The Current Outlook for the Economy

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Dr. Rivlin laid out some ideas on how to put the US' budgetary affairs on a sounder basis, as well as risks to our doing so. Her remarks came in the context of unflattering federal brinksmanship in late 2012 to avoid the so-called *fiscal cliff*. According to Dr. Rivlin, self-inflicted wounds (e.g. housing bubbles, inscrutable derivative investment instruments) and bad policy (e.g. automatic triggers for indiscriminant spending cuts and mindless austerity) are always possible.

Despite poor economic governance at the federal level, Dr. Rivlin pointed out that the real economy is in relatively good shape.

- This is due to recovery in the housing sector, better state and local government balance sheets, lots of bank and business cash on the sidelines ready for investment, improving energy supplies, and enduring American traits (e.g. innovativeness).

These advantages are likely to serve the economy well over the next couple of years (unless derailed by policy).

For Rivlin, the country's overwhelming economic problem is unsustainable federal borrowing to service an accumulating national debt (now equal to approximately 70% of GDP). Dr. Rivlin pointed out that the debt problem is driven by demographics – namely an *avalanche of seniors* leaving the workforce and starting expensive entitlement programs (e.g. Medicare, Medicaid, and Social Security).

- Driven by entitlements, without policy change, government spending will rise faster than GDP and tax revenues for decades to come.

As for entitlement reform, the task is to reduce the rate of growth in benefits. Such adjustments would still leave a spending-revenue gap, implicating further tax reform. The features of such reform would be to create a more efficient and fair tax code, and a broader tax base.

Dr. Rivlin encouraged new thinking in entitlement reform. For example, rather than start with health care, start with Social Security. Restructuring Social Security is conceptually easy, there are few moving parts, and it would not be politically contentious (incrementally phasing in over a long period of time).

Dr. Rivlin stated that a negative scenario going forward would be a series of fiscal cliff spats. To date, investors – both domestic and foreign – have been willing to hold

US debt (e.g. Treasury bonds) because they expect US political leaders to get their act together. If it becomes clearer that US leaders could not compromise and solve problems in a responsible way – with the risk of sovereign default growing – then investors might well have a change of heart. In such an instance it would take much higher rates of return to entice investors to lend us money, with higher interest rates generally almost sure to throw the US economy into a downturn.

How can the US avoid this negative scenario, and instead impel a more reasoned *grand bargain* (i.e. meaningful spending controls and revenue increases)? Dr. Rivlin said that it would take popular pressure. Leaders need to hear from the public that gridlock is no longer acceptable, presumably with recalcitrant policymakers susceptible to punishment at the polls.

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