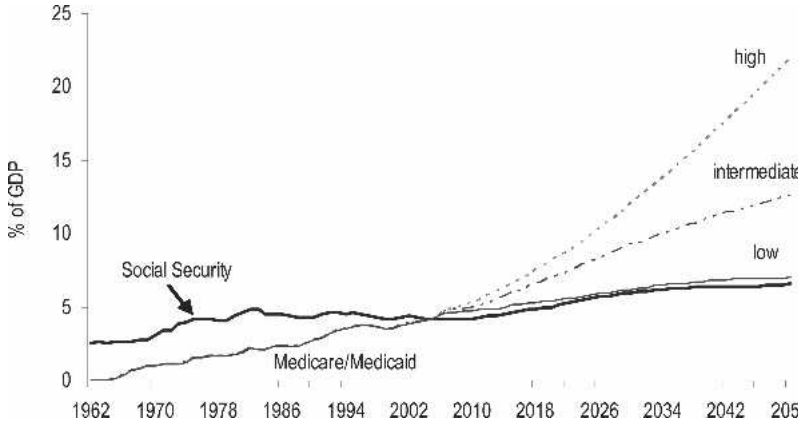


SOURCES: Haver; CBO; Bear, Stearns & Co. Inc.

Much attention has focused on the retirement of the baby-boom generation. CBO expects spending on Social Security to increase from 4.2 percent of GDP currently to 6.4 percent 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 4.5 percent to 12.6 percent of GDP, using its intermediate spending assumptions defined below (Figure 7).

FIGURE 7

LONG-TERM PROJECTIONS OF SOCIAL SECURITY AND MEDICARE/MEDICAID SPENDING



SOURCES: 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 (Figure 8).

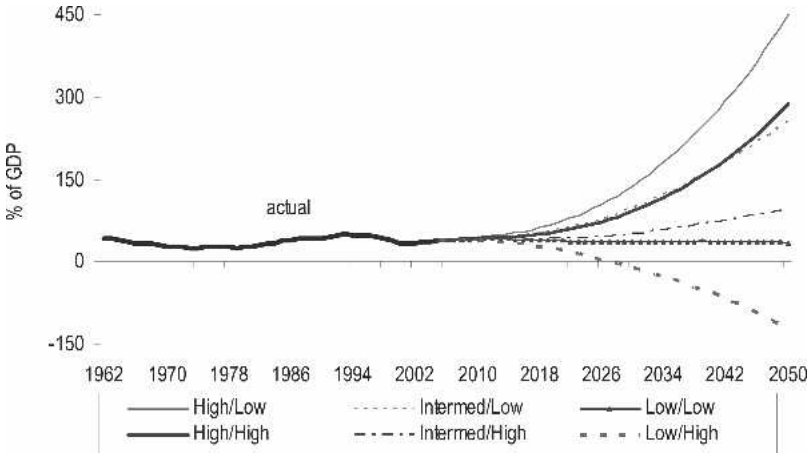
Conclusion

My expectation is that 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.

Looking to the fiscal impact on monetary policy, I think the Fed will be able to counter the political pressure, keeping its policy

FIGURE 8

LONG-TERM PROJECTIONS OF GOVERNMENT DEBT (UNDER THE VARIOUS CBO SCENARIOS)



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

focused on low inflation. I think it could do its monetary job easier if it paid more attention to the value of the dollar in setting interest rates, recognizing that a weakening dollar suggests monetary accommodation and a strengthening dollar, monetary restraint.