Will the Current Financial Crisis Strengthen Efforts to Prepare for Looming Long-Term Fiscal Challenges?

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Reasons for optimism

- **Full awareness that long-term sustainability challenge *must* be addressed**
  - Sources of problem different in EU & US
  - A clear framework to restore long-term fiscal sustainability is necessary to be established in order to provide confidence to foreign lenders to US Treasury
  - Also, in US, current crisis aggravates perceived weaknesses of US fiscal position, further strengthening case for long-term (LT) policy focus.

Reasons for optimism-2

- **Crisis situation affords “opportunities” for actions in addition to the fiscal stimulus**
  - To focus on LT growth agenda
  - To initiate major reforms that would have previously been politically difficult
- Some argue that short-term cost of stabilization action is dwarfed by the size of the LT fiscal burden
  - Though some of purported new debt from stimulus and bank restructuring may be offset by assets

But many reasons for pessimism-1

Converse: extent of short-term challenge makes it harder to orchestrate structural policy reforms in *other* sectors

- Addressing health care remains daunting task
  - Loss of Daschle removes best champion
  - Enormous power and depth of vested interests
  - Move to universal health care will add to costs
  - Complexity of challenge: dynamics of rising costs not simply restricted to US; other G7 (with global budget constraints) also experiencing challenge

Reasons for pessimism-2

- Rebuilding infrastructure and restoring growth dynamic: costly, wide-ranging, and fraught with uncertainty
  - Can one continue to build on past model of growth (financial sector, real estate, medical demand, debt-financed consumption)?
  - Cutbacks in medical care will limit this sector’s potential contribution to real growth
  - What sectors will prove new sources of growth?

What makes the situation less hopeful-3

- **Crisis is a setback for US and other countries in terms of targets for long-term fiscal sustainability**
  - *Before* crisis, US and other EU countries were not sufficiently addressing LT fiscal sustainability challenge
  - *Now*, the crisis ratchets up initial debt to GDP ratios: in US, UK, and other EU countries
    - EU countries will need to revisit their Medium-Term Objectives (MTO) for fiscal policy
      - Now a higher starting debt
      - "Uncoordinated fiscal stimulus efforts" (Dutch MOF)
      - Lowers GDP base and perhaps trajectory
      - Uncertainties on *r* and *g?*
    - Can one assume that short-term stimulus package measures can easily be reversed in future? Or will they add to the expenditure base? How many years of stimulus will be required?

What makes the situation less hopeful-4

- Some additional liabilities to government still to be revealed
  - What are the next shoes to drop? Real sector crisis likely to be costly for other assets of banks
  - Pressures on FDIC?
  - Central Bank balance sheets?
  - State and local government pension schemes?
  - Private sector bankruptcies may be reflected in additional fiscal costs on governments, e.g. PBGC in US? UK situation?

What makes the situation less hopeful-5

- May even be further pressure on medical care costs
  - Increased disability claims
  - Political pressures to provide medical insurance for increasing number of unemployed who have lost employer-provided health care insurance
- Deterioration in HH balance sheets--loss in value in Defined Contribution (DC). retirement schemes; will it add to pressure in the US & UK to increase the value of replacement rate in Social Security?
  - Increasingly difficult position for elderly dependent on fixed income securities with low interest rates

What makes the situation less hopeful-6

We are moving into uncharted terrain, looking ahead beyond the immediate crisis

- Have mentioned ***uncertainty on the growth dynamic*** in many industrial countries, particularly the US
  - Can't be based on high consumption growth financed by debt
  - Also, HH sector will need to rebuild its asset base as well as absorb more of burden in financing health care costs
  - Any Ricardian view on higher government debts in future may also lead to more savings
  - Also, confidence has been dramatically shaken--can't anticipate fallout from psychological effects re risk-taking, investments
  - Fiscal sustainability will require action to strengthen fiscal balances: will require withdrawal of government stimulus
    - Indeed, financing of current deficit will require clear fiscal framework to facilitate fiscal sustainability
  - Will it derive from exports? From investment?
  - Also, a number of real sectors questionable in their performance
  - Incipient protectionist worries (Buy America; British jobs for British)

What makes the situation less hopeful-7

- **Evolution of global imbalances remains unclear**
  - G7 countries: aging population would argue for shift towards current account deficits--but current crisis pushes in opposite direction (retrenchment by HH sectors; delays in retirement)
  - Many EMs continue to seek current account surpluses
  - Many energy producers seek to accumulate assets to replace assets in ground
- **Leads to uncertainty on the global growth dynamic**? on the future long-run interest rates? On the potential for inflationary pressure?

