**Peter G. Peterson Foundation**

Economic Forum: America's Fiscal and Economic Outlook - Session II

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**Featuring:** James Poterba, President, National Bureau of Economic Research
Diane Swonk, Chief Economist, Grant Thornton

**Moderated by:** Michael Peterson, CEO, Peter G. Peterson Foundation

Michael Peterson (00:00:16):

Good morning, and happy new year. Thank you for joining us today. The Peterson Foundation Economic Forum brings together thought leaders for in-depth conversations on America's most pressing fiscal and economic issues. The start of the new year is a perfect time to pause, assess, and look ahead. Rarely in our nation's history have we faced such complex questions and uncertainty as we do today in our fiscal and economic landscape. As we begin 2022, nearly two years after the beginning of the pandemic, we have undoubtedly learned significant lessons and are in a fundamentally different place than we were in 2020.

Michael Peterson (00:00:54):

There's cause for optimism in many areas, but new variants present new challenges to our health and our economy. Clearly, we need to continue to adapt. As always, the Peterson Foundation is focused on developing the optimal fiscal and economic policies for our country so we can respond as best we can to the challenges that we confront. There's no doubt that policymakers today face a wide, complex, and evolving set of challenges to support the economy.

Michael Peterson (00:01:21):

Many major questions exist around inflation, the labor force, supply chain, inequality, our fiscal future, and more. At the same time as we face these immediate challenges, we have a completely unsustainable short, medium, and long-term fiscal outlook. We have rising trillion-dollar deficits as far as the eye can see due to structural factors that existed long before COVID, but were accelerated by COVID. To us, the challenges was already urgent, threatening our future prosperity and preparedness for new challenges, known and unknown. But now it's even more dire in terms of the fiscal position and the continuing level of need. So we have plenty to talk about today.

Michael Peterson (00:02:03):

To help illuminate and improve the understanding of this critical moment, the foundation launched an initiative to ask some of the smartest and most insightful people we know to help answer the key question, where do we go from here? We convened 12 leading experts with a range of diverse viewpoints and experiences to provide solutions to guide policymakers and citizens through this uniquely challenging time. I'm so pleased to have two of our authors here with us today to outline their recommendations. So let's get the discussion started and bring on our two guests.

Michael Peterson (00:02:37):

James Poterba is the Mitsui Professor of Economics at MIT and the president and CEO of the National Bureau of Economic Research. Previously, Jim served as president of the Eastern Economic Association and the National Tax Association. Dr. Poterba's research focuses on how taxation affects the economic decisions of households and firms, particularly those involving saving and portfolio behavior.

Michael Peterson (00:03:03):

We also have Diane Swonk with us today. She's the chief economist at Grant Thornton, where she applies her knowledge of the labor market and monetary policy to guide corporate and investment strategy. Diane is a well-known resource for global business leaders and central bankers, in addition to being an internationally-recognized commentator on television, radio, and in print. She is the author of The Passionate Economist: Finding the Power and Humanity Behind the Numbers.

Michael Peterson (00:03:29):

So we're so glad to have both of you today, and thank you. Just a quick reminder that I'm happy to take questions from our audience. There's a button at the bottom of your screen. Use that to submit your questions and, toward the end of the conversation, I'll bring in some of your questions. So again, thank you both for joining us today. We have a lot to get into in terms of inflation, the numbers coming out this morning, the deficits, et cetera. But let me just start more generally.

Michael Peterson (00:03:54):

COVID has had an enormous impact on our economy, our way of life the last couple of years. Diane, starting with you, tell me what you're looking at right now and in 2022 to assess how COVID is impacting the economy. What can we expect in the coming year?

Diane Swonk (00:04:13):

Well, it's been incredibly humbling, and it is always humbling being an economist and forecasting. But forecasting during the financial crisis was kind of like standing on fault lines. I put this akin to standing on quicksand, because every time we have a tether out, we get another wave of infections. Omicron is unique in terms of it has pivoted from ... Well, first of all, it underscores how much the health of our economy and every economy around the world is dependent on the health of its population.

Diane Swonk (00:04:40):

Second of all, it's pivoted our economy from the fear of contagion and aversion to in-person events like this, which we would in previous years and hopefully next year have in-person with you and doing it remote. That pivot and that fear was the primary drive of economic losses right through the Delta wave over the summer, and it is no longer. Now we're seeing acute labor shortages basically mimic a mandated lockdown, only it's much messier. We're seeing it hit essential services across the board. Things like fire departments, emergency personnel, healthcare personnel are just in short staff already, and this is exacerbating that.

Diane Swonk (00:05:21):

Truckers are among the lowest-vaccinated group out there. Imagine the logistical nightmare and problems in supply chains in response to that. So what I see right now is that we're coming off the strongest year since 1984 and, with it, we got a price, and that was the hottest inflation since 1982, as inflation was coming down after two back-to-back recessions in the early 1980s. But on top of that, we are likely to see, I think it's very probable we see a pullback in the first quarter. The question is whether that hard stop will be enough to derail inflation.

Diane Swonk (00:05:58):

The Fed has come to the conclusion that variants are now more inflationary than disinflationary, and I do worry about where we are now that the Fed has pivoted from a position which has huge implications for our fiscal sustainability. The Fed has pivoted from being patient in record time to being panicked about inflation. With that, even as we see inflation slow in 2022, which it will just if ... Remember, in April 2020, we saw negative oil prices, and then they were real positive in April of '21. So if we don't see oil prices go from 80 to $150 per barrel, you're not going to see that kind of push on inflation in the spring of 2022. That's the good news, that inflation will abate.

Diane Swonk (00:06:43):

The question is, will it cool enough to not distort decisions? That's the Fed's goal. Right now, it doesn't look like it will, even with a hard stop and then the economy restarting up again in the next quarter. So I am very worried about the seesaw pattern we have to grow. It nets out to be really positive, but it is a stop-and-go, and it's a stop-and-go that adds friction. With that friction is inflation, which over time is something we've not had to deal with when it comes to deficits.

Michael Peterson (00:07:19):

Okay, thank you. Yeah. We can unpack some of that further. Jim, give us your initial impressions of where we are today, what you look back on the last couple of years, and what we can learn from it going forward.

