Peter G. Peterson Foundation

Economic Forum: Inflation, Interest and the National Debt

November 14, 2022

Featuring:	William C. Dudley, 10th President & CEO of the Federal Reserve Bank of New York Nela Richardson, Chief Economist, ADP
Moderated by:	Michael Peterson, CEO, Peter G. Peterson Foundation

Michael Peterson:

Good afternoon and thank you for joining us today. The Peterson Foundation Economic Forum convenes experts for in-depth conversations on America's most pressing fiscal and economic issues. Shedding light on complex problems is what the Peterson Foundation is all about. We believe that our nation's economic strength is closely tied to our fiscal outlook, and we work every day to build solutions for a solid fiscal foundation which we need for rising incomes and broad based opportunity now and in the future. The midterm elections were less than a week ago, a complex election in which many fiscal and economic issues were top of mind. So today is the perfect time to take a step back and look at the policy landscape as we head into a new Congress. To help demystify the current environment, our Expert Views Initiative asks leaders from across the political spectrum to share their ideas and insights.

We convene 12 leading experts to provide solutions to help educate Americans and guide policy makers. I encourage you to read them all at pgpf.org. I'm so pleased that two of our esteemed authors are with us today, and there's plenty to talk about. The current environment is certainly complex as we face a range of challenges including: continued economic turbulence and uncertainty, four consecutive interest rate hikes of 75 basis points, high inflation and low unemployment, real risks of a recession, significant financial market turmoil and, importantly for us, we just crossed the 31 trillion mark in national debt with another annual deficit this year of 1.4 trillion. Now that's certainly a lengthy and complex mix of critical problems for our speakers, and so we're looking forward to this discussion. Before we begin, let me remind you that we'll have some times for questions from the audience at the end. If you'd like to submit a question for our guest, please click the circular button at the bottom of your screen marked with the letter Q.

So let's get the discussion started, and here are our two guests. I'll introduce them now. Dr. Bill Dudley is currently a senior advisor to the Griswold Center for Economic Policy Studies at Princeton University and Chair of the Breton Woods Committee. From 2009 to '18, Bill was the president of the Federal Reserve Bank of New York and Vice Chairman of the Federal Open Market Committee. Prior to that, Bill served as Executive Director of the Markets Group at the New York Fed and was Chief US Economist at Goldman Sachs. Dr. Nela Richardson joined ADP as Chief Economist in November of 2020. Dr. Richardson is the co-head of the ADP Research Institute and leads economic research for ADP, an industry leading provider of HR and payroll solutions. Previously she was Principal and Investment Strategist at Edward Jones, analyzing and interpreting economic trends and financial market conditions, and she had also served as Chief Economist at Redfin and a Senior Economist for Bloomberg LP.

So thank you both for joining us today. We were trying to get Elon Musk on this call to help you out, but I hope you can all handle this on your own. So you think we can proceed without him?

Nela Richardson:

Think so.

William Dudley:

Absolutely.

Michael Peterson:

Think so. Okay, good. So we will have a new Congress in a few months here, and so why don't we start by talking about what we can expect with a new Congress. It's a little unclear still at this point what the make up of that Congress is, but it's likely to be divided government. I think that's the most likely outcome at this point. With that I think we have risk of gridlock of course, but we also have a requirement and an opportunity for bipartisanship. So Bill, let's start with you. Assuming divided government, what are your views on the prospects for new policies that will help the economy?

William Dudley:

I don't think there's going to be much prospect for major initiatives that are controversial across the parties, but you can certainly imagine things like progress on the crypto upfront where we've seen just a horrible set of events play out over the last couple weeks. Regulation there is sorely needed. Congress has begun to take this up, but I think this is going to be something that Congress will need to visit very closely over the next coming months and years.

Michael Peterson:

That's certainly a current topic. Let's just touch on it before we get into it. What do you think the solutions are on the crypto?

William Dudley:

Well, I think you need investor protections and I think you need market integrity. I think you need guardrails. I've done a lot of work on this for the Bretton Woods Committee. We have a digital finance working group which I chair with Carolyn Wilkins and our thesis is a very simple one. We think the technology of blockchain ledger has a lot of promise and we think it could be used, potentially, in a number of positive-use cases: cross-border payments, trade finance, digital identity. But we're quite skeptical about the rest of it: the cryptocurrencies, the tokens, the NFTs. I think we need to protect people because there's a lot of people who have been very trusting and are losing a lot of their fortunes.

Michael Peterson:

Okay. Dr. Richardson, how do you look at the next Congress and some of the opportunities we have there?

Nela Richardson:

Well, there's plenty of problems as you mentioned in your opening remarks. So there are plenty of opportunities for congressional and fiscal action, but it's likely that not all of them will be captured or captured efficiently. I think divided government is something stock markets tend to rally about simply because there's no change expected. And so if that is our expectation going forward, I think the most immediate concern that would require bipartisan action is the debt ceiling and a real thoughtful conversation about using this tool as a policy tool, which in my mind is dysfunctional. And I think in the minds of many is a dysfunctional tool for policy, but really how Congress can form a consensus about whether or not the debt ceiling is actually necessary given that it's really just a pay for debt not to allocate spending. So I know that's something that the Peterson Institute has had positions on and the Foundation has talked about, but I think that is the most immediate concern that could splinter a divided Congress.

