Storms on the Horizon

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Thank you, Bruce [Ericson]. I am honored to be here this evening and am grateful for the invitation to speak to the Commonwealth Club of California.

Alan Greenspan and Paul Volcker, two of Ben Bernanke's linear ancestors as chairmen of the Federal Reserve, have been in the news quite a bit lately. Yet, we rarely hear about William McChesney Martin, a magnificent public servant who was Fed chairman during five presidencies and to this day holds the record for the longest tenure: 19 years...

Chairman Martin had a way with words. And he had a twinkle in his eye. It was Bill Martin who wisely and succinctly defined the Federal Reserve as having the unenviable task "to take away the punchbowl just as the party gets going." He did himself one up when he received the Alfalfa Club's nomination for the presidency of the United States. I suspect many here tonight have been to the annual Alfalfa dinner. It is one of the great institutions in Washington, D.C. Once a year, it holds a dinner devoted solely to poking fun at the political pretensions of the day. Tongue firmly in cheek, the club nominates a candidate to run for the presidency on the Alfalfa Party ticket. Of course, none of them ever win. Nominees are thenceforth known for evermore as members of the Stassen Society, named for Harold Stassen, who ran for president nine times and lost every time, then ran a tenth time on the Alfalfa ticket and lost again. The motto of the group is *Veni, Vidi, Defici*—"I came, I saw, I lost."

Bill Martin was nominated to run and lose on the Alfalfa Party ticket in 1966, while serving as Fed chairman during Lyndon Johnson's term. In his acceptance speech, he announced that, given his proclivities as a central banker, he would take his cues from the German philosopher Goethe, "who said that people could endure anything except continual prosperity." Therefore, Martin declared, he would adopt a platform proclaiming that as a president he planned to "make life endurable again by stamping out prosperity."

"I shall conduct the administration of the country," he said, "exactly as I have so successfully conducted the affairs of the Federal Reserve. To that end, I shall assemble the best brains that can be found...ask their advice on all matters...and completely confound them by following all their conflicting counsel."

It is true, Bruce, that as you said in your introduction, I am one of the 17 people who participate in Federal Open Market Committee (FOMC) deliberations and provide Ben Bernanke with "conflicting counsel" as the committee cobbles together a monetary policy that seeks to promote America's economic prosperity, Goethe to the contrary. But tonight I speak for neither the committee, nor the chairman, nor any of the other good people that serve the Federal Reserve System. I speak solely in my own capacity. I want to speak to you tonight about an economic problem that we must soon confront or else risk losing our primacy as the world's most powerful and dynamic economy.

Forty-three years ago this Sunday, Bill Martin delivered a commencement address to Columbia University that was far more sober than his Alfalfa Club speech. The opening lines of that Columbia address were as follows: "When economic prospects are at their brightest, the dangers of complacency and recklessness are greatest. As our prosperity proceeds on its record-breaking path, it behooves every one of us to scan the horizon of our national and international economy for danger signals so as to be ready for any storm."

Today, our fellow citizens and financial markets are paying the price for falling victim to the complacency and recklessness Martin warned against. Few scanned the horizon for trouble brewing as we proceeded along a path of unparalleled prosperity fueled by an unsustainable housing bubble and unbridled credit markets. Armchair or Monday morning quarterbacks will long debate whether the Fed could have/should have/would have taken away the punchbowl that lubricated that blowout party. I have given my opinion on that matter elsewhere and won't go near that subject tonight. What counts now is what we have done more recently and where we go from here. Whatever the sins of omission or commission committed by our predecessors, the Bernanke FOMC's objective is to use a new set of tools to calm the tempest in the credit markets to get them back to functioning in a more orderly fashion. We trust that the various term credit facilities we have recently introduced are helping restore confidence while the credit markets undertake self-corrective initiatives and lawmakers consider new regulatory schemes.

I am also not going to engage in a discussion of present monetary policy tonight, except to say that if inflationary developments and, more important, inflation expectations, continue to worsen, I would expect a change of course in monetary policy to occur sooner rather than later, even in the face of an anemic economic scenario. Inflation is the most insidious enemy of capitalism. No central banker can countenance it, not least the men and women of the Federal Reserve.

Tonight, I want to talk about a different matter. In keeping with Bill Martin's advice, I have been scanning the horizon for danger signals even as we continue working to recover from the recent turmoil. In the distance, I see a frightful storm brewing in the form of untethered government debt. I choose the words—"frightful storm"—deliberately to avoid hyperbole. Unless we take steps to deal with it, the long-term fiscal situation of the federal government will be unimaginably more devastating to our economic prosperity than the subprime debacle and the recent debauching of credit markets that we are now working so hard to correct.