James Poterba (00:07:29):

Sure. Michael, it's great to be with you and Diane. I would just start by echoing what Diane explained. We have learned in the last two years just how sensitive our economy is to public health circumstances and how critical that the evolution of the pandemic is for economic outcomes, and I think we are very much in that place today. A year ago now, we had a 6.7% unemployment rate that had come off the December 2020 numbers. Inflation, of course, was much lower. We've had an extraordinary year in managing during a time of significant pandemic activity to get economic growth back on track.

James Poterba (00:08:10):

One of the things about economics which is always fascinating is it depends on what people believe and how they behave. I would say the thing I'm focusing on at this point is we've got a very low unemployment rate at a 3.9% number at the moment, but labor force participation remains significantly depressed relative to where we were in January or February of 2020. There are multiple explanations for why so many folks are not in the labor force. I'm sure all of the potential candidate stories have some element of truth.

James Poterba (00:08:42):

They include people being nervous about coming back into the workforce because of COVID and the risk of getting COVID. They include lack of childcare or reliable childcare or uncertainty about whether kids are in school in-person or remotely, and that keeps some folks at home. They include the lack of demand for the service sector which, of course, has been the hardest hit by the various changes. So that's just some sort of structural mismatch of a kind that we deal with all the time. They also include the generous transfer programs that were rolled out during the course of the last two years.

James Poterba (00:09:17):

I think one of the interesting things we've discovered is that as many economists have looked to see as transfer programs cut off, was there a spike in return to the labor force? Less than many people expected but, of course, we also have a very, very strong consumer balance sheet in the US at the moment, and a lot of households have relatively large liquid balances, which are probably providing a cushion and allowing them some flexibility in deciding when to return to the labor force. So I'm looking to see when we start to see the labor force numbers catching up to where we were previously.

James Poterba (00:09:51):

That doesn't mean I'm sure that they are going to catch up. There's the great resignation. There's also the great retirement. Particularly for older workers, it is quite possible that we are not going to see them back in the labor market and that we are going to be going forward from a somewhat lower starting point than we would have had the pandemic never happened at all. So for me, the labor market's a key thing to watch. And then, of course, looking at the Fed and seeing how the Fed decides to play its hand as we move through the coming year, but that's something I'm sure we'll talk about more as we go along.

Michael Peterson (00:10:23):

Okay, good. Yes, indeed. As you noted, Diane, we had some inflation news this morning. The labor department said the CPI rose 7% in December from the same month a year ago, up from 6.8 in November. So that's the fastest pace, as you noted, since 1982 and the third straight month above 6%. So what are you looking at more deeply within this issue? What are the factors you think are there? How long will they last? Are there particular categories of the economy that you're focused on specifically? So let's get into a little bit more detail on this issue.

Diane Swonk (00:10:57):

Sure. As I already mentioned, the oil price issue, that should help abate, and the math on inflation does get easier so that we just get harder comparisons as we get into the middle part of the year or the second quarter. That said, what I've been concerned about and what I was worried that the Fed was discounting too much for a long time was the increase that we were likely to see and has already begun to occur in shelter costs. It's not just hotel room rates up almost 25% from a year ago, which is happening. But of course, nobody was traveling a year ago because during the winter wave, we really all canceled a lot of in-person interactions.

Diane Swonk (00:11:34):

I think it's important to look at where that more broadening of inflation we're seeing in domestic services where the costs of wages have gone up even faster than inflation has gone up, which means margin compression. That is the early signs of wage-push inflation. Now, it's not broad-based wage-push inflation, but the kinds of inflation beyond food and energy which, let's face it, the Fed has some control over. But, for the most part, weather and everything else distorts those issues. But the core inflation is becoming more broad-based between both services and goods.

Diane Swonk (00:12:09):

Some of those things, like used vehicle prices up well over 30% from a year ago and accelerating after decelerating and in the wake of Hurricane Ida because of how many used cars were destroyed, the chip shortage actually that intensified in December and new car prices are up at a double-digit rate from a year ago. It's really insane to see some of these. The only deal out there is on smartphones, which are down more than 14% from a year ago.

Diane Swonk (00:12:35):

But to see this broadening of inflation in both the service sector and the goods sector and particularly in the shelter sector where I think we'll easily see, especially with relation to home ownership costs, an inflation that will likely touch the peak, if not exceed the peak we saw during the housing bubble, that is really disturbing. That's something the Fed can do something about. That is something that's more persistent and I think will linger, even though I do think we could have a hard stop in the first quarter.

Diane Swonk (00:13:07):

So the inflation data, although we're set up to have it lose momentum, what people often forget is will it cool enough to not be hot to the touch? No. Will it cool enough to not distort behaviors? Probably not, which keeps the Fed in this odd position of chasing inflation for the first time since the 1980s.

Michael Peterson (00:13:29):

Jim, what's your view on the transitory nature of this and some of the trends in the first couple of quarters? What are you looking at, and what are your predictions?

James Poterba (00:13:38):

I think, on inflation, we have come to realize, again, just how complicated the interlinkages in the economic system are. The chip shortage, for example, has multiple components to it. It includes weather shocks in Asia. It includes shutdowns of factories that were caused by the pandemic in some parts of the Pacific Rim. It includes the transportation shortages of trying to ship things across the Pacific. So all of these factors have come together to contribute some component.

James Poterba (00:14:09):

As Diane said, the inflation dynamic at this point is being driven by multiple shocks that are hitting. I do think there are some elements, particularly housing, as she noted, where there's some ... If you look at the difference between the increase in newly-contracted apartment rents at the moment and the change in the CPI component for rents and shelter, big disparity there suggesting that as people run into the renewal of their apartment leases, we're going to see some pressure flowing through if prices stay where they are.

James Poterba (00:14:39):

But I think there's another element to this that I would emphasize, and that is not just the supply chain side, but the psychology of businesses in thinking about market prices and market power. Because for a long time when inflation was running in the sub-2% range, if a major retailer raised prices, it was a news story. You'd actually read about it in the newspaper that, I won't pick on any company, but So-and-so is going to raise their prices and announced a price increase from the fall. That's not newsworthy anymore. I think it speaks to an issue. The economists call this inflation expectations.

James Poterba (00:15:20):

I think we know less than some of the claims suggest about the degree to which inflation expectations are anchored by historical experience, the extent to which the Fed's credibility is well-grounded in past actions. So I think the risk right now, and it's very hard to know how to gauge this, is that businesses begin to think of the moment when they can increase their prices because the customers will not think it's out of line to do that.

