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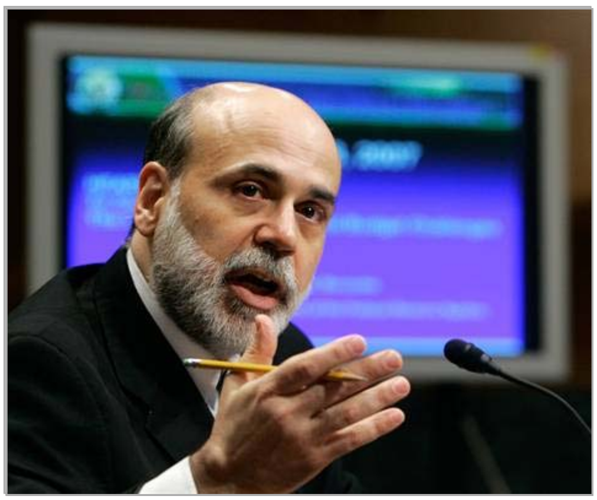
Bernanke warns of 'vicious cycle' in deficits

Wave of retiring boomers will put growing strain on budget, Fed chief says



Manuel Balce Ceneta / AP
Federal Reserve Board Chairman Ben Bernanke testified Thursday before the Senate Budget Committee

Associated Press

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WASHINGTON— Federal Reserve Chairman Ben Bernanke warned Congress Thursday that the economy could be gravely hurt if Social Security and Medicare aren't revamped and urged lawmakers to tackle the nation's thorny fiscal issues sooner rather than later.

"If early and meaningful action is not taken, the U.S. economy could be seriously weakened," Bernanke said in testimony to the Senate Budget Committee.

It marked the Fed chief's most forceful warning to date on the potential problems facing the United States with the looming retirement of 78 million baby boomers, the oldest of whom will start retiring next year.

This huge wave of retirees will hit the U.S. budget as well as the economy, he said.

"The longer we wait, the more severe, the more draconian, the more difficult the objectives are going to be. I think the right time to start was about 10 years ago," he told lawmakers when questioned about the urgency of the situation.

Absent policy changes by Congress and the White House, rising budget deficits are likely in the years ahead to increase the amount of federal debt outstanding to unprecedented levels, Bernanke said.

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That could propel interest rates for consumers and businesses upward, which would be a worrisome development, he said.

"Thus a vicious cycle may develop in which large deficits lead to rapid growth in debt and interest payments, which in turn adds to subsequent deficits," he said. Ultimately, a big expansion of the nation's debt "would spark a fiscal crisis, which could be addressed only by very sharp spending cuts or tax increases or both," Bernanke warned.

The budget deficit last year totaled $248 billion, a four-year low. Bernanke noted the improvement but likened it to a "calm before the storm."

Spending on entitlement programs will begin to climb quickly during the next decade, he said. Federal spending for Social Security, Medicare and Medicaid will total about 15 percent of the gross domestic product by 2030, compared to roughly 8½ percent of GDP in 2006, he said.

Forecasts call for the deficit to worsen for the 2007 budget year. The Congressional Budget Office is projecting $286 billion in red ink, while the White House is predicting an even bigger shortfall of $339 billion.

Bernanke said that economic growth alone is unlikely to solve the nation's impending fiscal problems.

Fixing the problems, he said, will take the White House to make difficult choices. It will be up to those policymakers to find the right balance between taxes and spending, he said.

The Fed chief steered away from offering specific solutions.

"In the end, the fundamental decision that Congress, the administration and the American people must confront is how large a share of the nation's economic resources to devote to federal government programs, including transfer programs such as Social Security, Medicare and Medicaid," he said.

President Bush wants to work on the looming insolvency of the Social Security program. But his one-time plan to add private accounts to the system, once the centerpiece of his second-term agenda, withered in 2005 after meeting resistance from Democrats and Republicans alike. Bush has tapped Treasury

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Secretary Henry Paulson to gather ideas on how to restructure the program.

Bush wants to work with Congress on a plan to balance the budget in five years. To help bring that about, he will again delay his plan to add private accounts to Social Security.

Now that Democrats are in charge on Capitol Hill, private accounts are a nonstarter, though Bush will mention them in his budget plan rather than abandon them entirely.

In his testimony, Bernanke did not discuss the future course of interest rates. Many economists believe the Fed will hold rates steady when it meets Jan. 30-31. The central bank has left rates alone since August, when it paused a two-year rate-raising campaign to fend off inflation.

The economy has enjoyed a “pretty good run” in terms of economic growth and productivity gains, he observed.

During questioning by lawmakers during the nearly two-hour hearing, Bernanke said that the “general view is tax cuts don’t pay for themselves” and their economic impact hinges largely on the nature of the tax cut.

When asked about streamlining the complex tax code, Bernanke said the current code is “very burdensome,” saying the average taxpayer spends 27 hours doing his taxes.

The Fed chief once called for the nation’s repeated his interest in seeing market discipline — not new regulation — act as a policing force on the rapidly growing hedge fund industry.