You might wonder why a central banker would be concerned with fiscal matters. Fiscal policy is, after all, the responsibility of the Congress, not the Federal Reserve. Congress, and Congress alone, has the power to tax and spend. >From this monetary policymaker's point of view, though, deficits matter for what we do at the Fed. There are many reasons why. Economists have found that structural deficits raise long-run interest rates, complicating the Fed's dual mandate to develop a monetary policy that promotes sustainable, noninflationary growth. The even more disturbing dark and dirty secret about deficits—especially when they careen out of control—is that they create political pressure on central bankers to adopt looser monetary policy down the road. I will return to that shortly. First, let me give you the unvarnished facts of our nation's fiscal predicament.

Eight years ago, our federal budget, crafted by a Democratic president and enacted by a Republican Congress, produced a fiscal surplus of $236 billion, the first surplus in almost 40 years and the highest nominal-dollar surplus in American history. While the Fed is scrupulously nonpartisan and nonpolitical, I mention this to emphasize that the deficit/debt issue knows no party and can be solved only by both parties working together. For a brief time, with surpluses projected into the future as far as the eye could see, economists and policymakers alike began to contemplate a bucolic future in which interest payments would form an ever-declining share of federal outlays, a future where Treasury bonds and debt-ceiling legislation would become dusty relics of a long-forgotten past. The Fed even had concerns about how open market operations would be conducted in a marketplace short of Treasury debt.

That utopian scenario did not last for long. Over the next seven years, federal spending grew at a 6.2 percent nominal annual rate while receipts grew at only 3.5 percent. Of course, certain areas of government, like national defense, had to spend more in the wake of 9/11. But nondefense discretionary spending actually rose 6.4 percent annually during this timeframe, outpacing the growth in total expenditures. Deficits soon returned, reaching an expected $410 billion for 2008—a $600 billion swing from where we were just eight years ago. This $410 billion estimate, by the way, was made before the recently passed farm bill and supplemental defense appropriation and without considering a proposed patch for the Alternative Minimum Tax—all measures that will lead to a further ballooning of government deficits.

In keeping with the tradition of rosy scenarios, official budget projections suggest this deficit will be relatively short-lived. They almost always do. According to the official calculus, following a second $400-billion-plus deficit in 2009, the red ink should fall to $160 billion in 2010 and $95 billion in 2011, and then the budget swings to a $48 billion surplus in 2012.

If you do the math, however, you might be forgiven for sensing that these felicitous projections look a tad dodgy. To reach the projected 2012 surplus, outlays are assumed to rise at a 2.4 percent nominal annual rate over the next four years—less than half as fast as they rose the previous seven years. Revenue is assumed to rise at a 6.7 percent nominal annual rate over the next four years—almost double the rate of the past seven years. Using spending and revenue growth rates that have actually prevailed in recent years, the 2012 surplus quickly evaporates and becomes a deficit, potentially of several hundred billion dollars.

Doing deficit math is always a sobering exercise. It becomes an outright painful one when you apply your calculator to the long-run fiscal challenge posed by entitlement programs. Were I not a taciturn central banker, I would say the mathematics of the long-term outlook for entitlements, left unchanged, is nothing short of catastrophic.

Typically, critics ranging from the Concord Coalition to Ross Perot begin by wringing their collective hands over the unfunded liabilities of Social Security. A little history gives you a view as to why. Franklin Roosevelt originally conceived a social security system in which individuals would fund their own retirements through payroll-tax contributions. But Congress quickly realized that such a system could not put much money into the pockets of indigent elderly citizens ravaged by the Great Depression. Instead, a pay-as-you-go funding system was embraced, making each generation's retirement the responsibility of its children.

Now, fast forward 70 or so years and ask this question: What is the mathematical predicament of Social Security today? Answer: The amount of money the Social Security system would need today to cover all unfunded liabilities from now on—what fiscal economists call the "infinite horizon discounted value" of what has already been promised recipients but has no funding mechanism currently in place—is $13.6 trillion, an amount slightly less than the annual gross domestic product of the United States.

Demographics explain why this is so. Birthrates have fallen dramatically, reducing the worker-retiree ratio and leaving today's workers pulling a bigger load than the system designers ever envisioned. Life spans have lengthened without a corresponding increase in the retirement age, leaving retirees in a position to receive benefits far longer than the system designers envisioned. Formulae for benefits and cost-of-living adjustments have also contributed to the growth in unfunded liabilities.