Michael Peterson:

So, in your mind, what would be the right solution? Would it be to eliminate it entirely, or just have a raise in a ceiling that's a significant period of time? What would your recommendation be?

Nela Richardson:

Well, I would be on the eliminate-it-entirely camp. I mean if you really want to control spending, control spending. Don't control paying up back the spending that's already been allocated by Congress. That's what puts us in a vulnerable fiscal position. And this coming up, I mean there's always a discussion about reasonable people would agree that not raising the debt ceiling would be a fiasco globally that would reverberate around the world for years, maybe even decades. So why do it? So why even play this game of chicken every couple of years? There's just no reason for it in terms of risk management. If this was a company, not a government, the risk would be eliminated. So I would offer that as a suggestion for our fiscal counterpart is to eliminate risk when you can.

Michael Peterson:

Well Bill, what do you feel about that? I think we all understand that risking the full faith and credit of the United States is a very risky scenario and that it's totally correct that the budget has already been approved and this is just funding what has already been voted on. I will say though that getting attention around our debt problem, getting attention around fiscal sustainability, is hard. The imbalances we're facing are sustained. This is one of the few times where people actually do converse around it and sometimes begin to address it. So if it were to be eliminated, which I saw your head nodding there, how would we gain attention back the way we should on some of these systemic issues?

William Dudley:

Well, I think the problem is that the debt limit ceiling has had no success in focusing attention on controlling budget deficits. We can just see that over the last few years. So I completely agree that eliminating the debt limit ceiling makes most sense. I think we need to make the case about why the government's pockets are not unlimited, why the budget deficits are likely to expand very sharply in the coming years, both from debt service cost and from higher entitlement spending. And the money may be harder to come by than it has in recent years. So I'm actually quite nervous about the fiscal sustainability path that the US is on, but I don't think the debt limit ceiling is the way to focus attention on that particular problem.

Michael Peterson:

Understood. Well, you both wrote a lot about our current trajectory. I'll quote Dr. Richardson, in your paper you said, "High debt as a shared GDP has well documented consequences, including fiscal instability and the loss of investor confidence. It can trigger a destructive spiral of fiscal weakness, rising rates, greater dead burden, and higher inflation." So Dr. Richardson, tell us where we are on that curve right now as we head to 200% of GDP. How close are we to that type of destructive spiral? Are we in a version of that in the current environment, in your view?

Nela Richardson:

I don't think we're close to a destructive spiral in the worst case scenario as envisioned, I think there is still... In my view, I'm an optimist. You'll hear that in this next 60 minutes. In my view, there is action that can be taken to control higher and higher deficits. There is action that can be taken to, for example, increase productivity and growth. There is action that can be taken, in terms of reasonable fiscal stimulus when needed during economic downturns, that could prevent the worst case scenario. So I think we're far from the dystopian view of deficits, but, as you've mentioned, this is a time where it really needs our full attention. I'll also say that this last couple of years of fiscal spending has been illuminating in terms of the fiscal capacity to push the global economy from a severe downturn.

If you think about the money and resources that not only were put to the worst effects of the pandemic and making it better for everybody, not only in this country but around the world, it really had a dramatic impact. But if you imagine a future where there could be more volatility in the economy and in the global economy, this is not a backup for growth. Fiscal policy, fiscal spending can't be a backup for growth. It can't step in every recession and make the difference between growth and decline, but that is a risk. It was such an effective tool during the pandemic. The risk is that the next recession there will be an open invitation for more fiscal spending to guide the economy towards growth. And doing that over and over again could lead to that worst case scenario, which seems far off right now but could rapidly become a norm if spending is not handled wisely.

Michael Peterson:

Well, I think one of the risks that we try to articulate is that we learn the importance of preparedness and the ability to step in these moments. If we don't get our fiscal house in order, our ability to do that in the future could be constrained. Bill, tell us where you think we are in that process of deterioration. You talked a lot about some of the statistics that concern you and the tripling of debt and interest, et cetera. So where do you see us on our path to where this becomes more and more dangerous or a spiral?

William Dudley:

Two things that happened over recent years that make people more comfortable with budget deficits. Number one, interest rates have been very low and in they've been very low both in nominal terms and inflation gusset terms. And so a lot of very smart economists have talked about the fact that that means that the country has more fiscal capacity. And the second thing is the very low nominal interest rates have meant that debt service costs have stayed very low, even as the level of debt has tripled since 2007. Debt service costs are only up about 20, 25%. That's all going to change going forward. Short term interest rates are going to probably close to 5%, and that means debt service costs are going to pile up very, very rapidly over the next few years. Just looking at the federal reserves on balance sheet, the Federal Reserve sent over $100 billion to the US Treasury in 2021.

They're now losing money and they're probably going to lose about $100 billion in 2023. The treasury's just going to give them an IOU, but it means that for quite a while the Fed's not going to be sending money to the US Treasury. I think the combination of higher debt service cost and higher entitlement spending means, to me, that we're on a pretty bad trajectory. And the starting point isn't good at all because we're pretty close to the end of this business cycle. I mean, I don't think we're about to fall into recession tomorrow, but we're towards the end of this business cycle and we're running a budget deficit of about 5% of GDP. That's not a great place to be, so I do think that this is going to go from being a non problem to probably a pretty big problem pretty quickly.

