Remarks of Jacob J. Lew

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It is a pleasure to participate in this second annual conference on public pensions and sovereign funds. Thanks to Taka Ito for convening this important discussion. As we approach the end of the first quarter of 2018, there are many challenges in terms of navigating macroeconomic trends this year. I will offer my sense of US and global trends, and focus in particular on the impact US fiscal and monetary policy is likely to have on macro conditions.

The situation today is different than even a year ago, and very much changed from the post crisis years. For the first time since the great recession, we see broadly sustained growth across major economies – from the US to Europe and Asia, and from developed to developing economies. US employment reports show more than seventy-five consecutive months of jobs growth – a record. Europe is showing signs of organic growth that are not just a response to lower energy prices and expansive monetary policies. Japan's short-term growth has been above expected levels, and China continues to maintain more sustainable growth rates. This base case of current conditions is an encouraging picture.

At the same time, for some time markets brushed off an unusual proliferation of significant political risks, from heightened concern about nuclear conflict to major power trade wars, and concerns that an economic bubble could burst in China. Around the world, populist candidates of right and left are showing strength, along with support for nationalism over globalization. Risks with the capacity to undermine economic and geopolitical stability, even if unlikely, normally produce some anxious volatility in markets. But until recently, markets were absorbing an unusual degree of uncertainty and risk as a new state of normal, and volatility was remarkably low.

In recent weeks we have seen a return of volatility. A number of monetary authorities are increasingly inclined to raise interest rates from near or below zero levels and to exit gradually from policies of quantitative easing. But this, on its own, should not be a big surprise. Many have been signaling for some time that they were prepared to move as economic data showed sustained strength. So why did a few nascent signs of price increases lead to an outsized reaction in recent weeks?

Here in the United States, it comes at a moment when expansive fiscal policies – deficit financed tax and spending measures – are making the difficult job facing monetary authorities even more complicated. Tax cuts enacted at the end of last year will add at least $1.5 trillion of debt over the coming decade, and if one makes the reasonable assumption that some of the provisions that were time limited to keep the cost down are extended, that cost rises substantially. And a few months ago Congress passed a two-year budget agreement that added several hundred billion dollars of additional deficits on top of the tax bill. The end result is that we are now looking at the US deficit rising from roughly 3 percent of GDP to nearly 6 percent of GDP and growing, at a time of peacetime full employment and economic growth.

This is unprecedented. We have seen rapid increases in deficits and debt during times of war and recession, but in the US it is hard to find comparable trends during peacetime growth. In a recent analysis, Goldman Sachs looked internationally for comparable trends, and points to three examples: Belgium in the late 1970s, Italy between 1983-1990 and Japan between 1994-

1997. In Belgium the debt continued to rise for nearly fifteen years; in Italy the debt to GDP doubled from 5 to 10 percent; and in Japan, while the debt service costs remained manageable because of high domestic savings, the debt to GDP ratio continued to grow for decades and remains above 200 percent of GDP.

Four points about what this means in terms of the US.

First, it will delay the ability to address long term demographic challenges. At the start of 2017 the US was in primary balance and projected to remain close to primary balance for most of a decade. That could have presented an opportunity to build a bipartisan consensus to address both spending and revenue issues to deal with long term projections of rising deficits beyond the next decade. In the post-tax cut environment, there is no talk of such an effort, and any steps to reduce the deficit would be seen as paying for the tax cut, which will make it far more difficult to bring both parties together.

Second, the cost of interest as a percentage of the budget will be growing rapidly, from roughly 1.5 percent of GDP to 3.5 percent in five years. At a time when spending is roughly 21 percent of GDP and revenues roughly 17 percent – this will both drive up deficits and create enormous pressure as tradeoffs are made between other tax and spending decisions.

Third, there is little chance of any near term action on fiscal challenges. No one is talking about a tax increase, the White House understands how unpopular it would be to reduce either social security or Medicare, and Democrats see avoiding these kinds of cuts as a core mission. Any realistic political forecast would have to conclude that no serious action to reduce the deficit and buildup of debt is likely in the next few years.

This means that the US debt as a percent of GDP is now likely to exceed 100 percent of GDP in just a few years, and it will rise from there as the full demographic pressure of baby boom retirement hits. The fiscal challenges that only a year ago were a decade off are now almost immediate.