The good news is this Social Security shortfall might be manageable. While the issues regarding Social Security reform are complex, it is at least possible to imagine how Congress might find, within a $14 trillion economy, ways to wrestle with a $13 trillion unfunded liability. The bad news is that Social Security is the lesser of our entitlement worries. It is but the tip of the unfunded liability iceberg. The much bigger concern is Medicare, a program established in 1965, the same prosperous year that Bill Martin cautioned his Columbia University audience to be wary of complacency and storms on the horizon.

Medicare was a pay-as-you-go program from the very beginning, despite warnings from some congressional leaders...who foresaw some of the long-term fiscal issues such a financing system could pose. Unfortunately, they were right.

Please sit tight while I walk you through the math of Medicare. As you may know, the program comes in three parts: Medicare Part A, which covers hospital stays; Medicare B, which covers doctor visits; and Medicare D, the drug benefit that went into effect just 29 months ago. The infinite-horizon present discounted value of the unfunded liability for Medicare A is $34.4 trillion. The unfunded liability of Medicare B is an additional $34 trillion. The shortfall for Medicare D adds another $17.2 trillion. The total? If you wanted to cover the unfunded liability of all three programs today, you would be stuck with an $85.6 trillion bill. That is more than six times as large as the bill for Social Security. It is more than six times the annual output of the entire U.S. economy.

Why is the Medicare figure so large? There is a mix of reasons, really. In part, it is due to the same birthrate and life-expectancy issues that affect Social Security. In part, it is due to ever-costlier advances in medical technology and the willingness of Medicare to pay for them. And in part, it is due to expanded benefits—the new drug benefit program's unfunded liability is by itself one-third greater than all of Social Security's.

Add together the unfunded liabilities from Medicare and Social Security, and it comes to $99.2 trillion over the infinite horizon. Traditional Medicare composes about 69 percent, the new drug benefit roughly 17 percent and Social Security the remaining 14 percent.

I want to remind you that I am only talking about the *unfunded* portions of Social Security and Medicare. It is what the current payment scheme of Social Security payroll taxes, Medicare payroll taxes, membership fees for Medicare B, copays, deductibles and all other revenue currently channeled to our entitlement system will not cover under current rules. These existing revenue streams must remain in place in perpetuity to handle the "funded" entitlement liabilities. Reduce or eliminate this income and the unfunded liability grows. Increase benefits and the liability grows as well.

Let's say you and I and Bruce Ericson and every U.S. citizen who is alive today decided to fully address this unfunded liability through lump-sum payments from our own pocketbooks, so that all of us and all future generations could be secure in the knowledge that we and they would receive promised benefits in perpetuity. How much would we have to pay if we split the tab? Again, the math is painful. With a total population of 304 million, from infants to the elderly, the per-person payment to the federal treasury would come to $330,000. This comes to $1.3 million per family of four—over 25 times the average household's income.

Clearly, once-and-for-all contributions would be an unbearable burden. Alternatively, we could address the entitlement shortfall through policy changes that would affect ourselves and future generations. For example, a permanent 68 percent increase in federal income tax revenue—from individual and corporate taxpayers—would suffice to fully fund our entitlement programs. Or we could instead divert 68 percent of current income-tax revenues from their intended uses to the entitlement system, which would accomplish the same thing.

Suppose we decided to tackle the issue solely on the spending side. It turns out that total discretionary spending in the federal budget, if maintained at its current share of GDP in perpetuity, is 3 percent larger than the entitlement shortfall. So all we would have to do to fully fund our nation's entitlement programs would be to cut discretionary spending by 97 percent. But hold on. That discretionary spending includes defense and national security, education, the environment and many other areas, not just those controversial earmarks that make the evening news. All of them would have to be cut—almost eliminated, really—to tackle this problem through discretionary spending.

I hope that gives you some idea of just how large the problem is. And just to drive an important point home, these spending cuts or tax increases would need to be made immediately and maintained in perpetuity to solve the entitlement deficit problem. Discretionary spending would have to be reduced by 97 percent not only for our generation, but for our children and their children and every generation of children to come. And similarly on the taxation side, income tax revenue would have to rise 68 percent and remain that high forever. Remember, though, I said tax *revenue*, not tax *rates*. Who knows how much individual and corporate tax rates would have to change to increase revenue by 68 percent?

If these possible solutions to the unfunded-liability problem seem draconian, it's because they are draconian. But they do serve to give you a sense of the severity of the problem. To be sure, there are ways to lessen the reliance on any single policy and the burden borne by any particular set of citizens. Most proposals to address long-term entitlement debt, for example, rely on a combination of tax increases, benefit reductions and eligibility changes to find the trillions necessary to safeguard the system over the long term.

