

DIALOGUE
WITH THE FED

Beyond Today's Financial Headlines



CENTRAL TO AMERICA'S ECONOMY™

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Bringing The Federal Deficit Under Control

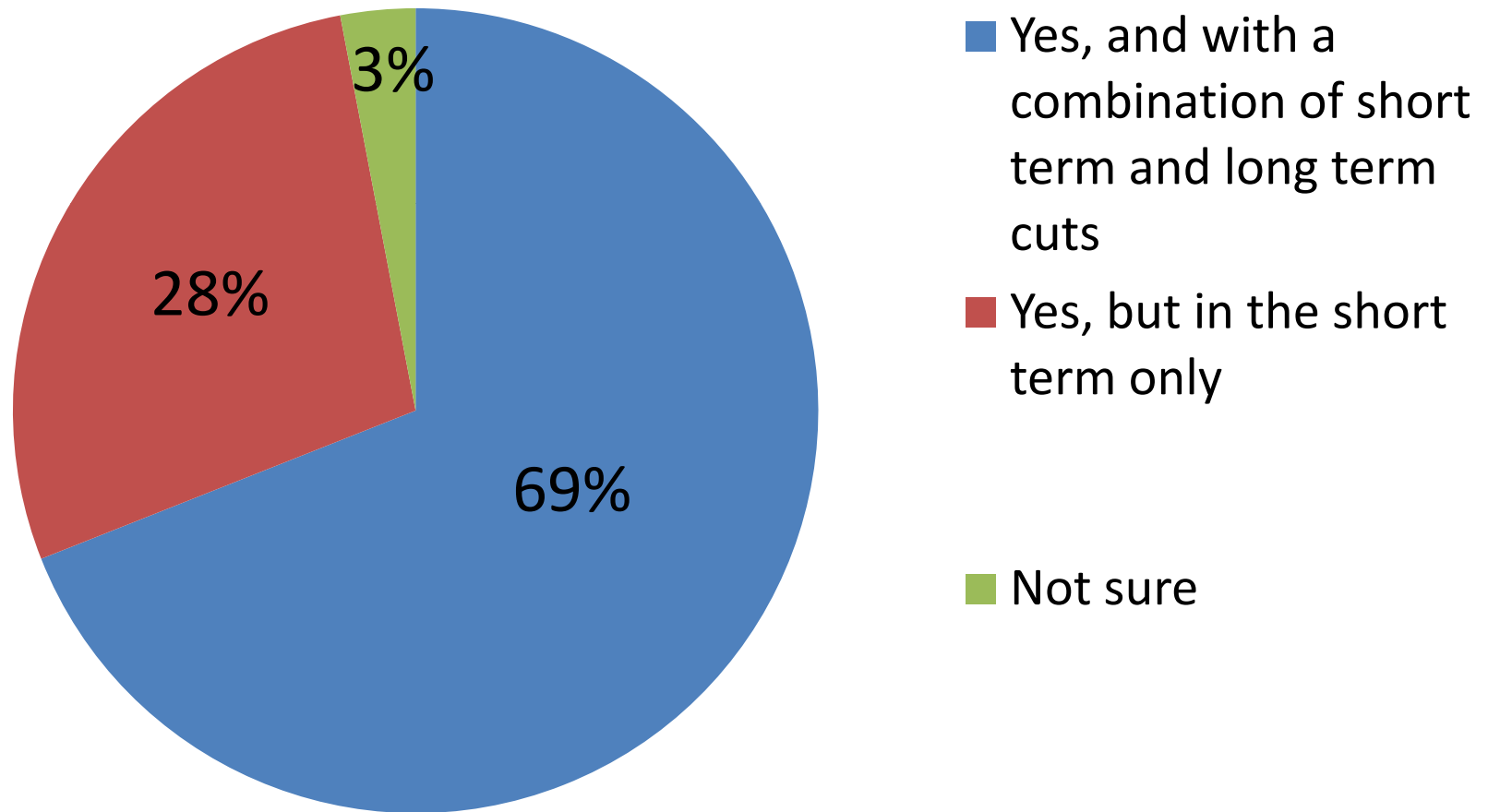
William R. Emmons

October 18, 2011

The views expressed here are mine alone, and do not necessarily represent the views of the Federal Reserve Bank of St. Louis or of the Federal Reserve System.

Pre-Event Survey:

Do you think it is necessary that we cut the federal budget deficit?



Which do you think is the most important issue facing the country right now?

1. Economy and jobs
2. Federal budget deficit/National debt
3. Health Care
4. Taxes
5. Educational system
6. Unsure/other

Do you think the federal budget deficit can be reduced without harming the economy?

1. Yes, and the sooner, the better
2. Yes, but it should be done gradually
3. No, but it might be a price worth paying
4. No, and it would cause unnecessary harm
5. Not sure/no opinion



“The United States is facing profound budgetary and economic challenges.”

--Congressional Budget Office (CBO), *The Budget and Economic Outlook: An Update*, August 2011

U.S. Indicators of Fiscal Health Compare Poorly With Peers

	Budget deficit	Gross debt	Net debt	Interest expense	Debt maturity	National saving
U.S. rank among 6 peer nations	#6	#5	#3	#3	#6	#6

	Credit Rating (Moody's / S&P / Fitch)	Ratings Outlook	Fiscal Balance (% of GDP)	Gross Public Debt (% of GDP)*	Net Public Debt (% of GDP)**	Int Exp / GDP (%)	Average Maturity (yrs)	Cur Acct Balance (% of GDP)
Canada	Aaa / AAA/ AAA	Stable	-4.6	84.0	35.1	0.7	8.0	-2.8
France	Aaa / AAA/ AAA	Stable	-6.0	87.6	77.9	2.5	10.0	-2.8
Germany	Aaa / AAA/ AAA	Stable	-2.3	80.0	54.7	2.2	5.7	5.1
Japan	Aa3 / AA- / AA-	Neg/Stab	-10.0	220.3	127.8	1.7	5.7	2.3
UK	Aaa / AAA/ AAA	Stable	8.6	77.2	75.1	2.6	13.4	-2.4
USA	Aaa / AA+/ AAA	Neg/Stab	-10.8	91.6	72.4	1.8	5.2	-3.2

Heat map colors are relative to countries listed; red highlights troubling fiscal indicators, while green highlights healthier fiscal indicators. IMF WEO April 2011 Estimates for: fiscal balance; gross & net public debt; & cur acct balance. OECD estimates for int exp / GDP as of June 2011. Otherwise, most recent official government figures.