James Poterba (00:15:50):

That changes the psychology of how a lot of things that consumers are facing will start to look. If we erode the anchor that we've had, that can potentially put the Fed into a much more difficult battle of trying to put the inflation genie back into the bottle.

Michael Peterson (00:16:08):

Well,

Diane Swonk (00:16:08):

Can I-

Michael Peterson (00:16:09):

... how many more months of this? Let me just do a quick follow-up and then ... How many more months of this does lead to that expectation change, do you think? I mean it's ...

James Poterba (00:16:19):

In some sense, it's all around the definition of the word, transitory, that we've been been wrestling with for the past year. I think most of us thought that, initially, transitory meant a couple of months and then it subsides. I think transitory is no longer the word we're using, but it's not permanent. So does that mean that we're back down by the second half of 2022? That would seem to me like the timeframe over which you'd say, "Well, at least this was a year long, unusual pattern."

James Poterba (00:16:49):

Diane already made the important point that we're still looking back to year-back prices, which were distorted by a pretty unusual period. So it's really when you start to get into the point where you're comparing prices with a base that feels more normal, I mean we're not normal by any means, and also continuing to see large rises. That's, I think, when things start to get a little more risky in terms of the expectations. So I think whether that's a few more months or that's half a year, I'm not quite sure. It's very hard to put a precise point on that.

Michael Peterson (00:17:20):

Okay. Diane, did you want to add something there?

Diane Swonk (00:17:22):

Yeah. I just wanted to add on that because Jim made some really good points. Yeah, there's an interesting difference between ... There's a University of Michigan Consumer Sentiment Measure of Consumer Attitudes, and there's a Conference Board Measure of Consumer Attitudes, and the two have diverged to their largest gap in history. It's interesting to see one deteriorating and one starting to improve.

Diane Swonk (00:17:45):

The main reason for that is that the Consumer Sentiment Index by the University of Michigan is much more sensitive to inflation and people's view about inflation and expectations about inflation, while The Conference Board index is much more sensitive to the labor market, where we see quit rates at a record high and wages accelerating. So you see that divergence between the labor market and, at the same time, inflation in those expectations. That said, the 1970s were such an extraordinary period where about 80% of wages in the US, at least by my former mentor's calculation when he was at the Fed in the 1970s, was that we saw about 80% of wages tied to a cost-of-living increase, a COLA, which was the CPI.

Diane Swonk (00:18:27):

One of the greatest concerns the Fed has is that that 7% figure could actually get baked into wages, given the unusual labor market power that workers have today. It's not that we don't want to compensate workers. We want workers to get real wage gains. But once you do that, and inflation has the dynamics that Jim just described of decelerating, you get much more wage-push inflation out there. So that's where the Feds worried about the entrenchment coming. It really is coming from a very different place than it was in the 1970s.

Diane Swonk (00:18:59):

In the 1970s, what we saw was, first of all, inflation tripled in the 1960s going into the '70s. And then we had a lot of shocks that exacerbated it in the 1970s and created what was called stagflation in 1973 when the economy was contracting, this is not that, and inflation was accelerating. But it's also important to remember how much of consumer expectations are tied to oil prices. The minute that oil prices come down, you tend to see consumers ease up on that. That will be really interesting to see what role Omicron has in terms of, is it as inflationary as other variants? Is it more inflationary?

Diane Swonk (00:19:38):

The Fed has decided variants are more inflationary than disinflationary because of disruptions to the supply chain at the same time demand is strong, which Jim made a really good point of that, is that we've collided. We've got, according to Indeed's work on their job listing site, our job postings could get up to 12 million at the end of December. That's almost two people looking for a job per job open, and that's before you start to try to match people's competencies. Even if you have a slow down, the gap on that is just extraordinary because of these constraints in labor supply, which I would add long COVID, immigration, and fatalities actually to Jim's list.

Diane Swonk (00:20:16):

But I think it's really important to put all this together because the jury's still out, and the Fed is going to fight the inflation now. They're ready to raise rates in March. They're talking about reducing their balance sheet, which it could have big implications for what we're talking about in terms of fiscal stability at the same time that they're talking about raising rates, and they're still adding to their balance sheet.

Michael Peterson (00:20:39):

Okay. Well, that's what I wanted to go to next, which is the role of the Fed. Jim, what would you do if you were in that seat? Maybe you're glad you're not at this moment. But what do you predict for them in terms of tapering and rate increases this year? If you were in the room, what would you be saying?

James Poterba (00:21:00):

Well, I mean first, I'm delighted, Michael, that that's not my job. You're absolutely right. This is an extremely challenging time to be a central banker, and they really have a very difficult signal extraction problem in trying to look through the raft of data we get on economic outcomes and performance and trying to figure out, precisely because this is a time when the behavior of firms and households is very fluid. It is affected by shocks that are hitting the economy at a much more rapid pace than usually.

James Poterba (00:21:33):

First, I very much endorse what I would call the data-driven approach that I think the Fed has taken, the notion that one would set very strong targets and then stick to them at a time when there's lots of news coming in about the economy, as opposed to saying much more realistically, "Well, we'll get new information. We may change our minds. But we'll have to see what that information is." That, of course, strikes me as extremely realistic and reasonable under the circumstances.

James Poterba (00:22:01):

I think the Fed has remarkably adjusted from where it was just a few months ago and updated the weight being placed on the risks of inflation. Almost a year ago, there were voices in the economics community that were beginning to say, "The inflation numbers are looking worrisome. The Fed is behind the curve already." Those voices have gotten louder, and there are more of them. I think the Fed has embraced some of that as we go forward. So I'm not going to guess at what the Fed is exactly going to do. I know we probably have listeners who are eager to know, is it three increases? Is it four increases in 2022?

James Poterba (00:22:43):

I certainly have no crystal ball. I'm like all of those who are wondering and watching what will happen. But I do think that, as Diane has kind of alerted us to with her comment about the balance sheet, what is very clear is the Fed is now reversing gears and that the policy of stimulus through monetary policy that we have been working with is now going to start to run in the opposite direction. Of course, the challenge that that's going to raise and something which if you put this on my list of what are you watching for, it's the reactions of the bond market to the actions the Fed is going to take.

James Poterba (00:23:19):

There are so many unusual circumstances at the moment in both global financial markets, as well as in the macro economy in the US and other economies that if you ask me what do I think is going to happen to the 10-year yield if the Fed starts to unwind the balance sheet, I'm not sure what I would tell you. I don't want to give you a number for that. But that's going to be a very important parameter, as Diane just said, for thinking about both fiscal policy and monetary policy as we go along.