There also are a number of structural issues related to challenge of aging populations-1

- Will the current crisis change popular views on what should be the appropriate balance between public retirement DB-type schemes and private savings schemes (401Ks, IRAs)?
  - Crisis has revealed the large risk transfer to households (volatile returns; low interest rates on fixed income securities)
  - Will there be pressure to raise the replacement rate in public pension schemes?
  - Will there be pressure for higher ‘forced” savings with stricter requirements re investment options?

There also are a number of structural issues related to challenge of aging populations-2

- Also, the crisis has exposed the risks associated with Government prefunding through the build-up of asset pools
  - Witness losses experienced by Australia Futures Fund; Singapore CPF?
  - State and local pension schemes in the US
  - Drop in asset values for private sector corporate DB-schemes in US, UK

Extent of the long-term aging challenge

- Most studies seem to argue that aging--demographic factors--will be an important factor influencing fiscal sustainability, but manageable.
- The *real* challenge: more that of health care cost dynamics
  - EU Aging Working Group study (2006) suggested magnitude of challenge in EU:
  - Led to EU efforts to develop MTOs to facilitate blend of structural reform and prefunding (through higher fiscal surpluses), particularly for high debt countries
  - But question mark for EU: over-optimistic assumptions on rate of increase in health care costs (beyond aging)
  - In US, CBO, CBPP studies suggest that demographics only accounts for small share of total rise in fiscal costs
    - Social security manageable
    - Health Care: largely excess cost growth

If major sustainability concern really rests on assumption on health care cost dynamic

- Clearly a challenge to modify the pace of historic cost growth (if things are unsustainable, will they stop?)
- Recognition that this is a challenge facing not only US but other countries with universal health insurance, with global budget constraints, and greater govt intervention in factor price determination
- Paradigm shift will be required to address the pressures arising from rapid technological change

EU Transitional Questions

- Will current crisis lead to
  - Better-off Euro countries (Germany) be forced to absorb the cost of fiscal transfers to bail out some of the countries in the Euro zone with weaker fiscal positions?
  - Might there be a breakup in euro zone? From the top, if the stronger countries are unwilling to finance weaker countries?

Where do we go from here?

- The words have been good.
- But the actions will need to clearly establish that we are making good use of this crisis to establish a clear blueprint on the interconnectedness between how we are addressing the current crisis and the imperatives of the long-term
- Unlike Marty Feldstein, I do believe that addressing the long-term simultaneously with the short-term is critical, even recognizing that not all spending will have a short-term stimulatory effect
- Why? Because
  - Reestablishing a growth dynamic is critical for the LT
  - Taking actions today that confront the long-term fiscal dynamic is critical if we are to ensure faith by our creditors in our borrowing today?
  - The crisis represents a chance to do the politically difficult

Will require

- Increased revenue--time for a national VAT and more progressive Income Tax
- Need to move quickly to address weaknesses in Social Security's financial position--increase the payroll tax base limit and defer age of eligibility, particularly if higher replacement rates become necessary
- Health care: universal extension necessary as first step. But must
  - Trigger debate on why there is the adverse cost dynamic, why it is unaffordable, and the difficulties implied for all in terms of obtaining financing for all new expensive technologies
  - Address the sources of gross inefficiency & rents

Will also require

- Focusing on growth dynamic and sources and the Government's role
- No, we do not want government planning. But recognize how many sectors of the US economy--agriculture, energy, health care--obtain much of their dynamic from government policies in the past. Not wholly from the market. And many government policies have fueled both past growth (internet) and many innovations (health care)

- And much of the borrowing, if used to finance real assets--in infrastructure--would not jeopardize Government’s net worth
- Finally, we need a clear signal of a fiscal framework that seeks binding targets for retrenchment