* Gross public debt includes debt issued to federal pension and social security funds

** Net public debt does not include debt issued to pension or social security funds; in the U.S. this is marketable debt

*** Average maturity from Bloomberg

Source: Federal Reserve Bank of New York

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U.S. Looks A Bit Better Against Peripheral European Countries

	Budget deficit	Gross debt	Net debt	Interest expense	Debt maturity	National saving
U.S. rank among a group of 6 peripheral European nations + U.S.	#6	#2	#2	#2	#7	#3

	Credit Rating (Moody's / S&P / Fitch)	Ratings Outlook	Fiscal Balance (% of GDP)	Gross Public Debt (% of GDP)	Net Public Debt (% of GDP)**	Int Exp / GDP (%)	Average Maturity (yrs)	Cur Acct Balance (% of GDP)
Belgium	Aa1/AA+/AA+	Stab/Neg	-4.0	97.3	82.3	3.3	6.4	1.0
Greece	Ca / CC / CCC	Neg	-7.4	152.3	152.3	4.4	7.0	-8.2
Ireland	Ba1/BBB+/BBB+	Neg/Stab	-10.8	114.1	95.2	3.0	6.2	0.2
Italy	Aa2/A+/AA-	Neg/Stab	-4.3	120.3	100.6	4.4	7.1	-3.4
Portugal	Ba2/BBB-/BBB-	Neg	-5.6	90.6	86.3	4.2	6.0	-8.7
Spain	Aa2/AA/AA+	Neg	-6.2	63.9	52.6	1.7	6.3	-4.8

Heat map colors are relative to countries listed; red highlights troubling fiscal indicators, while green highlights healthier fiscal indicators. IMF WEO April 2011 Estimates for: fiscal balance; gross & net public debt; & cur acct balance. OECD estimates for int exp / GDP as of June 2011. Otherwise, most recent official government figures.

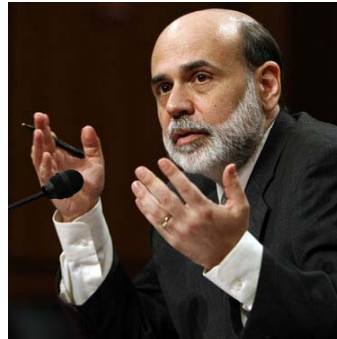
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*** Average maturity from Bloomberg

Source: Federal Reserve Bank of New York

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“Without significant policy changes, the finances of the federal government will inevitably spiral out of control, risking severe economic and financial damage.”

--Federal Reserve Board Chairman Ben S. Bernanke,
“The Near- and Longer-Term Prospects for the
U.S. Economy,” August 26, 2011

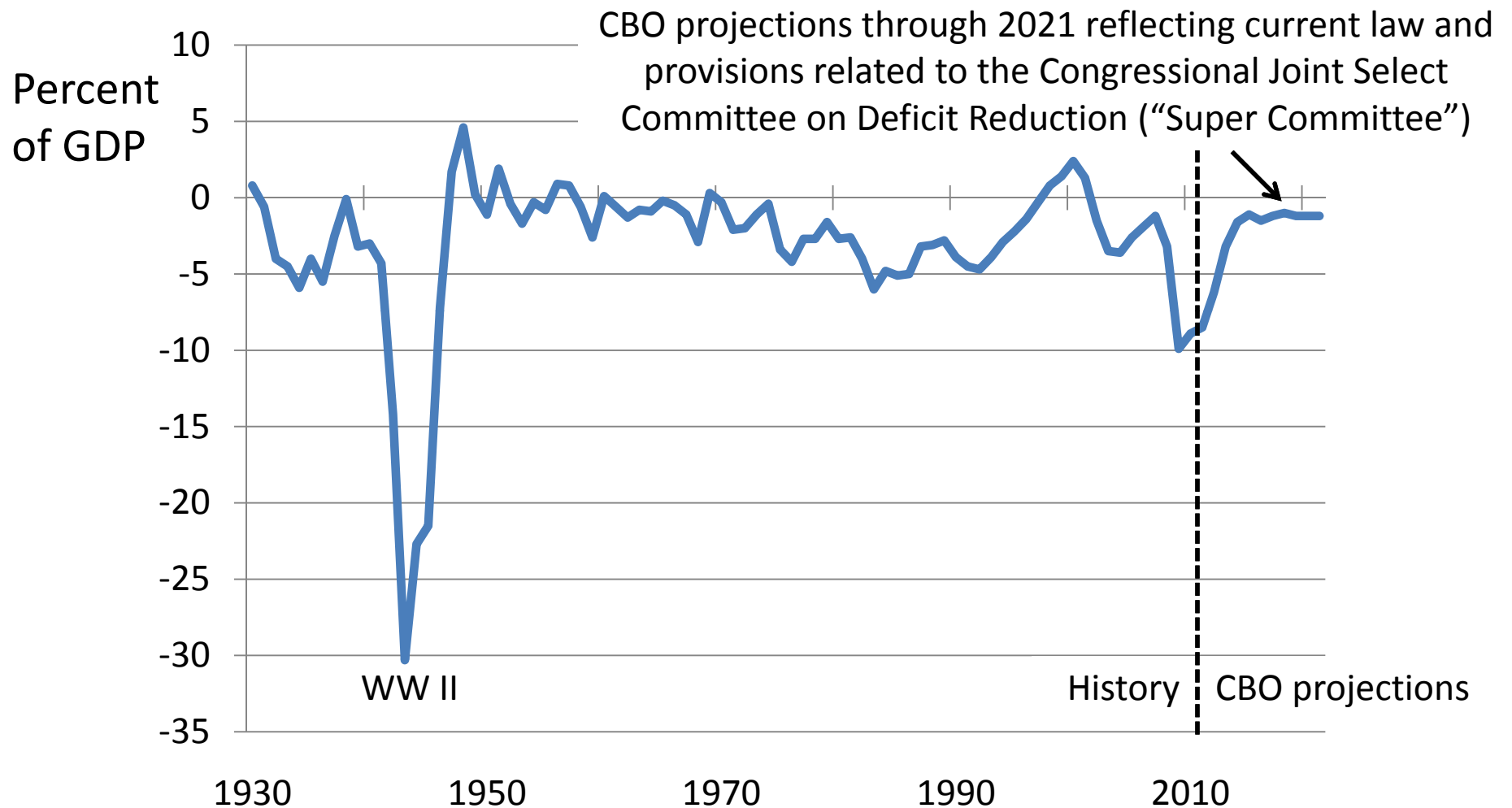
Tonight's Agenda

- The long-term federal budget outlook
- Bringing future deficits under control
- Your questions and comments