Because once the bond market starts worrying about the budget deficit bond yields go up, that service cost climbs some more and then all of a sudden we're back where we were in the 1970s. I always remember James Carville saying that he wanted to come back as the bond market because the bond market essentially got its way in terms of forcing the Clinton administration to be very tough-minded in terms of fiscal policy. That's the last time that the budget's been a really important constraint on economic policy making, but just because it was a long time ago doesn't mean it can't return again.

Michael Peterson:

Okay. Let's turn to inflation. So there's some recent signs that inflation may be cooling. Last week the Consumer Price Index showed inflation lower than expected, rising 0.4% in October and 7.7% year over year. Still, inflation remains quite high historically. Dr. Richardson, what are your key takeaways from the report? Do you think inflation has peaked?

Nela Richardson:

Perhaps. I would like to think so, and I think there's some encouraging signs that it has or at least will soon. I think, though, that rightly a lot of attention has been placed on this inflation cycle. But I think it's really important to imagine a new world where we don't go back to lower for longer interest rates and inflation at one to two, maybe two and a half percent. I think that time period may be gone and that we've entered into a new world of inflation where those drivers that kept inflation low have lost some of their power. You think about globalization versus fragmentation, which is becoming more commonplace, supply delivery going from just-in-time supply delivery to having a more strategic approach, friend-shoring or redundancies, resiliency, all of that that is actually higher cost production and dissemination, distribution, an aging population which supposedly should be disinflationary in advanced countries.

But actually when you couple that with what Dr. Dudley said about spending on our aging workforce and aging population when it comes to Medicare and Medicaid and all those things that go with it, Social Security, it doesn't look that inflation lowering. It looks a little bit like it's pushing prices up, at least in some pockets. So, added together, inflation may be with us in a more persistent way than it has been in the past. And the last place I'd like to land on this point about the role of inflation in a new world is on housing, because that's one place where we didn't see a pullback in price increases this last October.

We actually saw inflation go up a little bit from the previous month and I don't pin that on the current cycle. I pin that on a decade long shortage of affordable housing and housing supply. So even to some of my friends in the econ space who rightly point out that housing is a lagged contributor to CPI, I would argue that this chronic undersupply of housing is actually what's making housing very sensitive to both downturn, but also what could make it an inflation booster, not just now but in the future, if this undersupply problem is not corrected.

Michael Peterson:

Okay, thank you. Bill, what are your thoughts on where we are in this and your inflation expectations for the next coming months?

William Dudley:

Well, I think the report was a good report and what's happening is that goods inflation is coming down very sharply, partly because the supply chain disruptions are abating and also because the composition of demand has shifted back towards services, away from goods, now that the pandemic is easing and not affecting behavior as much. So that's sort of the good news, the bad news is that there's still plenty of inflation pressure out there and you can see that by looking at what's happening to the median CPI that's calculated by the Cleveland Federal Reserve Bank. That's still running at 7% year over year. So I think that we still have an inflation problem. More importantly though, it's not just what's happening to the inflation numbers themselves, it's also what's happening to the labor market that's really, really critical here. If the labor market's too tight, wages are then high and those wage inflation numbers are inconsistent with 2% inflation.

It looks like wage inflation right now, depending on what number you look at, is running about 5% annual rate. That is not consistent with 2% inflation. We need to see wages in the three, three and a half percent range to be confident that we can get inflation down to 2% to stay. So my view is that inflation probably has peaked, it's probably going to come down, but it's going to be a long slow process and it's really going to require the Fed to slow the economy down and generate much smaller gains in payroll employment than we've seen. I mean the last month, 261,000 increase in payroll employment is well above what's consistent with just a stable unemployment rate. So the Federal Reserve really hasn't gotten much done yet in terms of generating more slack in the economies, which is really the primary mechanism which brings inflation down.

Nela Richardson:

And this is the real tragedy of, if I could jump in on this point...

Michael Peterson:

Sure, sure.

Nela Richardson:

... Of Fed policy targeted towards the labor market, because the whole mantra of the Fed over the last decade before the pandemic is how lower-for-longer interest rates has led to wage gains and wage growth in more disaffected communities and lowered wages in communities of color. And yet this is the very demand from labor that the policy could be targeting in order to lower inflation. When you think about where we've seen the highest wage growth, it's for low-pay jobs and when you think about where we've seen the highest gains in jobs, it's been for service sector consumer-facing jobs that were lost during the pandemic. Again, these are jobs where women are overrepresented in and minorities are overrepresented in and low income households are overrepresented in. So the tool of going through the labor market to lower inflation has specific effects on certain communities and that's really the tragedy that, for this overall macro gain, some parts in the most vulnerable parts of the labor force are going to feel the effects more than others.

Michael Peterson:

Well, let's talk a little bit about the potential for a downturn or a recession. First of all, what is the right definition, Bill, of a recession these days and how would you assess the likelihood of however you would choose to define it? I'd love to hear from both of you on this.

William Dudley:

Well, the National Bureau of Economic Research has a group of people that actually decide when a recession has actually happened and it really requires not just two negative quarters of GDP growth, but broad-based declines on economic activity and employment. That's why what we saw in the first half of the year, very small declines in the first and second quarter, were not consistent with the definition of recession because they weren't broad-based enough. You don't have 400,000 jobs a month being created and call that a recessionary outcome. So I don't think we're going to be in a recession quite yet. I think right now the economy actually has a pretty good head of steam. If you look at what's happened to the consumer spending numbers over the last couple months, I don't expect a recession in the very near term but I do think that a recession is highly likely if the Fed Reserve is actually going to be successful in bringing inflation back down to 2%.

