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Bernanke Says Nation Must Take Action Soon to Shape Fiscal Future

By SEWELL CHAN and JAVIER C. HERNANDEZ

Ben S. Bernanke, the Federal Reserve chairman, warned Wednesday that an aging American population posed fiscal challenges for the United States.

In a rare foray into the realm of fiscal policy, Mr. Bernanke said the United States "must begin now to prepare for this coming demographic transition."

Mr. Bernanke, speaking before the Dallas Regional Chamber, said that the economy was still fragile, and he made it clear that he did not expect the federal government to raise taxes or cut spending anytime soon. But he spoke about the budget pressures posed by Social Security and Medicare with greater urgency than he has in the past.

"The arithmetic is, unfortunately, quite clear," Mr. Bernanke said. "To avoid large and unsustainable budget deficits, the nation will ultimately have to choose among higher taxes, modifications to entitlement programs such as Social Security and Medicare, less spending on everything else from education to defense, or some combination of the above. These choices are difficult, and it always seems easier to put them off — until the day they cannot be put off any more."

He said a "sharp near-term reduction in our fiscal deficit is probably neither practical nor advisable," but that a long-term plan for fiscal sustainability could help to lower interest rates and borrowing costs, and even stimulate economic growth.

Mr. Bernanke's comments on the nation's budget problems could lead to political confrontations. Raising taxes is anathema to Republicans while slashing entitlement programs is strongly opposed by Democrats. Still, Mr. Bernanke's comments could add urgency to the work of the bipartisan fiscal commission named by President Obama.

Mr. Bernanke also used his speech to review the Fed's conduct during the economic crisis. He voiced support for regulatory changes being debated in Congress that would seek to prevent any company from being seen as too big to fail.

"To end 'too big to fail,' the new regime should permit regulators to close a failing firm and impose losses on shareholders and creditors," he said.

"Indeed, I would argue that no financial instrument counted as regulatory capital should be allowed to receive any protection from losses."

Mr. Bernanke has hinted that long-term unemployment has become one of his major worries as the economic recovery slowly moves forward.

Noting that more than 40 percent of the unemployed have been out of work six months or longer, nearly double the share of a year ago, he said: "I am particularly concerned about that statistic, because long spells of unemployment erode skills and lower the longer-term income and employment prospects of these workers."

In a separate speech earlier in the day, a member of the Federal Reserve's policy-making board challenged the notion that financial markets were self-correcting, saying that asset bubbles existed and that central banks could do more to prevent them.

William C. Dudley, president and chief executive of the Federal Reserve Bank of New York, called on policy makers to more aggressively speak out against prevailing wisdom when asset prices fluctuated wildly.

"The costs of waiting to respond to an asset bubble until after it has burst can be very high," Mr. Dudley said in prepared remarks to the Economic Club of New York. "A proactive approach is appropriate."

In recent months, the Fed has faced intense criticism for failing to prevent the recent bubble in home prices that brought the economy to its knees.

Though Mr. Dudley acknowledged the difficulty in identifying bubbles, he said “uncertainty is not grounds for inaction.” He called for combining the power of the bully pulpit with other tools, like limiting loan-to-value ratios and debt loads.

Mr. Dudley’s remarks contrasted sharply with those of Alan Greenspan, a former Federal Reserve chairman. Testifying before the Financial Crisis Inquiry Commission, Mr. Greenspan defended the Fed against complaints that it had not done enough to prevent the subprime mortgage crisis.

Mr. Greenspan seemed to reject the idea that central banks could use the power of their words to ward off bubbles. Instead, he said central banks should rely on tools like requiring banks to hold more capital and demanding traders hold more collateral.

A third Fed official, Thomas M. Hoenig, president of the Kansas City Fed, raised the specter of higher interest rates on Wednesday. Mr. Hoenig has repeatedly expressed concern that extraordinarily low interest rates may spur inflation.

Mr. Hoenig said in a speech in Santa Fe, N.M., that the Fed should consider lifting the benchmark federal funds rate to 1 percent, from near zero, which he called a “highly accommodative policy.”

“I am confident that holding rates down at artificially low levels over extended periods encourages bubbles, because it encourages debt over equity and consumption over savings,” Mr. Hoenig said.