Part 1

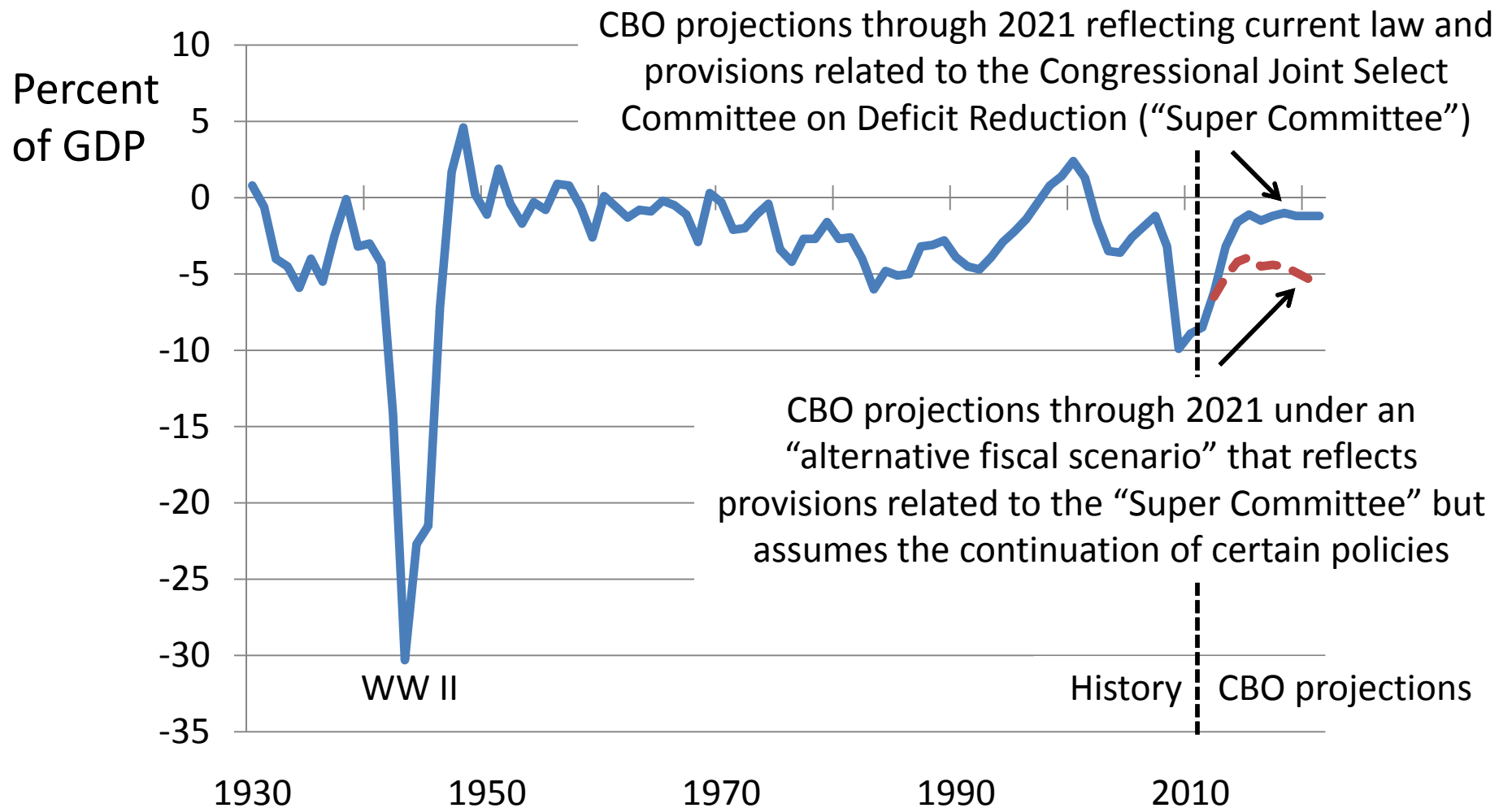
- The long-term federal budget outlook

Annual Federal Budget Balances



Source: Congressional Budget Office (CBO)

Annual Federal Budget Balances



Source: Congressional Budget Office (CBO)

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Facts About the Deficit and Debt

	Current amount	On a per-capita basis	Relative to GNP
Federal budget balance = (-1) x Annual change in federal debt	-\$1,298,613,000,000 (fiscal year 2011)	-\$4,146	-8.4%
Gross National Product (closely related to Gross Domestic Product)	\$15,458,200,000,000 (Q3.2011 forecast)	\$49,474 (Q3.2011)	--
Population	313,232,000 (end of 2011)	--	--

Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO), U.S. Treasury, Census Bureau, Macroeconomic Advisors

Why GNP vs. GDP?