In my mind, the Fed needs to push the unemployment rate up to probably 4.5 To 5% to be able to generate enough slack in the labor market to bring inflation back down to 2%. Well, that's a problem because every time the unemployment rate has risen by more than a half a percentage point since World War II, there's 12 examples of this, every time we've ended up in a full blown recession. The risk of recession's also high because the Fed Reserve has let the inflation genie out of the bag and now they have to tighten monetary policy enough to be confident that they can get inflation back down to 2%. That means that monetary policy will likely overstay its welcome in terms of being tight, because that's what's necessary for the Fed to be confident that they're actually going to succeed in their mission, which means the Federal Reserve will probably be late to cut rates.

The good news is that if we do have a recession, it's probably going to be pretty mild. And the good news is if we have a recession, I don't think a lot of things in the financial system are going to break like they did during the great financial crisis. And the Federal Reserve will have quite a bit of room to stimulate the economy if we actually fall into a recession. So short term interest rates, they'll have 500 basis points or more to use to cut rates. So I think the recession is really, it's all in the Fed's control. When does it happen? How long does it last and when does it end? That's going to be really mostly driven by the Fed Reserve over the next 12 to 18 months.

Michael Peterson:

Dr. Richardson, how would you choose to define it? And in particular, do you think we can achieve a short enough and mild enough recession that limits the negative impact to some of the vulnerable populations that you mentioned?

Nela Richardson:

I will go with Dr. Dudley's definition. I think that's pretty good. It's not just contraction, it has to be broad-based. And we've lost practice. We haven't had a recession, besides this big downturn, for 10 years, so it's been a while since we've experienced it. The last time we did it caused a global trigger, so it was a big one. It may not be as big going forward. I think, to me, the recession's not the biggest risk. I think it's something of having this slow growth economy that doesn't grow enough for population increases. That's what I'm most concerned, one, with and that contributes directly to productivity and the tax base. So to your question of is there a soft landing...

Michael Peterson:

You're talking about over a longer period, the slow growth, I mean you're looking at over...

Nela Richardson:

Yeah, over a longer period, not just the current cycle. Cause when we're talking about fiscal debt, right, we're not talking about next year, we're talking about the next 10 years, the next 20 years when I retire, the next 20 years. I'm really worried about that outlook and so I want to make sure that there is a labor force in place that can carry the debt burden. And I think the question, when you couple the vulnerabilities that you see in the global economy, not just the United States, but with the productivity numbers that we are seeing, these quarterly declines in year over year productivity, it is concerning not just what a recession will be in the next year, but what does growth look like in the next 10 years when you're in the midst of these productivity declines. And so I think that is a bigger concern than the cycle effects, that if there's something structural that is going on in the economy that is limiting productivity. And that feeds right back to wages, to profits, to standards of living, and ultimately to tax revenues that helps bring these debt increases down.

Michael Peterson:

Well, I guess while you're on that long term theme, and you're right, the way we look at the fiscal challenge is not over any given year but over a longer period of time on in the future, Dr. Richardson, how do you see as the threat of this growth and debt over the same period you're concerned about where there might be systemic factors in the economy leading to slower growth, but also on top of that an unchallenged growth and our debt burden and interest costs at the same time, right? Doesn't that lay a second burden on top?

Nela Richardson:

Yeah, I think so. When you think about what would drive a recession in the United States, it's not likely to come directly from the manufacturing sector as it has done in previous cycles. It may come from the service sector, for example. And I think that that has huge implications for labor, consumer-facing labor in particular. What happens when we're in this economy of labor shortages that have now been crippled by interest rates, and so companies can't grow unless they add people, but they're not going to add people for fear of recession or because of wage pressures or costs? Well, that's a limiting factor that there is a technological solution called, that many companies may invest in, AI, but then what happens to the labor force? So AI unfortunately doesn't pay taxes, that I know of. The companies do. But if you have these labor saving technologies as a replacement for some service sector jobs, and I'm talking over the long term, this is not a short-term fix, what happens to the workforce and will these technologies actually make the economy more productive and grow?

I think these are open questions and, what I argue in the essay that you gave us an opportunity to write for the Peterson Foundation is, government actually can help nudge the needle in the right direction that actually helps contain fiscal deficits, improves productivity of the workforce over the long term. And so I think the conversation about inflation and wages and labor force productivity has been a bit short term, not this conversation but the public discourse, and prolonging our days into the future would be helpful when we think about debt and deficits.

Michael Peterson:

Okay. Bill, prolong your gaze a bit for us as well. How do you see some of these trends in the coming decades and, in particular, with the fiscal and economic interactions?

William Dudley:

So the first thing I just wanted build on what Dr. Richardson said about productivity. What the money is used for matters, so if the government spends the money through transfers that's one thing. If the government spends the money to build better infrastructure, better access to broadband, things like that, that actually supports productivity growth. So I think that a good place to start for the budget would be have a better budget accounting where you actually discriminate between current spending versus capital investment, because I think capital investment is actually a good thing. And if you look at discretionary domestic spending, the share of the GDP, it's actually come down over the last couple decades. So I think that you could actually argue that the federal government has been under-investing in the nation's infrastructure, in the nation's human capital and so I think we do have to pay attention to that.