James Poterba (00:23:45):

So it is going to be a remarkably interesting time to live through in the next year or so because it's going to be a lot of shock, not just from the pandemic and the public health side, but also from the policy side as the Fed begins to take some new actions.

Michael Peterson (00:24:00):

Okay. I do want to move to the fiscal implications in a minute. But Diane, do you want to add anything on what you're looking at from the Fed and particularly what

[crosstalk 00:24:08]-
Diane Swonk (00:24:08):

Yeah. Unfortunately, I have to make a forecast, and I'd love to be in Jim's shoes at this point in time. I'm expecting the Fed to do three rate hikes starting in March. I know that they could do more, but I think the speed with which they want to reduce their balance sheet is pretty remarkable, talking about 100 billion a month or more. That is this pivot in terms of how rapidly they start shrinking their balance sheet.

Diane Swonk (00:24:34):

It's interesting, the synchronous and symphony of voices talking about a March rate hike, regardless if we get a hard stop within the Federal Reserve and the consensus on reducing the balance sheet and also the concern about a very big point that I want to emphasize that Jim made about financial fragility. Financial markets are priced to perfection in a wholly imperfect world, and it couldn't be more imperfect. That said, we know developing economies have taken on a record amount of debt and that debt is held on their commercial bank balance sheets.

Diane Swonk (00:25:10):

So if they default, it also shows up on their commercial bank balance sheets, which creates a doom loop. We know that there's no Las Vegas in the global economy. So anything the Fed does as the central bank of the world, developing economies have to match those increases or outpace them. You have the extreme in Turkey right now where they've really made a mess of things and have stagflation. But you've got that spillover and knockoff effects that could come back to our own shores, and that's something the Fed is very cognizant of.

Diane Swonk (00:25:40):

In fact, Esther George said yesterday, as we heard the symphony of voices, in addition to Chairman Powell's confirmation hearings saying that we're going to move and we're going to deal with inflation. But she said, "But I am worried about what reductions in the balance sheet," and she's for it, "mean for financial stability." You can knock me over with a feather that we got down to 52 basis points on the long bond as we were issuing all these trillions of dollars in debt. I never would have forecast that.

Diane Swonk (00:26:14):

I view that as the rest of the world was willing to buy our debt, and buy debt in general, rather than face the consequences of what would happen if demand imploded in response to the pandemic. It's not clear that that's something that you should count on going forward.

Michael Peterson (00:26:34):

Okay. Well, I wanted to get into both of your papers a little bit. So Diane, starting with you mentioned in your paper that the pandemic made you feel like Alice's trip through the looking glass. I think we all share some of those feelings. Let's unpack a little bit what you're saying about the investors willing to absorb the debt. Another thing you said is, "Deficits and debt don't matter until they do, then it can get ugly," is how you closed off your paper.

Michael Peterson (00:27:04):

So help us understand how you look at the bond market. What's going on with our debt relative to interest rates, et cetera, and how you see this equation?

Diane Swonk (00:27:15):

Well, it's interesting. We can never time it. It's like a straw that breaks the camel's back. I'm really struck by how much within the bond market they're like, "Well, we've been through rate hikes before, and everything's fine." First of all, a soft landing, much easier to engineer in an economy that's moving at a glacial pace relative to an economy that's moving as rapidly as the one we're in. But second of all, we've not had the Fed chasing inflation, like I said, since 1980s.

Diane Swonk (00:27:41):

What we really don't know is, and Jim talked about it, too, I have to put a forecast on it. We do have a model that looks at reductions in the balance sheet and how does that affect the bond market? But there's the emotional component that has obviously helped us to now. The question is, when does it flip? And if the Fed does do as abrupt as I think they're going to do pull back in their balance sheet and how rapidly they decide to do that, we just don't know how much that could push up yields on the US Treasury bond, especially long-term yields.

Diane Swonk (00:28:19):

Now, relative to the rest of the world, is the rest of the world going to ... Maybe you could have a global crisis situation where we were the epicenter of the crisis, and yet everyone bought our bonds because it was better to be here than elsewhere. We don't know. But my suspicion is that I wouldn't count on that, given how unique this situation is that it really is accompanied by inflation. Even though I see inflation cooling, it's not a Goldilocks economy. Cooling inflation, as it decelerates, as Jim and I have both laid out, over the course of the year, it still doesn't cool enough.

Diane Swonk ([00:28:53]()):

Even as it cools the level of prices, and this is what consumers get so frustrated by, the level of prices still aren't coming down. Their wages may have leveled up, but they may not level up enough to compensate for that. I think those are the issues that make it really a very treacherous time for the bond market, and that's why I'm so concerned about it. I'm an old deficit hawk. I've been humbled many times. We've done really well at financing our deficits and debt through all of this. But I'm also humble enough to know that past performance is not a good predictor of future performance.

Michael Peterson ([00:29:31]()):

Jim, in your piece, you talked about the uncharted waters that we entered last year, the significant increase in debt to GDP by 30% in just two years, how do you look at this very sharp sort of one-time rise, so to speak, in debt to GDP versus the ongoing structural deficits that you also talk about? How do you see the interaction there and your predictions?

James Poterba ([00:29:56]()):

Yeah. Well, let me start, Michael, by sort of linking back to what Diane just said because there's a very close connection between her comments about real rates and the fiscal aspects of what I have been focused on. If you look at, say, the last 20 years of US fiscal policy and the summary statistics, like the debt-to-GDP ratio for the federal government or interest as a share of GDP paid by the federal government or interest as a share of federal outlays, there are two very striking developments. One is that debt to GDP has moved up sharply, right on the eve of the financial crisis.

James Poterba ([00:30:34]()):

In 2007, debt to GDP for the US was on the order of 35 to 40%. Today, we're in the high 80s looking to 100 very soon, depending on exactly which measure you use, so a really substantial increase in debt to GDP. At the same time, interest rates have fallen so much that interest to GDP paid by the federal government has declined over this same period. I will not attempt to use a short-term crystal ball, like Diane's on monetary policy, but I'll at least give a shot with a longer-term fiscal ball and think about the long-term fiscal policies in the US.

