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A Central Banker's Perspective on Entitlement Reform

I'd like to discuss why Social Security reform—and more broadly, entitlement reform—is important to a monetary policymaker. Why is a central banker interested in Social Security reform? I'm concerned, of course, because it's an important issue for the economy, and I have a more-than-passing interest when it comes to such matters. But, more importantly, it's an issue that has implications for my job at the Fed. The failure to reform Social Security and other entitlement programs will most likely result in massive future budget deficits. These deficits are a concern to me and other policymakers for at least two reasons:

Number one: Federal budget deficits will affect national savings rates and investment. Savings and investment, in turn, will affect productivity. And a lower rate of productivity growth will increase inflationary pressures, everything else being equal.

Number two: Massive deficits, over time, will generate enormous inflationary pressures on the economy and possibly pressures on the Fed to monetize the government's debt. This, of course, is a direct threat to the Fed's goal of price stability, the necessary ingredient for maximum sustainable growth.

Given these concerns, I'd like to make two points today. First, we as a nation need to move as quickly as possible to put entitlement programs on a sound financial basis. The faster we move, the smaller the adjustments that need to be made. We can avoid hard decisions in the short run by borrowing to cover ongoing deficits. But this will simply result in more severe problems as we find ourselves financing even larger deficits down the road.

Second, the Fed—with the help of researchers and business leaders like yourselves—must help to educate the public about the dangers of large deficits and the need to put our entitlement programs on a sound financial basis. Only an educated public will support the hard choices that need to be made.

Entitlement Reform

To begin, let me provide some background on our entitlement programs. As most of you know, about one-half of U.S. federal spending is devoted to entitlement programs. The three largest entitlement programs are Social Security, Medicare, and Medicaid. As we've all heard at this conference, the U.S. faces significant challenges in financing the Social Security program. Consider the following figures: Social Security benefits were equal to 4.4 percent of GDP in 1990. The Congressional Budget Office (CBO) projects that Social Security benefits will increase to 6 percent of GDP by 2030.

Clearly, we face difficult challenges in funding this type of increase. But this challenge, as difficult as it is, looks fairly manageable when compared to the problem of financing Medicare and Medicaid. The CBO estimates that spending for Medicare and Medicaid will increase from a combined 2.6 percent of GDP in 1990 to 5.5 percent in 2007 and 11 percent in 2030.

The projected increases in these entitlement programs have two sources. The first is the cost of health care. Here we've seen some progress as growth in health care costs has slowed recently. The second source is a more difficult problem—we're all getting older. That's nothing new, of course. The problem is a lot of us are getting older. Consider the "aged-dependency ratio"—the ratio of people 65 or older to people aged 20 to 64. This ratio in the U.S. is projected to be about 21 percent by 2010, about what it is now. In other words, we'll have about 5 people in the working age category of 20 to 64 for each person 65 or older. That ratio is projected to rise to 36 percent by 2030. We'll have about three people in the working age category for each person 65 or older.

This development isn't unique to the U.S. In fact, the demographics in other countries point to an even greater problem. The aged-dependency ratios in Japan and Germany are expected to increase from around 33 percent in 2010—or a 3 to 1 ratio—to about 50 percent by 2030—a 2 to 1 ratio.

So we're not the only ones facing some challenges. Perhaps there are lessons we can learn from others. But unless you change immigration laws to encourage an inflow of younger people, there's not much that public policy can do to change demographics. So we have a problem: A smaller percentage of the population will need to generate enough income to fund Social Security and health benefits for an aging population.

The bottom line is that spending on Social Security, Medicare, and Medicaid is expected to increase significantly. The CBO estimates that spending on these entitlement programs will increase from 8.5 percent of GDP in 1995 to about 10.5 percent in 2007 and 17 percent in 2030.

The billion dollar question—perhaps I should say the hundred-billion dollar question—is how are we going to finance these increases?

Could these increases be offset by cuts in other areas? It's highly unlikely. For example, suppose we assume the U.S. can't reduce grants to state and local governments. That seems like a reasonable assumption since more and more federal programs are being transferred to state and local governments. Just to offset the increase in Medicare and Medicaid spending projected from 1995 to 2007, the U.S. would need to make drastic cuts in remaining government expenditures. If we further assume that defense spending won't be cut, the U.S. would have to eliminate the bulk of all remaining non-defense spending. That simply won't happen.

There are a number of other possibilities for cutting spending, but they all have a common end point—they're simply not realistic. This leads to an inescapable conclusion. There are only two ways to avoid a significant increase in our budget deficits: raise taxes or scale back entitlement programs. These obviously are not attractive options. But failing to act now will only make these choices even more onerous in the future. If we don't address this situation, we'll be facing a budget deficit that's projected by the CBO to be about 10 percent of GDP by 2030. Granted, there's a lot of uncertainty about the exact number. But I think we can all agree that the number will be large if nothing is done.

Savings, Investment, and Productivity Growth

Some might argue that the U.S. can live with deficits. In my view, however, deficits do matter. The massive deficits projected by the CBO would have dire consequences for the economy. They would substantially reduce national saving, investment, and per capita income in the U.S.

Why do I say that? The single most important way the government affects national savings is through budget deficits. An increase in the budget deficit reduces national savings, other things being equal. Now there are other offsetting factors. For example, businesses and households may save more when there are large deficits because they're anticipating higher tax bills down the road. But in my view these offsetting factors aren't enough to eliminate the negative effect of large government deficits on national savings.