I think that the productivity issue is really important here because the faster the economy can grow, the more that taxes can be generated which can then make you able to afford your entitlement spending and to afford some of these investments. There's a number of things that we could do, obviously, to make things better. Immigration policy is another thing that we could look at. I think it's really remarkable in the United States that we have so many foreign students that come to the United States, get advanced degrees and then we tell them, get out of here. Obviously they've developed a lot of human capital and I think we should encourage them, at least some of them, to have the opportunity to stay there. They would be paying into Social Security and Medicare for 30, 40, 50 years before they retire. And this just seems an easy solution to allow the economy to grow a little bit faster and therefore be able to generate resources for the federal government.

I do think the productivity growth numbers are probably going to be pretty poor going forward, both because we're going to be spending more money, as Dr. Richardson talked about, for supply chain redundancy. Globalization, as she said, is moving in the wrong direction. We're also going to be having to spend a lot of money on something that's very, very important. We're dealing with climate change. We obviously have to do that, that's an existential problem, but the near-term return in terms of productivity growth... That's not going to show up in terms of the productivity statistic in the short run.

Michael Peterson:

Well, you talked about underinvestment in the federal government. Let me just go through a few of the interest cost statistics and I'd like to ask you about how growing interest costs affect our ability to fund investments. So about 10 trillion of the debt currently held by the public will roll over within the next two years, presumably at much higher rates. The total CBO estimate for interest costs over the next decade is 8.1 trillion. We think it's about a trillion higher than that based on some of the recent hikes, so 9 trillion versus 6 trillion or so a little more than a year ago. That's $3 billion a day in 10 years. That's about $9,400 per household by year 10. By 2052, it's 40% of all revenues going to interest costs. So Dr. Richardson, tell us what it might be like in 2032, '42 or '52 as a society and as a government having this growing interest burden while we have demands of climate, demands of future recessions, investment shortages, et cetera.

Nela Richardson:

It's a world where fiscal policy is captive to short term interest rate fluctuations, and that's a hard world to manage because you have to manage not just the fiscal part, which we all know is challenging, but how susceptible your plans fiscally are to just interest rates. And that could be a critical difference-maker in terms of growth and recessions. None of the challenges, I think... I said at the outset I was an optimist, but maybe I'm not that optimistic because I don't think any of the challenges we've seen hinted at are going away. So inflation I think is, it's persistence is a longer-term trend. Climate change is certainly a disruptive force in the world, but also in the workforce specifically. We're heading into a space where targeted fiscal policy, and I'm going to use that word specifically, targeted, is probably going to be a difference maker in terms of recession and growth.

And if that targeted fiscal policy is hampered by the servicing cost of the debt on the other side, then it's a world where we have these big problems but have fewer tools or limited power in order to get through downturns like we were so effective at doing in 2020. That world, those tools may not be available for the next pandemic and that's a scary thought. So the question is how do you reverse that trajectory to get to a point where those tools are available when needed? And I know Dr. Dudley had laid out some suggestions in his essay, but they boil down to being very targeted in your selection of tools. Not every nail needs a hammer or... I'm not even going to go there. I'm terrible at construction, but we have to figure out a broader toolbox so that we don't have to use these big spending tools to solve problems in the short term that could be with us for a really long time.

Michael Peterson:

Well, before we get to solutions Bill, do you think this growing interest burden will have the hampering effects that Dr. Richardson is mentioning here?

William Dudley:

Yeah, eventually. I mean what will happen is bond investors will start to worry about debt brinking so big that the central bank will be forced to inflate away the debt and once bond market investors start to worry about that, interest rates will be higher and that will just feed into even higher debt service costs. One thing that I think we should do is think also about strengthening the automatic fiscal stabilizers. It seems to me if you actually knew that there was automatic fiscal support coming when a downturn was occurring, that would be reassuring to businesses and households and that would cause them to cut back by less. And as a result of that, the recessions wouldn't be as severe and people would be less concerned about their ability to sustain their households, feed their kids, pay their heating bills.

So I think having automatic fiscal stablers in place much more powerful than the ones we have today would be very useful. This is something that we do very differently than Europe. Europe has a lot more fiscal support for their citizens when they get into economic difficulty and I think it helps them. It helps keep people better attached to the labor force. Heat causes a lot more stress. So I think doing something about the automatic fiscal stabilizer to make them more automatic I think would be a really good way forward.

Michael Peterson:

Well let's get it as a solution. So that was one of them, you had a few others. Can you mention two or three others that you think are your top priorities as you outline in your paper?

William Dudley:

I think need to get the entitlement spending on a sustainable trajectory. We're already having these conversations about Social Security running out of money and that's a scary proposition to most voters because they don't really realize that running out of money doesn't mean that Social Security just goes away, it just means that the government doesn't have enough money to pay the full value of the Social Security benefits that they promised. Also, the earlier you make adjustments to Social Security, the smaller the adjustments have to be. And I really do think Social Security is actually relatively easy to fix because there's a number of different changes you could make. But getting that done sooner rather than later I think would be a really important thing as people are looking out towards their retirement and are wondering what's going to happen on this very key point.

Michael Peterson:

Well let's just stay on that for a minute and then I'll come to you, Dr. Richardson. With divided government coming, likely, and the debt ceiling coming, until you guys are able to get rid of it, do you think there's a possibility of some sort of Social Security reform along the lines you mentioned whereby some lawmakers who are concerned about debt and deficits could use that as a reason to feel okay about another debt ceiling increase? I know you don't prefer that they get linked, but for the moment they are linked.