Facts About the Deficit and Debt

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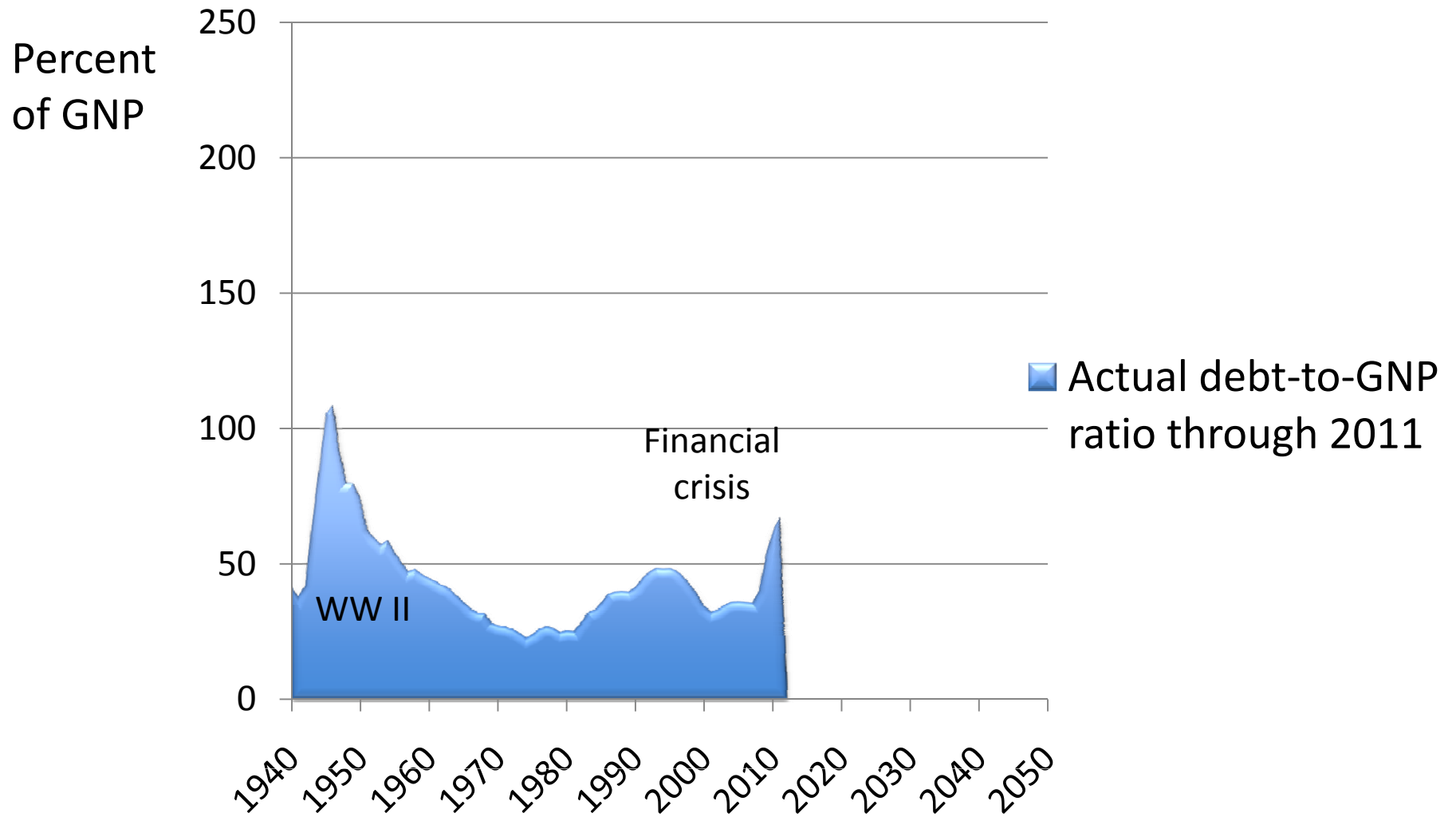
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<u>Debt held by the public</u> : Most meaningful measure economically	\$10,142,000,000,000 (Oct. 13, 2011)	\$32,379	65.6%
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Debt Held By the Public



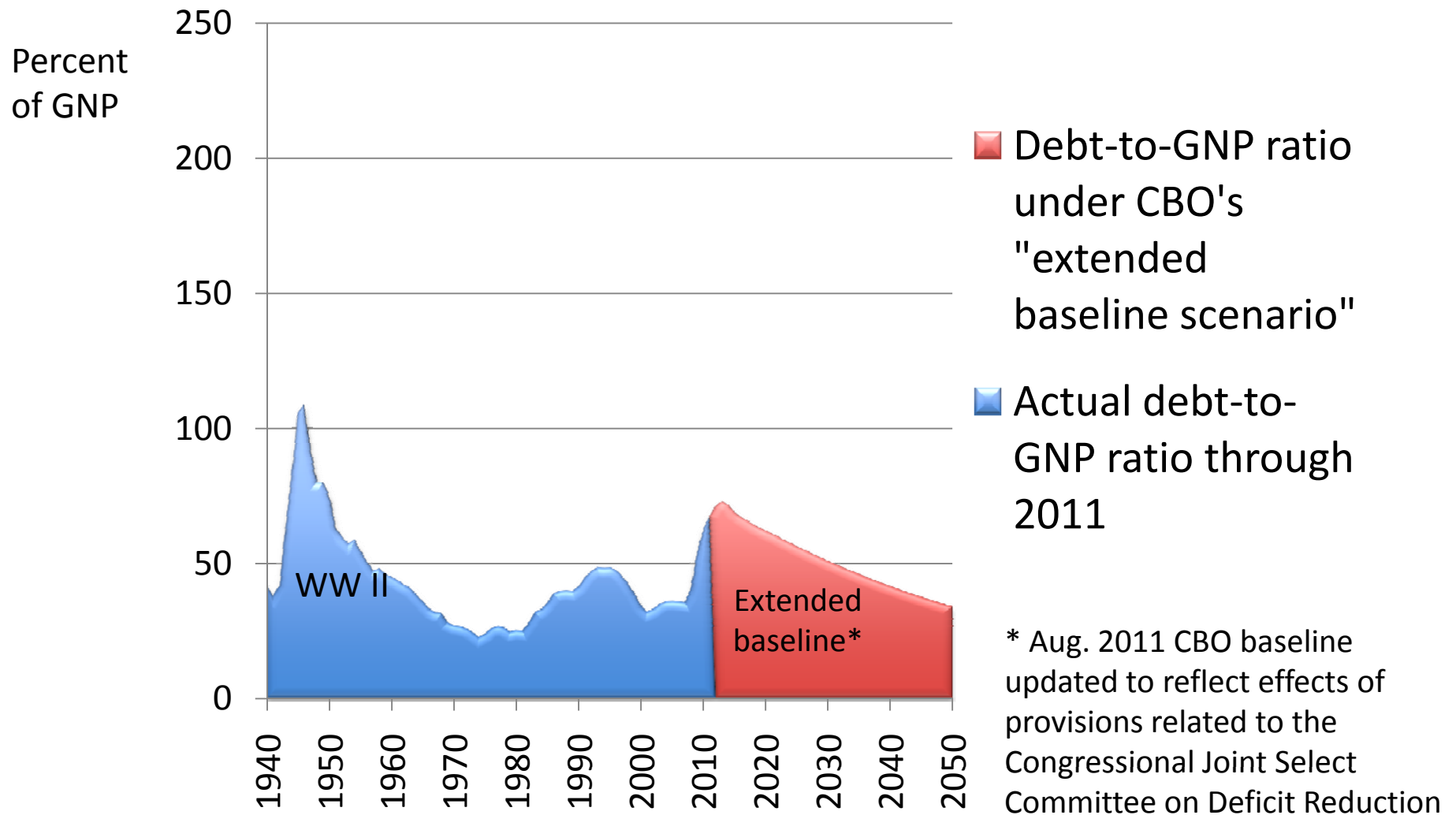
Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO)¹⁷