Some might say, so what? The problem is a decline in national savings will have a ripple effect on the economy. Slower growth in savings will reduce the pool of capital available for investment. Granted, international flows of capital will delay this effect for a while. But it seems clear that domestic savings efforts will dominate in the end and the supply of capital will fall. A decrease in the supply of capital tends to result in higher interest rates. Higher interest rates, in turn, will dampen investment in human and non-human capital. And a reduction in investment ultimately will have a negative effect on the growth rate of productivity.

That's a concern for the Federal Reserve as we seek to foster maximum sustainable growth. Productivity growth that is picking up reduces price and wage pressures, helping to contain a rise in inflation that would undermine economic expansion. So the Federal Reserve clearly has a stake in encouraging entitlement reform. Without reform, we'll likely be facing very large federal deficits. And these deficits will make an already difficult job even more difficult.

The Deficits and Inflation

Even if we set aside the issue of productivity, the deficits we're facing are extremely troubling for a central banker because of the potential implications for inflation. High inflation is ultimately caused by high growth in the money supply. As Milton Friedman put it, "Hyperinflation is always and everywhere a monetary phenomenon." But why is money growth high in some countries? At least in episodes of hyperinflation the answer is clear. High money growth results when countries have very large deficits and resort to balancing the books by generating seignorage revenues. In other words, they print more money.

History is very clear on this point. Countries with very high deficits have very high inflation. That's why one of our earlier speakers, Tom Sargent, is fond of saying: "Inflation is always and everywhere a fiscal phenomenon."

What's the connection with entitlement reform? Let's begin with a basic fact. One way or another, the government's books eventually need to balance. If the current deficit increases, one of two things has to happen: the present value of future deficits has to go down or the present value of seignorage revenue has to go up. In other words, if the government doesn't cut future spending, it must increase taxes, increase borrowing, or resort to the only remaining alternative—print more money.

Why not keep borrowing more and more? Here's the problem. As a deficit increases, the government will soak up an increasingly large portion of the available pool of private savings. In addition, lenders start to worry that the government won't be able to pay off its loans and they start to demand a higher interest rate. So the government is faced with higher financing costs. Eventually, the government becomes increasingly unwilling—or even unable—to borrow at home or abroad. That leaves only one source of finance available—printing more money.

Economists Phil Cagan and Tom Sargent, among others, have argued that this scenario has played out in nearly all of the episodes of extreme inflation in the Twentieth Century. The hyperinflation that plagued Europe in the 1920s and the very high inflation in Latin American countries during the late 1970s and '80s have one thing in common—high rates of money growth fueled by a government's decision to print money because of large budget deficits.

So what does this have to do with the U.S. and entitlement reform? Can we learn anything from these extreme experiences? Right now, the U.S. budget is nearly balanced. That's an important accomplishment that we should all take great pride in. Printing money—or seignorage revenue—is not a factor in current budget discussions. In fact, it's rarely been an important source of revenue for the U.S. Seignorage usually accounts for less than 1.5 percent of federal government outlays.

But suppose the U.S. budget deficit increased to 10 percent of GDP? We as a nation would face some hard choices. Many would oppose any changes to entitlement programs. And many others would oppose the huge tax hikes that would be necessary to fund these programs at their current level. History suggests that monetizing the debt—in effect, printing more money—would strike some as a relatively painless antidote to our troubles. What would happen if we took such a course? We won't have hyperinflation, but we won't have 2 percent inflation either. Our hard-earned progress toward price stability would be an old memory.

The Fed has a strong and ingrained belief in the absolute need to keep inflation low. Our resolve is firm, a resolve I believe is based on sound judgement, experience, and evidence. The consequences of monetizing large deficits are clear. But the Fed is a creation of Congress and ultimately accountable to the public at large. I believe the American people would understand and agree with the need to stand firm…to refuse to take the seemingly easy route of money creation. But I'd prefer to avoid such a critical crossroad in the future of our economy. We need to prevent large future deficits by putting our entitlement programs on a sound financial basis. The sooner we do this, the better off we and our children will be.

Conclusion

The point I've tried to emphasize today is the connection between entitlement reform, deficits, and inflation. In my view, we need to act now to put our entitlement programs on a sound financial basis. A failure to do so could result in very large deficits. And such deficits pose unacceptable risks to the economy.

The key relationship between entitlement reform, deficits, and inflation needs to be made very clear to the public. I think the Federal Reserve can make an important contribution by helping to educate the public on this issue—through conferences such as this as well as other efforts.

At the same time, the Federal Reserve must continue to make it very clear that it will not monetize large deficits. The results would be disastrous for the economy. The Fed's continued credibility on this point will significantly enhance the chances for meaningful reform.

In conclusion, we as a nation need to act now on the issue of entitlement reform. It's an economic time bomb that we're bequeathing to the next generation. The fact that it's a bomb with a slow-burning fuse doesn't make it any less dangerous. We've made impressive progress on reducing our current deficit. But that was only the first step. We must not relax and avoid the even more difficult issue of entitlement reform. Failure to implement reform will mean an even worse deficit problem in ten or twenty years. Credible entitlement reform combined with a monetary policy focused on price stability is the best way to help ensure a healthy, growing economy for years to come.