James Poterba (00:31:16):

There, the number that I focus on is projecting out healthcare spending for Medicare and Medicaid, Social Security, and the evolution of the demography in the US, which gives us a larger older population as we go forward. There are some basic trends that look like they are very likely to play out, and those are greater demand for public spending under the existing configuration of programs we have in place and slower growth of taxes by comparison to the spending programs.

James Poterba (00:31:49):

So what that leaves us with, if you look at, say, the Congressional Budget Office's forecast starting from 2020 or 2021 and moving out, say, 30 years, what you find is that we are in a structural imbalance between spending and revenue at the federal level. So even something like the last two years when we bumped up the debt-to-GDP ratio by 25%, I mean this is clearly an unusual period. Now, we've had two very unusual things happen in the last 15 years. We had a financial crisis that looked like we hadn't seen anything like it since the Great Depression, and we had a pandemic that we hadn't seen anything like since 1918.

James Poterba (00:32:34):

As I say what I'm about to say, there's a little voice in my mind that says, "Are these really once in 100-year events?" But if we proceed as though we think these are once in 100-year events, then we've done what we did during the 100-year event, and now we're back heading toward what I'll call the more normal times as we go ahead. I am nervous that as we look at the normal times, we've got this structural imbalance which says that even if everything just goes according to average growth of the economy and the revenues and spending programs evolve as we expect them to, we will be continuing to add debt to the federal balance sheet as we go forward.

James Poterba (00:33:15):

It's hard to forecast 30 years out, for sure. But CBO's baseline case has us at around 200% debt to GDP by the time we get to something like 2050 and growing at that point, not getting there and bringing it down, but getting there and on a rapidly growing trajectory. What drives that? Well, some of it's the spending programs, the gap between the spend and the revenues. The other is, frankly, the interest assumption. This is where the link to Diane's comments becomes very important.

James Poterba ([00:33:44](#)):

If you think that we are in a very long-term period of very low interest rates, that the experience of the last year or two and the trend of the last 20 years will continue, then running up the debt balance is more manageable than otherwise. Now, I mean having an imbalance which lasts forever, for as far as the eye can see, at some point, that becomes a problem. The hard question is exactly when. So I'm not going to guess there, but I'm going to tell you that I am nervous that we're never converging.

James Poterba ([00:34:14](#)):

But the more immediate concern is that if something happens and real rates rise significantly, real interest rates rise, then the burden of having 100% debt-to-GDP ratio is significantly greater, and this is just arithmetic, than the burden of having a 40% debt-to-GDP ratio. Now, the last 15 years, we've taken on this debt. Interest rates have been our friend, and the trajectory of the interest burden has gone has gone down. But it is possible, and because we start with this initial condition now, the last couple of years having added this additional bit of debt, that we now run the risk that if an interest rate shot in the positive direction comes along, the impact on Federal finances and on the economy could be larger.

James Poterba ([00:34:59](#)):

Rough number, and I'll close with this, today with a debt-to-GDP ratio that's getting to around 100%, what that tells you is that 100 basis point increase in the interest rate on federal debt is adding something like 1% of GDP in additional federal interest outlays. Therefore, the leverage of interest rates on federal deficits becomes larger than it was in the past. That, to me, is something clearly to keep an eye on.

Michael Peterson ([00:35:27](#)):

Diane, what's your reaction to all that? How do you think about the risks of these structural deficits? I mean in terms of predicting the number of rate hikes this year, that's hard. In terms of predicting the long-term future, we've all done that. CBO's been doing that. So that's fairly certain. What do you see as the risk parameters associated with that kind of long-term path?

Diane Swonk ([00:35:47](#)):

Well, I agree with Jim on I mean what really gets ... Think about it, what he just said, 100 basis points. That's 1%. 1% off of the low rates we have has such a larger impact, four rate hikes or three rate hikes and reduction in the Fed's balance sheet. That could be here this year, easily. That has such a more disproportionate impact than when rates were, in the early 1980s, going from 18 to 19% on the short end of the market.

Diane Swonk (00:36:19):

I think that's important to keep in mind is that what appear to be low rates and small changes, a percent, it's only a percent, is actually a huge change in interest expense. That math is really important. Also, as Jim said, trying to assume there's some sense of normalcy, I think unlike Alice going through the looking glass, we don't get to wake up from this dream and be back on the other side of the looking glass. I think the world has structurally changed. We've changed it a lot, accelerated digitization, done a lot of things. But with it, we've also intensified nationalism, populism, frictions at borders.

Diane Swonk (00:36:59):

All of that tells me that there's more frictions going forward, more insular. The whole is no longer as great as the sum of the parts when the parts are broken apart more globally. Even though China is moving from ... It actually contracted, it looks like, probably in the fourth quarter and probably going to flat line this year, although they won't publish that. So China is no longer going to be the marginal consumer in the global economy that it once was, pushing up commodity prices. But we are in a world where we're seeing a lot of dissonance and a lot of frictions.

Diane Swonk (00:37:29):

I do worry that that is a world in which we don't have the same appetite for debt and that the things that Jim is talking about are going to come to fruition, and it's unsustainable. I'd also add, we spend $6 for every old person versus $1 on children in this country. We're not investing at all in our future at the time when we have just really dealt a very heavy blow to educational attainment in this country. Even though, as Jim pointed out, we've seen the mass stimulus that was not always targeted because of the holes in our safety net.

Diane Swonk (00:38:09):

We gave all these checks and overstimulated in some areas, and it wasn't well-targeted, but it did also help people pay down a lot of debt. It did help a lot of people save. Saving is much higher for higher-income households than lower-income households. The lower-income households will burn through it much quicker, and they're closer. This is the first variant we've hit without savings and so the inequalities implicit in this and the fact that you're talking about a world where you're also not investing in your young.

Diane Swonk (00:38:38):

Getting to that one issue that Jim made the point of earlier, how do we get people to participate back in the labor force? Well, first of all, we got to get to an endemic. Hopefully, we get there. But there's no guarantee there's not another pandemic right around the corner. Hope springs eternal. We hope we've learned something, that coordination is really key. When I look at these things, I think about all of the implications for inflation and all of what we've seen. It really would have helped if the world had taken the perspective that they did during the global financial crisis and, that is, we're all in this together.

