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Consequences of the Current Fiscal Trajectory - Opening Remarks

Not very much. You're starting to hear even some market people some political people, some in the commentariat, talking about potentially reaching limits. We saw the deficit to GDP ratios like 11 percent, which we haven't seen since the WWII. It's an extraordinary number. But really—you have to understand how much this came from the recession and the efforts taken to fight the recession and in consequence of that, will go away by itself. Now, that will still leave us a substantial deficit probably. And as how Charlie Cook sort of finished his remarks by saying: "have a nice day." I'm tempted to start mine with saying: "have a nice decade." This is not over when the recession is over and while I'm not at all worried about the short run deficit, even though if had asked me ten years ago if I ever in my lifetime see an 11 percent GDP deficit, I would've said no way, but I'm not so worried about that. We have a huge long run deficit problem. Now we've had this long run deficit problem for a long time and the way I think about it is the year 2010 has been fixed in the calendar since the year 1. So in 1980 we knew about the year 2010 but that was really far away. It's now 2009. So with 2010, by the way, is what you get when you add 1945 plus 65, so you get all the 1945-plus babies eligible for Medicare, a word I'll come back to in a moment. So 2010 is here basically. So the long run is now the short run and they're combining. So we do need to think seriously about getting some fiscal discipline but as the old song goes: "we want virtue, but not quite yet." We don't really want it in the year 2009; we don't want it in the year 2010. I'm not sure whether we would it in the year 2011. We might—that depends on how the economy goes. I mentioned Medicare and Medicaid. Peter Orszag has put the phrase 'bending the curve' into the national lexicon. And somebody, I think John mentioned it earlier. I just want to mention one point about that. I don't fancy myself a health care expert, although all of us who survived the Clinton wars of 1993-1994 feel a little bit like health care experts. I just want to make the point that when you look at the numbers in the CBO projections, the OMB projections, the Center's projections, it doesn't matter. They differ in details, they all carry the same message—you can actually simplify the budget, the long run budget problem—I'm not talking about this year's huge deficit—the long run budget by saying Medicare and Medicaid. That's about it, in the sense that if we can bend the curve effectively—by the way, downward; it's easy to bend the curve upward. If we can succeed in bending the curve downward, then we're going to get control. We can solve this long run budget problem or at least most of it. If we cannot, then we will not; it's that simple. There's no where anywhere else in the budget where you can make as serious a dent as needs to be made in the long run fiscal imbalance. Nowhere, it's only in health.

Now the big problem in that which I would love to hear David Cutler or Judy Feder or someone who contradict me later is nobody knows how to do that. I think—Without going into it, I would say there are lots of sensible ideas in bringing down health care reform. As far as I can tell, they all have to do with the level and not with the growth rate and that's welcome. I mean, we're spending so much on health care, we knock something

out of the level, we should want to do that. I don't see much curve bending in the long run, although I would love to be proven wrong.

The last thing I want to say in answer to your question, Jackie, is to bring back Stein's law which, someone, Bob mentioned—between the two of them, they stole all my thunder—Herb Stein said “if something cannot continue on forever, it will stop.” If you look at those—this I think is at your place. This is the Center's—and you saw on the chart—deficit-to-GDP, what are you seeing there? You're seeing the chart of what a mathematician would call ‘an unstable path.’ It's something shooting off to infinity, rather than going back to a stable position like a pendulum does. So if you stopped it at 2020, it looks bad; if you stopped it at 2050, it looks horrible. The CBO has gone out to 2080, when it looks beyond absurd, like the Earth has become Mars or something like that. What is that telling you? It's telling you we cannot possibly go there. That is a forecast of something that cannot possibly happen; it's completely impossible. So the question is since it can't go on forever, what's going to stop it? What will give? I think there are two basic candidates as the economy of the political system, and let me just finish by giving a couple of quick remarks on that.

If it's the economy that gives, what does that mean? Some people think inflation. If you look at the history of the world, not the United States, of the reaction to massive public deficits, inflation is the thing you see more often than anything else. I don't think we're going to see that in the United States. That would be a huge abdication of responsibility by the Federal Reserve. I think it'll be extremely, extremely unlikely. And by the way, at least as far as you can see that, in the markets, in the Treasury inflation tips, Treasury inflation protection securities, the market thinks that also. Now they don't go to 2080, but as far as you can see it they believe that. So I don't think it'll lead to inflation; it's a small probability. Interest rates are a likely candidate, especially long term interest rates. And higher long term interest rates which are a likely consequence of large budget deficits have their consequences on trend growth, on—its not about business cycles—it's about the trend growth, and that can add up. That's a concern. I would put at the top of my list though in terms of probability is the dollar. I think if the economy cracks, it cracks on the dollar, basically. I would say the longer we stay on this explosive path, the more likely a crack in dollar is. I'm going to leave most of that topic to Laura. I know she can say a lot more about current account deficits—say with China—and things like that. So let me just drop it on the table and leave it at that.

The other place it can crack is on the political system. You know, I think of the New Deal as that way. The system was breaking up and the political system cracked. Cracked in a good way, I think. Political systems can crack in good ways and they can crack in bad ways. But I think that's the other possibility and I wouldn't even begin to try to forecast under the heading what it means for the political system. But either one of those two can happen, unless, now I come to the third alternative. We actually look forward a little. I know this is a very un-American thing to do or at least an un-American politics thing to do. And to look forward and say: you know, we don't really want the economy to crack; we don't want the political system to crack and wouldn't it be smarter to do something about this deficit soon. Last sentence. When I say soon, I mean don't take the actions

now. We don't want to have government thorough-going deficit reduction in 2009, 2010. But it's not beyond the imaginable that we can actually legislate or otherwise pre-commit the system to reduce the deficit later when the economy is healthy. I just want to put the last thought.