William Dudley:

I would be very surprised if we see anything on the Social Security front in near term, partly because the Congress is so divided. Some of the Republican leadership has actually talked about revisiting Social Security as a program every five years. So I don't see that there's a consensus across the aisles in Washington to do something about fixing Social Security. And you know how it works in Washington. Things get deferred, if they're difficult, until they can't be deferred anymore. Decades ago we had the Greenspan Commission that actually did push back the timing of Social Security running out of money by several decades. It'd be nice if we could do that again, but I'll be very surprised if we see anything coming out of Congress on that front any time soon. It's a very good idea, something we should do, but unfortunately I don't think that's going to happen in the near term.

Michael Peterson:

Dr. Richardson, what do you think? I'd like to talk about some of your other solutions, but while we're on the Social Security challenge, don't you think it's a concern that 12 years from now there'll be a deep decrease in the benefit payout unless it's addressed and do you see any prospects for that in the near term?

Nela Richardson:

Not in the near term, no. And it is a huge problem. It's a problem right now without enough conversation, let alone solution building. 12 years is not that far away. A decade from now is not that far away when you think about how we are going to have to support an increasingly older population with a workforce where the average workforce participation level has still not recovered from the pandemic. We've had this trend of prime-age workers leaving the labor market. We have a slowdown in immigration. So what is the mechanism by which this increased fiscal burden is actually going, whose backs is it going to fall on increasingly? And I think that's a big question because if we're not adding to the total employment headcount, people who are working are going to be paying a bigger share of that eventual fiscal burden.

And that's a huge concern in terms of motivating and incentivizing work. If you're paying more in taxes to fund Social Security where you may not have access to yourself, it does change the incentive structure around providing work into the economy. The last point I'll make on this is we've seen this happen in real time, how incentive structures around work changed so dramatically during the pandemic when people left, stayed on the sidelines and were slow to return back to work. That could happen again or that could be made more permanent if the tax burden on households and on work actually increase to pay for a greater allocation to Social Security and other entitlement programs.

Michael Peterson:

Are you referring to some of the payments that were made during the pandemic that essentially...

Nela Richardson:

Some of that. The pandemic is a strange combination of people shock, reflection. There's a lot of psychology, there's a lot of behavioral economics. I mean you could throw every social science discipline into studying why people made the choices that they did, maybe a few of the biological sciences as well. So I don't want to pinpoint just direct payments to households as the reason why people changed their propensity to work. There was also a lot of household decision making around childcare for example, or taking care of parents that limited decision making in terms of providing that work. But we have seen that there's stickiness to these decisions and once people decide to leave the labor force, even when jobs are plentiful and wages are high, it is sometimes slow to get them to come back. And so you add to that any kind of tax increases that lowers those incentives in the future, I think you have a real problem in terms of workforce productivity and just overall workforce numbers given the environment that we are leaning and entering into.

Michael Peterson:

Okay. Bill, I wanted to ask you about one of your recommendations. You actually mentioned it earlier about distinguishing between current expenditures, capital expenditures and transfer payments. Why do you think that's important and what are you hoping to teach people with the accounting that you recommend?

William Dudley:

Where the money goes matters, so if I'm spending on things that raise productivity growth I'm going to actually have faster economic growth than I'm going to get tax revenue from it. That's very different than if I spend money on transfers. I mean think of, for example, the Biden administration infrastructure bill. To the extent that allows you to build things that increase the productive capacity of the economy, economy grows faster, tax base is larger, it can basically pay for itself.

Transfer payments are not going to pay for themselves by definition. So I think the budgetary accounting needs to be more aware of the difference between consumption and investment. And I think spending a little, making it so that what the government spends the money on is more tilted towards investment, would be a good thing. Research and development is another example where the federal government provides a lot of the dollars that fund pure research in the United States and that pure research is what essentially supplies the raw material that leads to some of these ideas eventually making their way into new products and services. So this is something that we don't want to shortchange the country on just because we're running large fiscal deficits. So I think making that distinction I think is very, very important going forward.

Michael Peterson:

This ties into one of your recommendations, Dr. Richardson, about using technology to boost productivity and the role that fiscal policy can play in stimulating these types of investments. So talk a little bit about what you were hoping to achieve with your recommendation around technology, artificial intelligence, et cetera.

Nela Richardson:

Yeah, it's a strange paradox, isn't it? We're seeing more and more AI adoption at a time where productivity numbers have started to decline. By productivity, I mean labor force productivity. So how do you marry the two? How do you have an economy built on technological advancement? Because we all know that that does lead to growth but also leads to higher worker productivity, which leads to higher wage growth but real wage growth, not growth that we've seen over the last two years, or the last year at least, of wages going up because of labor shortages. We want wages to go up, but for productivity increases not just because it's hard to find people in the current economic environment. And so here I think is where governments can actually work with the corporate sector and guide corporate investments in technology, not merely to be labor saving.

There is a huge incentive for companies to invest in labor-saving technology so they don't have to be ever caught again in this worker shortage scenario, but labor enhancing scenario so that we actually invest in AI to do the work that humans can't do, as opposed to investing in AI to do the work that replaces humans. There are some things that humans are really good at and we want them to get better at it. And making those investments are important.