Diane Swonk (00:39:12):

We're not going to, all of a sudden, raise tariffs and do all kinds of things like that and raise trade barriers. Instead, we went the other direction and everyone said, "We want to regionalize. We want to nationalize." That, to me, makes an even more tenuous future and, if we were to hit another pandemic, even less coordination. Now, I find the only hope in, and Jim's seen a lot of the research that has been published in the economic community through this crisis and what we've learned is just phenomenal.

Diane Swonk (00:39:42):

Science is amazing. All these things, of course, are evolving. Our information is not becoming knowledge because it's evolving faster than we, as human beings, are willing to leverage it. But I have hope that we will. But these are the points that Jim makes. If we do get other crises, which I think are probable given climate issues as well, that makes the situation all the worse.

Michael Peterson (00:40:07):

Jim, Diane brought up something important, which is investment. I think one of the concerns we have at the foundation is what is all this debt being used for? People will talk about interest rates. What's the interest burden? It's lower. We can handle this. But there's often very little discussion about what the capital is being used for. As you mentioned, the key drivers of our debt over the long run are basically baby boomers, retirement issues, demographics, healthcare costs, compounding interest.

Michael Peterson (00:40:35):

I mean that's where all, frankly, all of the growth in our deficits are. Is that a concern that you share, too, which is the debts being accumulated, maybe we could afford it, but it's not investing in our future?

James Poterba (00:40:48):

Yeah. That's a great question, Michael, and I'm going to link back. At the risk of sounding like Diana and I planned the back and forth here, which we didn't, but I'm going to start my answer by invoking something that Diane mentioned, which is the question of whether or not the shift in demand for capital goods and other things like that is one of the contributors to the low rates that we have seen and exactly understanding what's happening here.

James Poterba (00:41:14):

Because if you were to open a standard macroeconomics textbook and say, "What is the cost of government debt?" The standard answer would be the more debt, it crowds out other assets in the portfolio with households and other investors. As a result, it raises the interest rate in the economy. That flows through to the real side of the economy, businesses, businesses investing in plant equipment and intangibles, R&D. It raises the cost for households, of financing homes or cars or other durable goods.

James Poterba (00:41:44):

So we see a decline in the demand for these long-term assets, which are sources of productivity. The business assets are things which raise our long-term labor productivity and output in the corporate sector. On the household side, your housing assets, your fancy new dishwasher, I mean those are things which raise your productivity and home production. They all have this long-term productivity effect. We know that, at the moment, business investment has been somewhat subdued during the last few years and, at the same time, interest rates have been incredibly low.

James Poterba (00:42:20):

So if you'd gone back and said, "What would you expect at a time when interest rates are where they are today?" Leaving aside some things that don't seem to be present like, is the equity risk premium incredibly high? So is it really costly for firms to finance themselves? We'd say, given capital market conditions, there should be a race to do all kinds of investing activity, and we aren't seeing that in the way that we might expect. So the challenge right now is to put these facts together and to figure out what's going on.

James Poterba (00:42:49):

One possibility is that for a variety of things involving structural change in the economy, the business sector has moved toward businesses which are somewhat less physical capital-intensive than the business sector 25 or 30 years ago, software firms, platform industries versus making steel or building cars. The result of that is that perhaps the demand for capital investment, the demand for those assets that are financed by capital has drifted down.

James Poterba (00:43:24):

We are still struggling to understand the answer to that. But the puzzle right now, and I'm going to leave it as a puzzle because I don't think I can quite square this circle, but maybe Diane can, is what we would have expected as debt had gone up would have been increased interest rates and a decline in investment in the business sector coming from the increased interest rates. What we saw was decreased interest rates and rather depressed investment in the business sector.

James Poterba (00:43:50):

But the channel by which we would expect the first part, which is the debt, and the last part, which is the investment, to be connected doesn't quite seem to have worked the way we thought it should work. So that leaves us with a puzzle to understand here, and I don't think I've got a complete resolution for it. But that is partly why, as I think we've said in this conversation, it would be a mistake to think that we fully understand all of the dynamics in both the real and the financial side of the economy that we've experienced in not just the last two years, but the last half dozen years.

James Poterba (00:44:21):

I remember, Michael, an earlier panel hosted by the foundation at which we were talking about why were interest rates so low? I think it was Olivier Blanchard who said, "We have seven different explanations of why interest rates are so low, which means we really don't understand why they're so low." I think that is, in some sense, an important element to hear, but it does mean that the risk that we may get a bump up in interest rates for reasons that we are not expecting, I think, is somewhat greater. That motivates some of my concern on the fiscal side.

Michael Peterson (00:44:55):

Well, Olivier sort of answered your question, which is there is a disconnect, but there's many other factors that are going into the equation. So I think the concern we have is people look at the interest rate and say, "Well, it's not that big a deal. We can afford it." But as you said earlier, with the permanence of the deficits, that burden is there forever, basically, on our current path. So I think to judge it today as what the burden was, given all the factors you mentioned, is hard.

Michael Peterson (00:45:22):

But if you're thinking about the next generation, it's not at all clear that they're not going to be heavily burdened in the future with it being there permanently.

James Poterba (00:45:30):

Yeah. And if you went back and looked at the econometric evidence on the link between federal debt outstanding and interest rates, looking back, I think pre-financial crisis or maybe even updating for more later times, the number that you'd find, say, in a Congressional Budget Office report on that is that if you increase the debt-to-GDP ratio by about 10%, so you go from 80 to 90%, that that will increase the long-term borrowing rate, long-term real rate on federal debt by 25 basis points, let's say.

James Poterba (00:46:05):

So how do you translate that into numbers we can think about today? Well, that forecast would have said you add 25% to the debt-to-GDP ratio. You've just taken yourself up by something like 60 basis points or so on your long-term federal debt. Now we've added 25 basis points to the debt. We have not seen that increase in the long rates. We've seen the opposite. But as we've been talking about on this panel, that's because a lot of our other stuff's been happening in the last couple of years, and you can't really control for that very well. That's the challenge.

James Poterba (00:46:39):

Diane's given you a great list of all the things happening in the global economy and global financial markets, which make it very hard to tease this out.

Michael Peterson (00:46:47):

Okay. We have some good questions from the audience. Diane, do you want to just chime in on any of that quickly before we go to those questions?

Diane Swonk (00:46:54):

Well, I just could add one issue on that, and that is that this work-from-home environment. I think hybrid models are going to be challenged in a lot of ways as we try to ... Hopefully, Omicron speeds us more rapidly into an endemic. But what we've seen is there's been studies done on tech workers in Korea. Initially, the move to work from home boosted productivity dramatically. Part of it was because a lot of people were afraid that they would actually be fired. But a lot of their commute time was being devoted to work hours.