No combination of tax hikes and spending cuts, though, will change the total burden borne by current and future generations. For the existing unfunded liabilities to be covered in the end, someone must pay $99.2 trillion more or receive $99.2 trillion less than they have been currently promised. This is a cold, hard fact. The decision we must make is whether to shoulder a substantial portion of that burden today or compel future generations to bear its full weight.

Now that you are all thoroughly depressed, let me come back to monetary policy and the Fed.

It is only natural to cast about for a solution—any solution—to avoid the fiscal pain we know is necessary because we succumbed to complacency and put off dealing with this looming fiscal disaster. Throughout history, many nations, when confronted by sizable debts they were unable or unwilling to repay, have seized upon an apparently painless solution to this dilemma: monetization. Just have the monetary authority run cash off the printing presses until the debt is repaid, the story goes, then promise to be responsible from that point on and hope your sins will be forgiven by God and Milton Friedman and everyone else.

We know from centuries of evidence in countless economies, from ancient Rome to today's Zimbabwe, that running the printing press to pay off today's bills leads to much worse problems later on. The inflation that results from the flood of money into the economy turns out to be far worse than the fiscal pain those countries hoped to avoid.

Earlier I mentioned the Fed's dual mandate to manage growth and inflation. In the long run, growth cannot be sustained if markets are undermined by inflation. Stable prices go hand in hand with achieving sustainable economic growth. I have said many, many times that inflation is a sinister beast that, if uncaged, devours savings, erodes consumers' purchasing power, decimates returns on capital, undermines the reliability of financial accounting, distracts the attention of corporate management, undercuts employment growth and real wages, and debases the currency.

Purging rampant inflation and a debased currency requires administering a harsh medicine. We have been there, and we know the cure that was wrought by the FOMC under Paul Volcker. Even the perception that the Fed is pursuing a cheap-money strategy to accommodate fiscal burdens, should it take root, is a paramount risk to the long-term welfare of the U.S. economy. The Federal Reserve will never let this happen. It is not an option. Ever. Period.

The way we resolve these liabilities—and resolve them we must—will affect our own well-being as well as the prospects of future generations and the global economy. Failing to face up to our responsibility will produce the mother of all financial storms. The warning signals have been flashing for years, but we find it easier to ignore them than to take action. Will we take the painful fiscal steps necessary to prevent the storm by reducing and eventually eliminating our fiscal imbalances? That depends on you.

I mean "you" literally. This situation is of your own creation. When you berate your representatives or senators or presidents for the mess we are in, you are really berating yourself. You elect them. You are the ones who let them get away with burdening your children and grandchildren rather than yourselves with the bill for your entitlement programs.

This issue transcends political affiliation. When George Shultz, one of San Francisco's greatest Republican public servants, was director of President Nixon's Office of Management and Budget, he became worried about the amount of money Congress was proposing to spend. After some nights of tossing and turning, he called legendary staffer Sam Cohen into his office. Cohen had a long memory of budget matters and knew every zig and zag of budget history. "Sam," Shultz asked, "tell me something just between you and me. Is there any difference between Republicans and Democrats when it comes to spending money?" Cohen looked at him, furrowed his brow and, after thinking about it, replied, "Mr. Shultz, there is only one difference: Democrats enjoy it more."

Yet no one, Democrat or Republican, enjoys placing our children and grandchildren and their children and grandchildren in harm's way. No one wants to see the frightful storm of unfunded long-term liabilities destroy our economy or threaten the independence and authority of our central bank or tear our currency asunder.

Of late, we have heard many complaints about the weakness of the dollar against the euro and other currencies. It was recently argued in the op-ed pages of the Financial Times that one reason for the demise of the British pound was the need to liquidate England's international reserves to pay off the costs of the Great Wars. In the end, the pound, it was essentially argued, was sunk by the kaiser's army and Hitler's bombs. Right now, we—you and I—are launching fiscal bombs against ourselves. You have it in your power as the electors of our fiscal authorities to prevent this destruction. Please do so.

About the Author
Richard W. Fisher is president and CEO of the Federal Reserve Bank of Dallas.

Notes
The views expressed by the author do not necessarily reflect official positions of the Federal Reserve System.

1. William McChesney Martin, "Alfalfa Club Dinner Script," delivered at the Alfalfa Club Dinner, Washington, D.C., Jan. 22, 1966, Box 163, William McChesney Martin Collection, Lyndon Baines Johnson Presidential Library, Austin, Texas.
2. "Does Monetary History Repeat Itself?" Commencement Day Luncheon of the Alumni Federation of Columbia University, June 1, 1965, New York City.
3. "The Euro's Success Could Also Be Its Downfall," by Harold James, Financial Times, May 18, 2008.