Also, ADP pays one in six workers in the United States so we have a lot of information on jobs and employment and wages. And what's clear to us is that there are sectors of this economy where workers are just simply aging out of. There are not enough vocational workers. There are not enough accountants. There are not enough construction workers to build residential housing. And so here's another place where skill development, partnering with community colleges to fill in these gaps so that young people do want to be airline pilots, so we're not all sitting on crowded flights and waiting two hours for a canceled flight, that we do have enough crew members for that flight there.

There's a whole spectrum of jobs I could bore you with where we need young people to go into these jobs. We've seen, on top of these problems, men who are going into universities, that number has been dwindling. Men who are graduating our public universities, that number is also dwindling. So how do we reengage the male workforce to do some of these jobs that are so needed? The reason why these investments are important into labor when it comes to fiscal debt is this is what grows us out of some of the debt problems that we have. But I think that productivity is really the fly in the ointment of the labor market. As tight as it is, it is not productive enough to get the sustained growth that is needed to meet the fiscal challenge. And so here's where investment makes sense to plug in these holes in our labor force that lead to real growth.

Michael Peterson:

Thank you. Okay, we've got about 10 minutes left. I want to turn to some of the questions from our audience. Paul is asking about inflation with respect to the global economy. Other countries are experiencing high inflation as well. How can the Fed maximize policies to address global versus domestic concerns and cross currents? So Bill, you want to take that one or both of you even?

William Dudley:

Well, what the Fed is doing is putting a lot of strain on the rest of the world because what's happening is the dollar is appreciating against most foreign currencies. And as those foreign currencies depreciate, that's causing more inflation in those countries because it's driving up the cost of import prices. But the Fed is not going to do anything about this. The Fed's mandate on monetary policy is a domestic mandate. It's about maximizing US employment. And as long as the Fed is achieving price stability...

Right now, they're doing pretty well on maximizing employment, not so well on the price stability angle. And that's why they're tightening monetary policy. That's why the dollar is going up in value and that's putting a lot pressure. But at the end of the day, the only thing that Fed can say is, "We're really sorry that we're doing this," because that's not something that's going to deter them from their decision making. So it's unfortunate that the Fed was so late, it would've been better if the Fed had tightened in a more timely way. Because they were late, they had to go very, very aggressively and that's putting a lot of scrutiny on [inaudible 00:49:38].

Nela Richardson:

The only thing I would add to that comment is the power of ounce of prevention. It's worth that pound of cure. And so the most responsible thing, I think a globally important central bank, but definitely the Fed can do is prevent inflation from peaking up this high in the first place. And I know that goes without said, but the ramifications are not just domestic, it's really about global growth too.

Michael Peterson:

Well that certainly applies to fiscal as well. This person, Michael, is asking about entitlements. He says "Medicare is bankrupt in 2028 and Social Security in 2034. What solutions can be put in place to shore them up?" So maybe start with you, Dr. Richardson, what do you think the top ways are to introduce some stability into these critically important programs?

Nela Richardson:

If I had the answer to that question, I would run for... No, I wouldn't run for Congress, I am just joking. But I wish I did, I wish I did have the answer to that question, so I'm going to have to defer that cause I don't know. I don't know how you do it other than some of the solutions that we've talked about already in terms of growth and productivity and automatic stabilizers, obviously getting spending in check. But I'm open as anyone to actual solutions to this issue.

William Dudley:

So on Social Security, I think it's pretty easy to fix in the sense that you have a lot of dials that you can turn, you can raise the income cap on Social Security payments, you can reduce benefits for high income workers, you can extend the retirement age a bit further. Medicare, though, is much more difficult because Medicare is already paying hospitals and doctors less than what they're getting from the private reimbursements and so if you really try to reduce the payments for Medicare to healthcare providers, you're going to actually reduce the level of service. You'll have doctors opting out of taking Medicare patients. So I think fixing Medicare is much more difficult because people have an expectation that this is the basket of healthcare services that I need and they're becoming more expensive over time. Healthcare costs typically rise faster than the overall rate of inflation, and that's a problem in terms of the Medicare sustainability. So I think of the two, Medicare is much more difficult to fix than Social Security.

Nela Richardson:

There is, by the federal government, the measurements committee, there are different inflation rates that people pay, right? For older populations, their inflationary basket looks a lot different than for millennials and Gen Z. And so even though we talk about inflation with one number, there's actually different numbers for different people and that definitely feeds into your question about entitlement spending because that's going to... If you're already paying a sizeable household inflation rate, adding this constraint of working longer, lower payments is really burdensome to the people who are affected. So there's no easy solution, I think, on this one, just by targeting the spending in these or the rules in these programs. It's really about, in my view, domestic growth.

Michael Peterson:

Well, we talked about these issues. Both of you did not expect any action in the near term. We have one person here asking, if not now, then what will it take for action on entitlements? What type of event has to occur? Do we have to wait until the day before insolvency? Can you see anything that would trigger some action in Washington to stabilize these programs?

William Dudley:

Well, I'd like to think we get action sooner rather than later because sooner you act, the unless you have to do actually put the Social Security on a sustainable footing. But, like Dr. Richardson, I just don't see any appetite to take that on in the current very polarized situation. So the way I think a fiscal policy works in the United States is, it's very attractive to use aggressively when the interest rates are low. But at some point markets start to block, bond yields rise, the dollar weakens, all of a sudden the burden of the deficits becomes a lot larger and then that's when people realize that they have to act.