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<u>Future deficits and debt?</u>			
Gross National Product (closely related to Gross Domestic Product)	\$15,458,200,000,000 (Q3.2011 forecast)	\$49,474 (Q3.2011)	--
Population	313,232,000 (end of 2011)	--	--

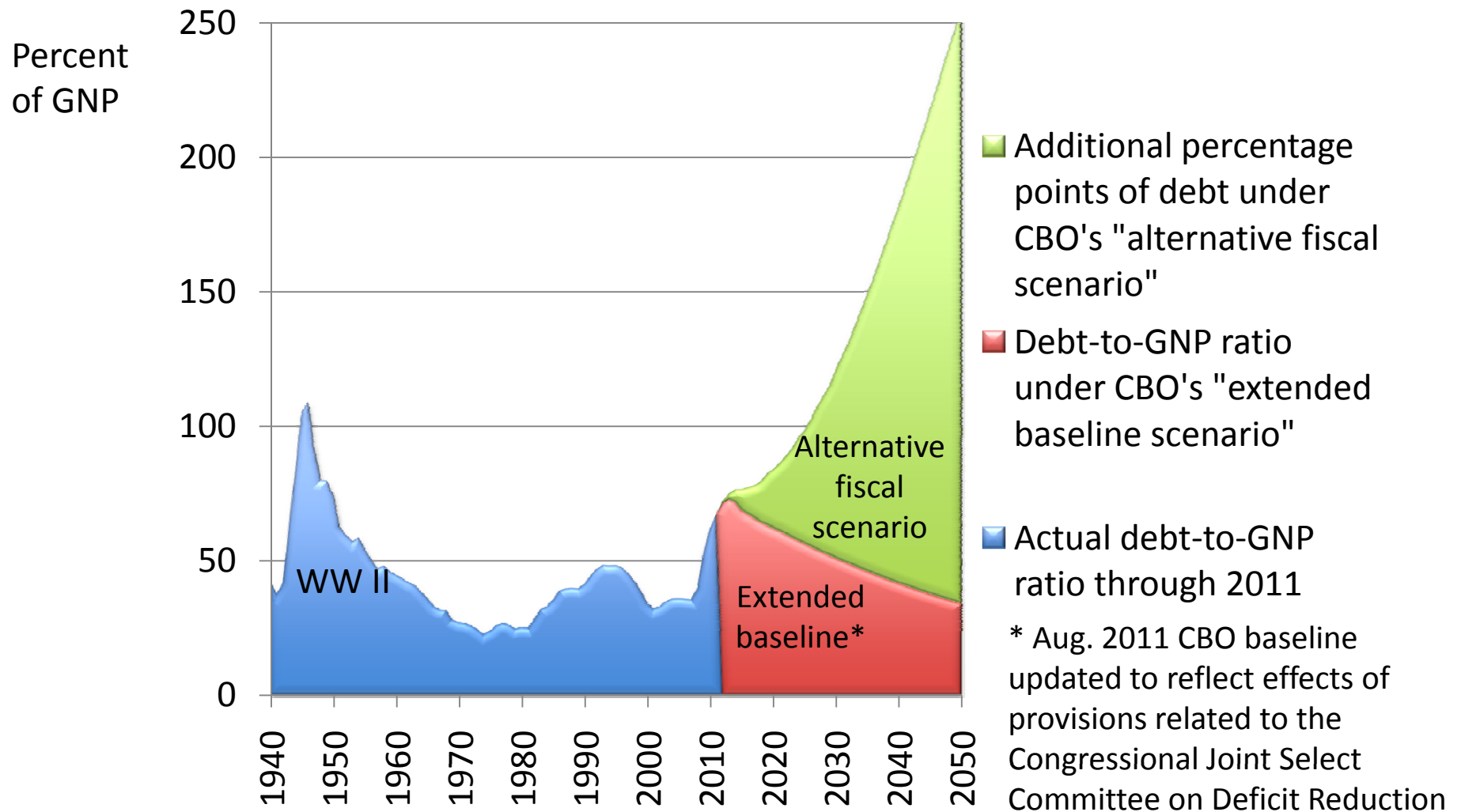
Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO), U.S. Treasury, Census Bureau, Macroeconomic Advisors