Diane Swonk (00:47:26):

The fatigue that we see now is starting to erode at that productivity. So even the digitization of the economy that we've seen and the move to online gets disrupted if you can't get deliveries and you don't have delivery people. This kind of disruption really changes a lot of the dynamics and further erodes at some of the things for potential growth in the US economy. Jim talked about the participation rate. You've got low labor force growth. You've got an aging demographic.

Diane Swonk (00:47:55):

But we're also eroding potential growth of the US economy, which is another factor that erodes the ability to service those debts and deficits. The CBO assumes that immigration rebounds to the levels we saw prior to about 2016 levels, and we're at about one-tenth of those levels today. Clearly, the pandemic exacerbated it, but we had a 40% decline in mostly legal immigration from 2016 to 2019 before the pandemic started and then another double digit down in 2020. Our estimates are again down.

Diane Swonk (00:48:30):

Now that we're shutting consuls again, it's backing everything up all over again in borders. So the potential growth over the longer haul that can support these debts and deficits is also diminishing. That's something that gets lost in translation as we're in a boom economy right now.

Michael Peterson (00:48:47):

All right. Well, thank you. Okay. Let me turn to some of the very good questions we have here from our audience. First question is from Megan Leonhardt for you, Diane. She's from Fortune Magazine. "Diane discussed the threat of wage growth leading to more entrenched inflation. But on the flip side, if workers only see a 3% wage growth, will that prolong the period of extreme turnover?" How do you [crosstalk 00:49:13]-

Diane Swonk (00:49:13):

Yeah. If it's only aggregate 3% wage growth, we're not going to see the same kind of worker turnover because workers are changing jobs because they're not tethered to their employers because we're all working like this. We've got people who are hired on in this environment and never met people in person. It removes some of the networking and all of the stuff that you get. All of a sudden, the only thing that matters is wages. So you get workers willing to quit. So the quit rates are high, one, in places like healthcare because I mean we've gone in that area where I saw a recent statistic on this.

Diane Swonk (00:49:53):

Before the crisis, 40% of doctors suffered PTSD, depression, suicidal thoughts. Mental health is a big problem in healthcare. Now it's 60%. You think about what we've done to these healthcare workers. So yes, you have quit rates there where people are willing to flip into other jobs and leave the profession or quit. During the Delta wave, you had people literally walking off the job in the middle of the Delta wave because they were so frustrated and overwhelmed and burnt out.

Diane Swonk (00:50:26):

The issue is you get wage-push inflation because wages are going up. It's when you get into this cycle where you're basing wages off of last year's CPI at 7% and inflation is supposed to decelerate. But all of a sudden, you're baking into it higher wages that then get into this vicious cycle of margin compression, which we've seen only in some sectors. It's interesting. In November and December's CPI data is domestic services, which are the most labor intensive. Inflation there is picking up, but not as much as wages have picked up, which is margin compression.

Diane Swonk (00:51:03):

That's exactly what you would expect to see of a wage-push inflation. So the early signs of it, where you would be most vulnerable to it, it's starting to show up. The question is, can we derail that? It's important because, of course, inflation, first of all, for me is lower than it is for, Austin Goldsby did some great work on this, is lower for someone who's a higher-income household than it is for a low-income household because I can shop online and I can get better deals. Inflation's not going to burn me as fast as it's going to burn those who have been hardest hit by the pandemic.

Michael Peterson (00:51:36):

Thank you.

James Poterba (00:51:36):

Just two other-

Michael Peterson (00:51:37):

Go ahead.

James Poterba (00:51:38):

Go ahead. Go ahead.

Michael Peterson (00:51:39):

Go ahead. Sure. Sure. If you want to add something quickly.

James Poterba (00:51:42):

On the turnover issues in the labor market, I mean I think the work-from-home environment that Diane was just talking about, one other implication is it is a lot easier to search for a job when you're working from home than when you're physically in the office-

Diane Swonk (00:51:54):

At your computer.

James Poterba (00:51:56):

When people say, "Gee, where'd Jim go this afternoon? I wonder if he's looking around for something else." That raises some questions. Whereas, if Jim's just on Zoom, nobody knows that between 2:00 and 3:30 this afternoon, Jim has an interview at another firm. The first thing you do is Jim announces on Friday that he's going to be around for two more weeks, and then he's gone. So I think that one of the unanticipated consequences of work from home is that it has provided a bit more fluidity in the labor market for some groups of workers, for your-

Diane Swonk ([00:52:24](#)):

Some groups is important.

James Poterba ([00:52:25](#)):

For some groups is important, but I think that's actually something which it may have some consequences as we go forward if we've got a lot more work from home going on.

Michael Peterson ([00:52:35](#)):

Okay, good. In the interest of time, I'm going to combine two questions, one from Zachary, which is, "Does high inflation reduce deficit to GDP, e.g., US growth after World War II inflated our way out?" And then Steven asked a somewhat related question which is, "What are the risks of increased or sustained inflation to the government in terms of COLAs and other costs?"

Michael Peterson ([00:52:57](#)):

So Jim, maybe start with you. Explain inflation as it relates to debt to GDP, but also as it relates to expenditures in the budget.

James Poterba ([00:53:06](#)):

Yeah. It's a great question. In fact, it invokes a very important piece of economic history, which is that in the decade after World War II, the US, which finished World War II with a debt-to-GDP ratio of over 100%, brought that debt-to-GDP ratio down very quickly. A significant part of the way that happened was that we essentially we inflated away the real value of a lot of the nominal debt that was held at the end of the Second World War. So that meant that the holders of that debt were paid back in dollars, which were worth a lot less than the dollars they lent the federal government during World War II. At the same time, we also were in a very rapid growth period.

James Poterba ([00:53:48](#)):

This comes back to everyone's heard the R minus G discussion, the rate of interest versus the growth rate. If you are growing quickly enough and you've got a fixed stock of debt, then that debt to GDP can actually come down as a result of the growth. The challenge with that, especially for the long-term fiscal picture that I described, is that while we do have a stock of nominal debt at the moment, going forward, a lot of the federal liabilities are actually indexed. So Social Security beneficiaries receive COLA. So if you run the higher inflation rate, you're not able to reduce the value of that Social Security.