The Clinton administration's the best example of that. When they came in, I don't think they thought that deficit reduction was going to be the first thing that they were going to have to tackle. But if you remember that they did tackle it and they tackled it quite well. In fact, the deficits turned to surpluses for a very short period of time. And I remember at one time in the late 1990s, people were talking about, "Boy, what are we going to do when we've paid off all the treasure debt?" I mean it's sort of a fantasy conversation when you think about it today. But it does show you that when the markets start to become demanding, that's typically what generates action. So I'm expecting nothing to happen until the markets block and when the markets block, then that will force action.

Michael Peterson:

Okay, we've got some questions here back on inflation. We have just a few more minutes. Given the fiscal and macroeconomic picture, should the Fed reconsider its 2% inflation target, should it change it to, for example, 3%? How do you both feel about that target rate at this point?

Nela Richardson:

I think that you can't move the goalpost while you're still playing the game. It's about, for the Fed, credibility and saying mission accomplished at 3% is no mission accomplished, it's just giving up the mission. So, at this time, I don't think lowering the target makes sense. Perhaps once the target is reached, a reconsideration of the target is open to fed policy makers and discussion, but not before they actually reach it, which makes the job harder, it puts them in a really difficult situation. I understand.

William Dudley:

I agree with that. I mean, it would not be credibility enhancing. So that would not be good for interest rates and the government's funding cost. So it would be a very bad idea to do at a time when you're not actually able to achieve your 2% objective. The other thing I think is important to recognize is the Fed takes its marching orders from Congress. Congress sets the mandate, maximum unemployment subject to price stability. And the Fed has stretched that definition of price stability a little bit by saying, okay, 2% inflation. That's pretty close to price stability. But I think taking that price stability mandate and stretching it even further to 3% inflation, I think might be a bridge too far from the Federal Reserve's perspective.

Also, the whole idea of raising the inflation target is really about making sure that there's enough room for the Federal Reserve to reduce interest rates when you have an economic downturn to get the economy out of recession, to not be in a Japanese style situation where interest rates are pinned at zero and inflation expectations are falling below 2%, but that risk may be abating. The Fed's going to end this cycle probably with the short term rates peaking at 5% or higher, which means the Fed actually has plenty of ammunition to respond to economic weakness when that time arises. So this fear of being trapped at the zero lower bound may abate. We may find out that the last two cycles are not illustrative of the future, and if that's the case then the need to potentially raise the inflation target to have more room for the Fed to ease when you face recession, that need won't be as great.

Michael Peterson:

Okay. Well let me close with one last question about the next generation. I think one of the concerns we have about our growing debt is the burden that's placed on them. You both talked about the future of a rising interest burden. And Bill, you talked about the fact that a lot of the debt is not being used for investment in the future and things that may benefit them, like capital expenditures, infrastructure, education, spending and so forth.

The vast majority, as you mentioned, discretionary has kind of been on a downward path. About a hundred percent of the increases in the coming years are for entitlements. So this burden is going to fall on them. So the question is, how do we bring young people into this conversation? How do we get them active and engaged in some of these economic issues that they may not be feeling yet, might not feel for a while in terms of this burden? But as you said several times today, the earlier we get at it, the better.

And we actively try to engage this group. A lot of times they're focused on other things in their current lives. So how should we get the young people engaged on this and do you agree it's a generational question for them?

William Dudley:

Absolutely generational question. The burden on them from a tax perspective is going to be quite a bit higher than the burden was on me through the same level of economic benefit. I think the problem though is that as long as there's no problem, no sign, no signal from financial markets, it's going to be very hard to convince people this is a real problem. So I think you want to basically continue to make the case because your credibility is going to go up over time, because this eventually will be a big problem. And when it is a problem, then you'll have the credibility to make the case of how we need to address it. But unfortunately, I think it's going to be hard to convince young people today that this is a huge problem. Now, if you think about young peoples' concerns right now, I would say climate change, gun control, women's rights are probably higher up the list than fiscal sustainability, even though fiscal sustainability is also going to be very, very important to them.

Michael Peterson:

Well, and it interacts with all the issues you mentioned too, right? Dr. Richardson...

Nela Richardson:

I agree with that...

Michael Peterson:

... We can close with any thought you have on this.

Nela Richardson:

Well, I think ending with young people is an optimistic way to end because they maybe have some more open-minded solutions that could be good for the future. But I think getting them involved through the things that they care about, because that ultimately... You'll need a fiscal partner to achieve those things. It's important to have a fiscal partner that is well equipped for the problems of their generation, like climate change. And so tying those issues together is more important. And then the thing that we didn't hit on that I'm quite concerned about is borrowing costs writ large for younger people starting out their lives.

That means buying a house, for example. And we've seen mortgage rates skyrocket as an effect of higher interest rates, short term interest rates. There are young people who've never seen, until this year, 30 year mortgage rate above 5% and now it's close to seven, it may be over seven. So we've seen a huge ramp up in borrowing costs and so getting that kind of containment on their household decision-making level and relating that to having containment on the fiscal side, relating the debt burdens that we're seeing appear to their own personal experience is a way to get a new generation that's concerned not just about spending through our problems, but saving through them as well.

Michael Peterson:

Okay. Well, terrific. I want to thank you both for your participation, not only today in the economic forum but also in our economic view initiatives with your excellent papers. We really appreciate your involvement today and all your words of wisdom for the future. And to our audience, thank you for attending and we'll see you next time on the Economic Forum. Thank you for attending today, both of you.

William Dudley:

Thank you.

Nela Richardson:

Thank you.