Two Scenarios for Debt Held By the Public



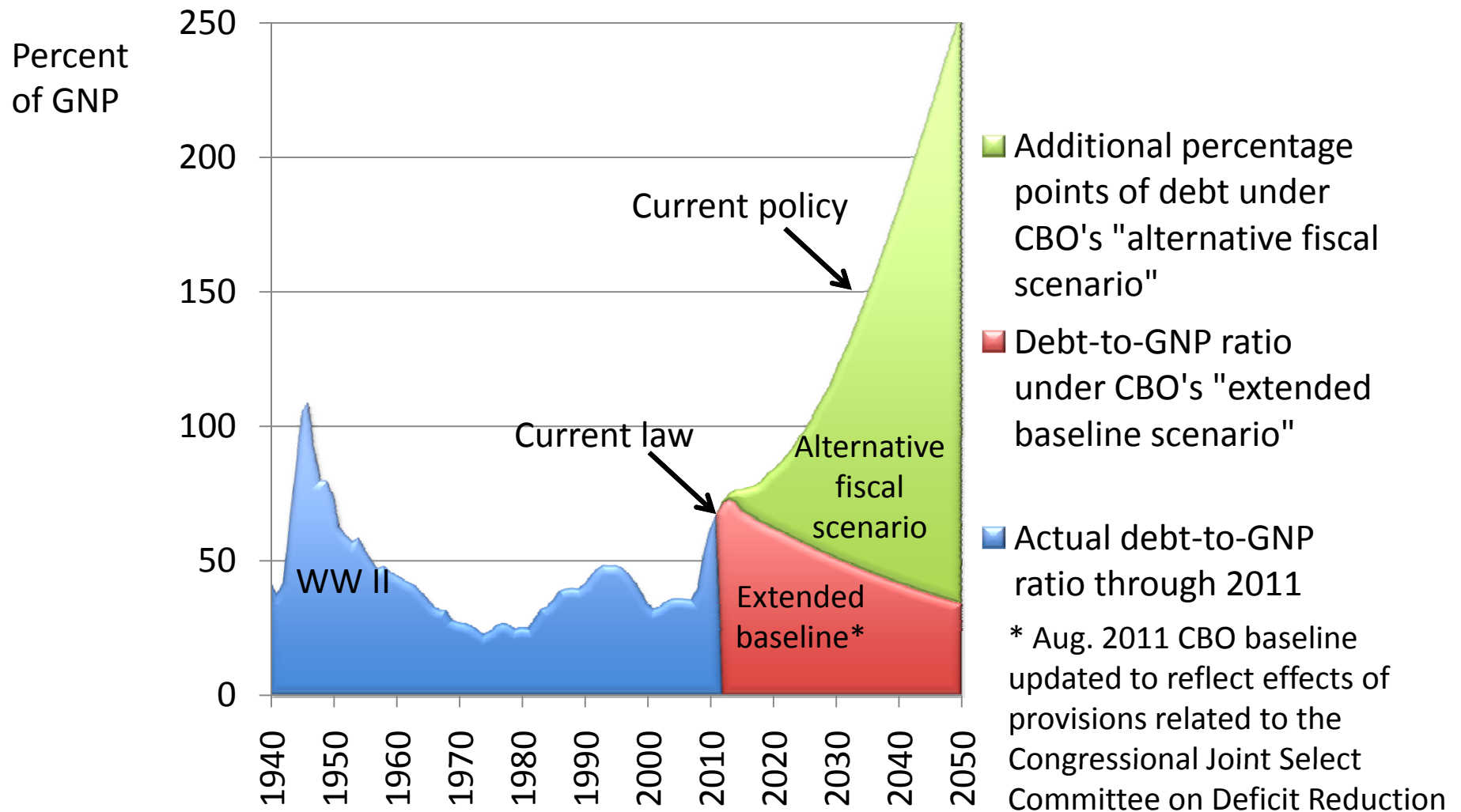
Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO)¹⁹

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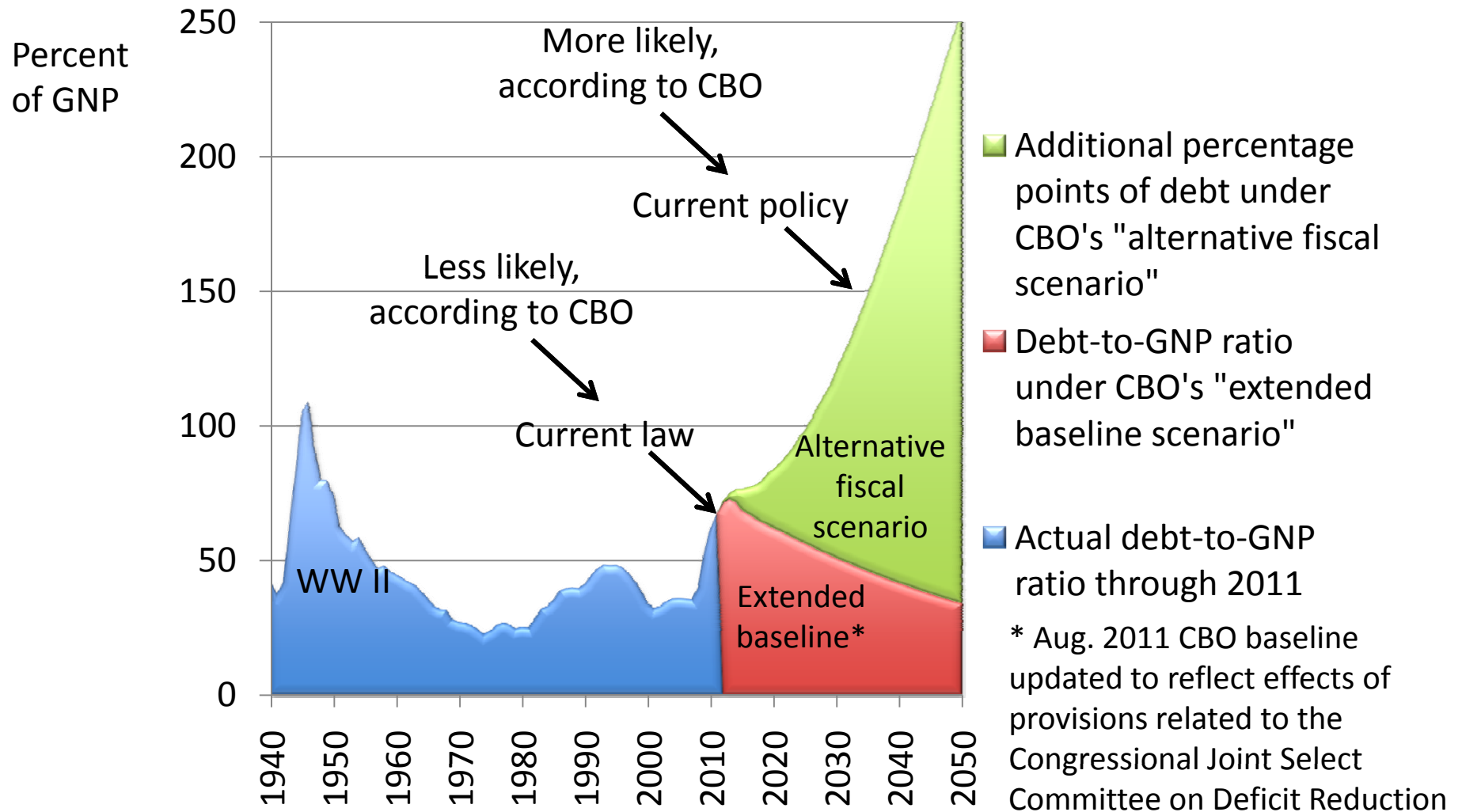
Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO)²⁰