James Poterba (00:54:23):

That component of what you're going to spend in the future is going to increase as you run at higher inflation rates. Similarly, if you think that medical care costs are going to reflect, and historically medical care costs rose faster than economy-wide inflation, that hasn't been true for a while, but it could be again. But even if you just keep up, the federal government is basically on these entitlement programs going forward has committed to a stream which is significantly indexed to inflation as well.

James Poterba (00:54:49):

So inflation can't bring down all of that long-term deficit and the structural imbalance that I described. It can help you somewhat to bring down the value in real terms of the debt that you have got. I think it's important to remember, the maturity structure of the federal debt today, weighted average maturity structure is a little bit over six years, I think. It's around six years. So the debt refinances not immediately, but before too long. So there is a limit to how much you can get.

James Poterba (00:55:21):

You have to do your inflation quickly, in some sense, to be able to get the full value because otherwise interest rates respond, markets look forward, and you don't get the action any further. But it's a very good question.

Michael Peterson (00:55:32):

Okay. Thank you. Another one from Kim for you, Diane. Kim asks about how changes in population and demographics will factor into long-term trends. So mortality from COVID, population aging, immigration, we spoke a little bit about earlier. Help explain some of these demographic and population-related trends that impact all of the things we've been discussing.

Diane Swonk (00:55:55):

Well, there's no question the pandemic sort of accelerated the aging, even though we lost a lot of souls that were older. We also, in the more recent rounds of, first of all, excess deaths globally are now on par with other pandemics when you look at what's not being counted in developing economies, like when India got slammed with the Delta variant,. Even in the US, we have pockets, particularly in communities of color that are low-wage, that there were hotspots and excess deaths that were not counted as COVID, but likely were related to the pandemic as well.

Diane Swonk (00:56:25):

You're starting to get to a place where actual fatalities are cutting into your labor force growth. But also, we have the issue of not having immigration, and immigration being absent is the primary reason that we do not have more growth in the prime age labor force. At the same time, we really have to get what Jim alluded to, the issue of participation in the labor market, which will take another setback in response to the Omicron variant. That is something I worry about in terms of we don't know how …

Diane Swonk (00:56:57):

It's a less virulent form of the virus, although it helps to be vaccinated versus not. We don't know if it has long haul with it or not. That's another debilitating factor that is hitting the prime age labor force, and particularly younger workers, that we don't know the extent of that yet. That, of course, has different implications if you can work from remotely, like this, part of the time versus if you have to be in person and exert yourself physically. I think that's important as well.

Diane Swonk (00:57:28):

The fact that it causes diabetes in children is also very worrisome. So we've really knocked our demographic. So I would love to see a surge in immigration and immigration reform. Canada is the other side of this, where they have a lot of immigration and they've been able to really deal with their demographics with a lot of immigration, even throughout the pandemic. That's pretty stunning and amazing, and we've gone the other direction. So the potential growth, if we don't see a major bounce back in participation, which is also inhibited by aging itself and, as Jim noted, retirees.

Diane Swonk (00:58:04):

Now, in November and December, the participation rate, and in October a little bit as well, of the over-65 retirees that had likely begun to ... They got boosters and they had begun to go through some of that excess savings they had, they began to come back. They were starting to come back in a pretty massive way. This sets that back again. We just don't have the demographics. We're getting hurdled into the demographics that the rest of the world has been dealing with and Japan has been dealing with. China is another extreme. It's not as extreme as that, but it is not great. That's something that I worry about.

Diane Swonk (00:58:40):

The other issue is that the composition, people don't realize that teenagers ... Whites are in the minority. Women are now out-attaining men already in Millennials in terms of educational attainment and are about 60%, 59% of current college grads. But on the new incoming classes are much, much higher in women, whether the pandemic and the move to online, much better than men did and educational attainment and that they're not participating as well. We need to be able to open avenues for them to be able to stay participating throughout their lives. That's something that I'm very, very concerned about.

Michael Peterson (00:59:21):

Okay. Thank you. Well, we're almost at time here. I just wanted to close on one thing, Jim, you said in your paper, and I would love Diane's view on this as well, is the urgency of dealing with our fiscal challenge. So in your paper, Jim, you wrote, "The higher the debt-to-GDP ratio when a program of fiscal adjustment begins, the larger the changes in taxes our spending must be to achieve a given long-term target." So just explain the math a little bit about the longer we delay, the more costly it is and, Diane, then any closing remarks you have would be great.

James Poterba (00:59:52):

Yeah. I think I can do this quickly, Michael. It's just the old adage that when you're in a hole, you should stop digging right there. The sooner we recognize this long-term fiscal imbalance and try to do something about it, the smaller the changes we'll need to make in order to get back onto a fiscal path that does not involve a continuous increase in the debt-to-GDP ratio. So when the CBO does these calculations, and I think they're very helpful and illustrative, if you're targeting getting to a debt-to-GDP ratio in 2050, that is, say, around current levels, if you started doing that adjustment in 2025, you can do it with an increase in the tax burden, relative GDP of about three percentage points.

James Poterba (01:00:36):

If you wait until 2030, you have to do it with 3.6 percentage points. If you just think of the pain of making those kind of fiscal adjustments is going to be larger, the larger the changes have to be, it's just telling you it's going to be easier if we begin to take a longer-term thing. We don't have a chance to talk today much about Social Security but, in my paper, I also do address Social Security issues. This is something where the trustees are predicting that the trust fund will run out around 2034.

James Poterba (01:01:07):

There are many levers that can be used to shore up Social Security's finances. The longer we wait, the more we're going to have to pull on whichever levers we choose to use. It just means that there's a real incentive to try to take action earlier, looking at the numbers that we face.

Michael Peterson (01:01:23):

Good. Well, thank you again. Diane, any final words or thoughts on that?

Diane Swonk (01:01:29):

I absolutely agree. Unfortunately, until we have a crisis, we don't really make decisions. Right now, we're in the situation we are because we've not been pressured to make those decisions. I don't want people to take away that that's the Fed's fault or anything else. It's just where we are right now. People don't usually, they don't realize the non-linearity of the world.

Michael Peterson (01:01:56):

Okay. Well, listen, thank you both so much for your participation today as well as in the overall initiative. I would encourage our viewers to take a look at your longer papers, which are on our website, along with the 10 other scholars that we included. It's been a terrific program. So thank you for your participation, and thanks to our audience for joining us today.