And fourth, we have little ammunition left for our fiscal cannons in the event the economy turns down and really needs stimulus. At a time when monetary tools have been so heavily used, and monetary authorities worry about restoring the ability to use interest rates and quantitative easing in the future, it would have been wise for fiscal policy makers to similarly look to the future to restore the capacity to act in a timely way should there be an economic downturn. When the Fed wanted more help in the form of fiscal stimulus in the early days of the recovery, Congress did the opposite – reducing short term spending while ignoring the need for long term action. Today, when the economy is at full employment, loose fiscal policy only makes the job of the monetary policy makers more complicated.

And this brings us back to the challenge facing the Fed – with fiscal stimulus now promising to accelerate short term pressure on prices, and the deep concern that inflation not pick up a head of steam, it is more likely that interest rate increases will come sooner than may have otherwise been expected. Speculation on the number of rate increases and ultimate end point have both grown in recent weeks, with many forecasters now predicting four or five rate increases this year, instead of three, and a likelihood that rates will be in the mid-3's far sooner than previously expected.

For those in this room who manage large sovereign and pension funds, the prospect of rates getting closer to 4 percent risk free returns may help to regain more acceptable yields at lower levels of risk than you have taken on in recent years. But the prospect of higher rates also means that the economic benefit of the stimulus is likely to be time limited, and growth will revert to lower levels after a brief period of stimulus induced accelerated growth. There is always a risk that efforts by monetary authorities to hit the perfect balance will miss the mark. Tightening monetary policy just fast enough to avoid inflation, without slowing down the economy prematurely is as much art as science. But the introduction of stimulus right now increases the risk of overshooting and possibly bringing a long period of growth to an end.

It will come as no surprise that I think this fiscal policy is misguided, and I fear that it will increase economic risk, and worsen income inequality problems we already face. You can already see in the Administration's proposed budget that cuts in food assistance and medical care for the poor are being offered as an antidote to rising deficits. After an election that brought out populist voters in both parties, it is ironic that sixteen months later we have reduced taxes for the most fortunate, and the only solution offered to pay for them now is to increase the burdens on the least fortunate. As the reality of these policies settles in, it will only fuel populist appeals in the future, and that will make it even harder to return to the sensible center where bipartisan solutions can be found.

Funding long term entitlements is indeed a challenge, but from the perspective of the US government, it is important to note that our social security system is largely funded on a pay as you go basis: current payroll tax revenues will continue to fund roughly 75 percent of social security benefits going forward, even if there were no reserves in the social security trust fund. The fact that there will be revenue shortfalls to meet other public needs is a reflection of the decline in revenue as a percentage of GDP because of tax cuts over the years. The solution to meeting our general revenue challenge is not to cut social security and redirect revenue elsewhere, it is to recognize that 17 percent of GDP in revenues cannot support a public program that costs over 20 percent of GDP over time.

With the social security trust fund, old age and survivor benefits are still full funded for roughly two more decades, which allows some time to address the issues of solvency going forward beyond the mid 2030s. Since all of the solutions that could muster broad support require time for implementation, it is unfortunate that the current climate is unlikely to permit a serious discussion for some time.

Some view the trust fund with skepticism because it is totally invested in special US treasury bonds, and therefore the ability to draw on the trust fund is subject to the ongoing ability of the government to finance current operations, which circles back to the broader fiscal challenge. While general revenues are indeed needed to pay back the special treasury bonds held by the trust fund, it is unthinkable for those bonds to go into default, and there would be a political and financial firestorm were they to be treated as any less of an obligation than other treasury bonds. But is also the case that unless the overall fiscal picture improves, paying those bonds will require additional borrowing by the general fund, new taxes or massive reductions in other spending that would be both unwise and unpopular. Yet more evidence that the current fiscal policy is both irresponsible and dangerous.

The direction of interest rates for US treasuries is likely to be higher. General conditions are leading to a tightening of interest rates, and increased need to go to the market, even in the deepest and most liquid market in the world, will drive rates up. I see no evidence that the appetite for risk free US treasuries will diminish greatly, but expect that government borrowing costs will rise significantly as the amount of debt issued rises, and as older debt with longer maturities and low rates is replaced in a higher interest rate environment. The first wave of higher costs will be associated with new debt requirements, and it will take a while for the cost of servicing legacy debt to go up.

I think the lesson for fund managers is simple: stick to the fundamentals. After a long period of bull markets, this is not a time to place excessive confidence on general equity market growth; it is a time when steady increases in interest rates should improve low risk yields somewhat – though there is substantial reason to believe that the new normal for interest rates will be below rather than above recent historic levels, and it underscores the need to focus on fundamental value in alternative private equity investments, whether in businesses or public private partnerships.