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<u>Debt held by the public</u> : Most meaningful measure economically	\$10,142,000,000,000 (Oct. 13, 2011)	\$32,379	65.6%
<u>"Fiscal gap"</u> : Projected annual average budget balance thru 2085	-\$1,283,000,000,000	-\$4,096	-8.3%
Gross National Product (closely related to Gross Domestic Product)	\$15,458,200,000,000 (Q3.2011 forecast)	\$49,474 (Q3.2011)	CBO's "alternative fiscal scenario." Does not reflect provisions related to the "Super Committee."
Population	313,232,000 (end of 2011)	--	

Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO), U.S. Treasury, Census Bureau, Macroeconomic Advisors

The Extended Baseline: Current Law

- CBO must project current laws into the future under an “extended-baseline scenario”
- This scenario assumes all provisions will take effect as written
 - All temporary revenue-reducing measures expire on schedule
 - All temporary outlays expire on schedule
 - Discretionary spending caps are enforced

The Extended Baseline: Tax Changes

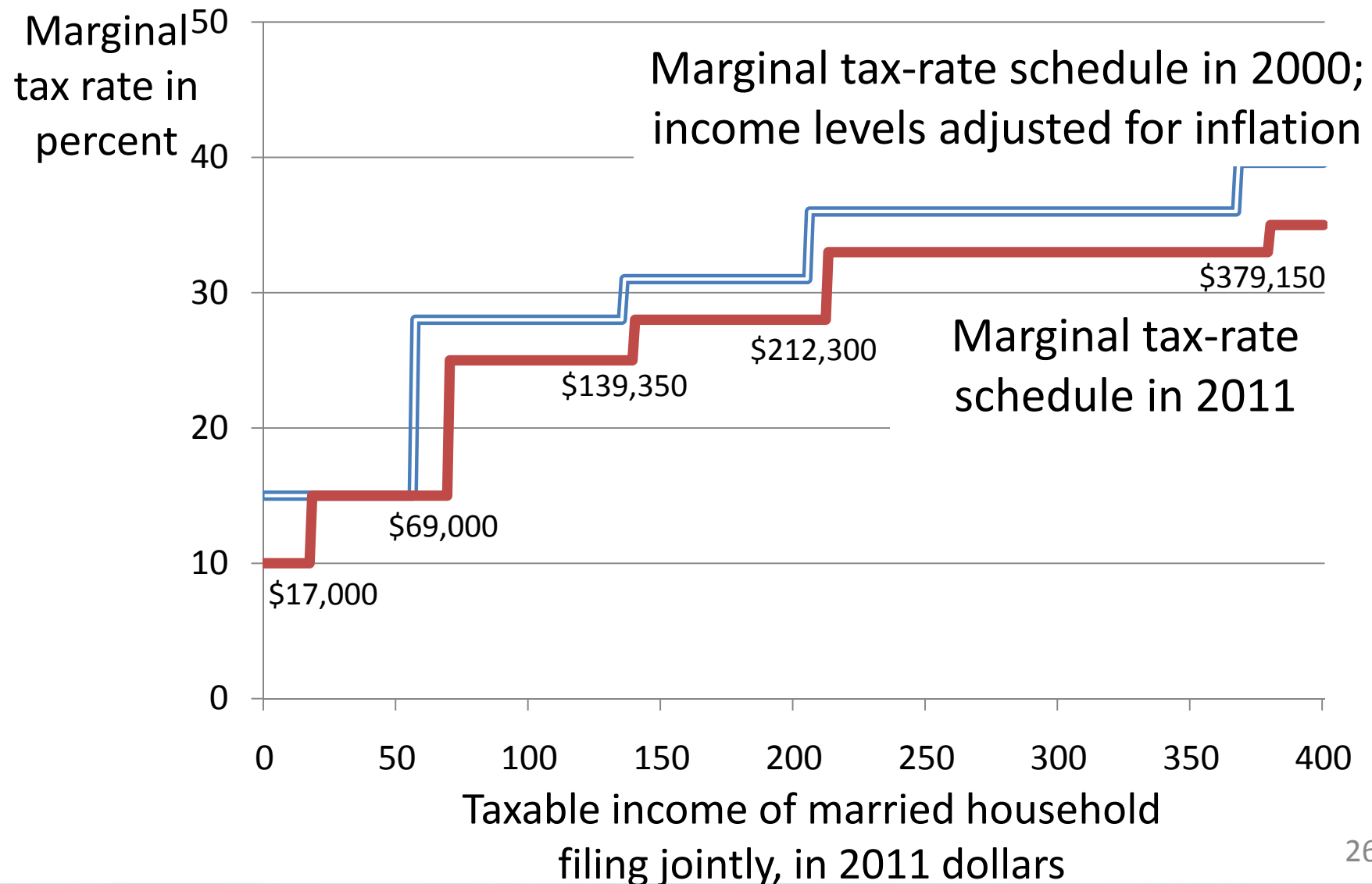
1. Expiring 12-31-2011:

- The two-year extension of provisions limiting the reach of the AMT (alternative minimum tax)
- The one-year reduction in the payroll tax

2. Expiring 12-31-2012:

- Certain provisions of the 2010 tax act originally enacted in 2001, 2003, and 2009, including:
 - Extensions of lower marginal tax rates
 - Expanded tax credits and deductions

Marginal Income-Tax Schedules



An Example

- A household with taxable income in 2011 of \$100,000 pays **\$17,250**

$$[17,000 \times 0.10] + [52,000 \times 0.15] + [31,000 \times 0.25] = \mathbf{\$17,250}$$

- Using indexed 2000 tax brackets that same household would pay **\$20,720** (a 20% increase)

$$[56,000 \times 0.15] + [44,000 \times 0.28] = \mathbf{\$20,720}$$

- Current law imposes this change after 12-31-2012

The Extended Baseline: Spending Changes

3. Effective 1-1-2012:

- Sharp reduction in Medicare's payment rates for physicians' services (-30%) due to smaller deferred annual cuts that have been accumulating since 2003
- Extended unemployment compensation ends

4. 2011 Budget Control Act (BCA) provisions to be implemented during the next decade:

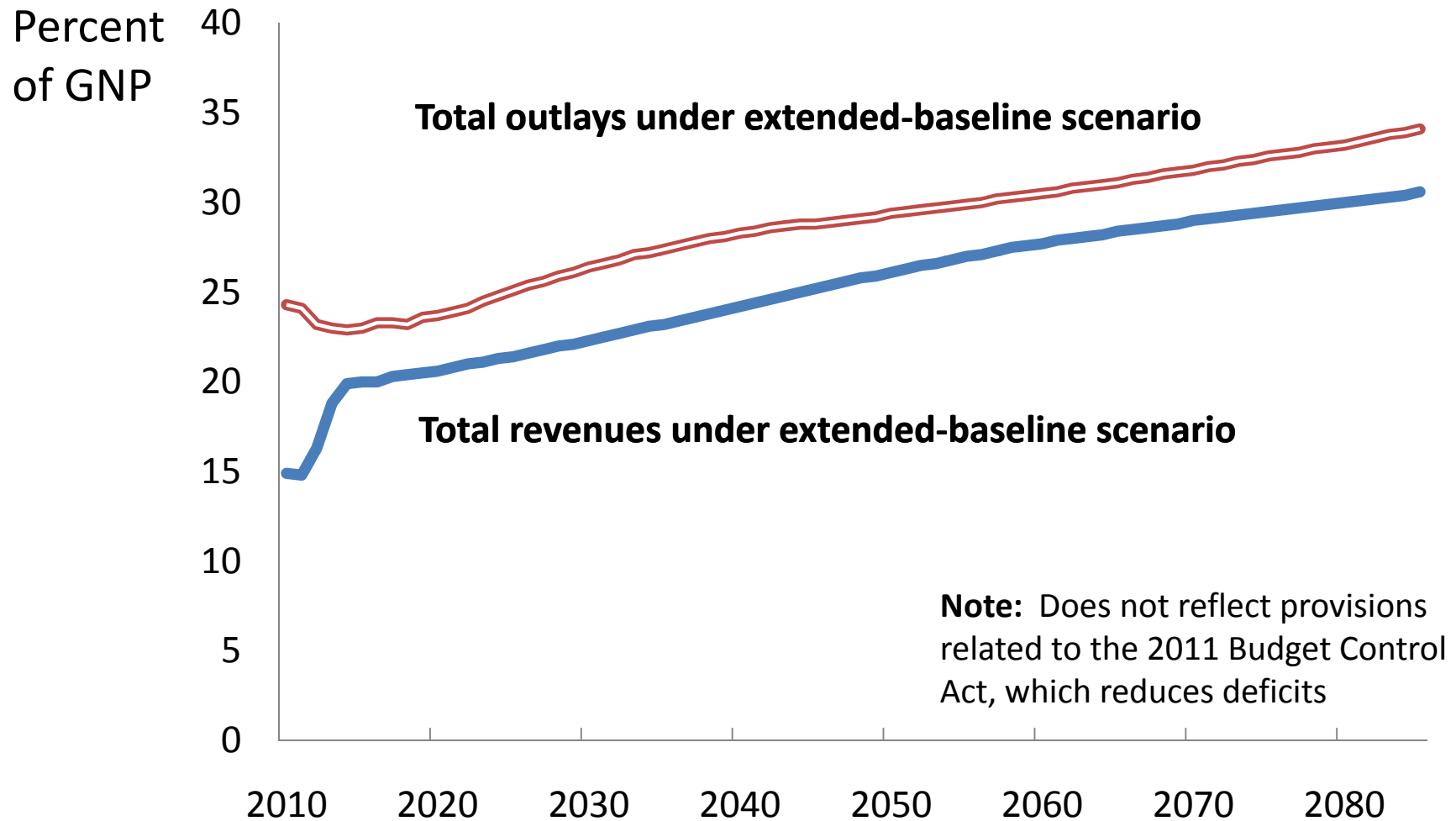
- Funding for discretionary spending declines over time in real terms, in accordance with BCA caps
- Additional deficit reduction of \$1.2 trillion or more as required under the BCA; details determined by the "Super Committee" or sequestration if no agreement

Source: Congressional Budget Office 28

Is Current Law Sufficient To Solve the Problem?

- Current laws plus 2011 Budget Control Act would shrink long-run deficits and reduce debt levels relative to GNP after 2013. However:
 - Tax revenues as a share of GNP would continue rising forever due to the restoration of higher marginal rates, “bracket creep”, and the AMT which is not indexed for inflation
 - Rising federal health-care costs would be passed through to taxpayers

Projected Federal Outlays and Revenues Under CBO's Extended-Baseline Scenario



Source: Congressional Budget Office (CBO) 30

CBO:

**Certain Provisions of Current Law
Are “Widely Expected To Be
Changed”
Or
“Might Be Difficult to Sustain For
a Long Period”**

Source: Congressional Budget Office (CBO), “2011 Long-Term Budget Outlook”, Aug. 2011 31

Provisions Likely to Change

- Most important: Assumptions about revenues
 - Under the extended-baseline scenario, federal tax revenues would increase at double-digit percentage rates for each of the next three years, then continue growing faster than the economy
- All planned spending cuts may not occur
 - Medicare payment rates scheduled to fall 30 percent
 - All non-interest, non-defense federal spending is scheduled to decline at an annual rate of one percent for the next three years

Source: Congressional Budget Office (CBO), “2011 Long-Term Budget Outlook”, Aug. 2011 32

Economic Impacts

- Policy changes assumed under the extended-baseline scenario could affect the recovery
 1. Projected tightening of fiscal policy over three years (2012-14) would be 6.3 percentage points of GDP
 - Relative to the size of the economy, these cuts would be nearly as large as those made during 1947-49, which may have contributed to a recession at that time
 2. Higher tax rates might reduce incentives to work, save, and invest – harming growth potential
 3. On the positive side, lower deficits and debt might reduce interest rates, boosting growth

Source: Congressional Budget Office (CBO), “2011 Long-Term Budget Outlook”, Aug. 2011 ³³

The Alternative Fiscal Scenario: Current Policy

- CBO projects what it believes is more likely to happen based on recent experience—what CBO terms “current policy”—under an “alternative fiscal scenario”
 - Alternative scenario assumes no painful fiscal provisions will be allowed to come into force, ever
 - **None** of the temporary revenue-reducing measures expire on schedule
 - **None** of the temporary outlays expire or spending caps bite on schedule

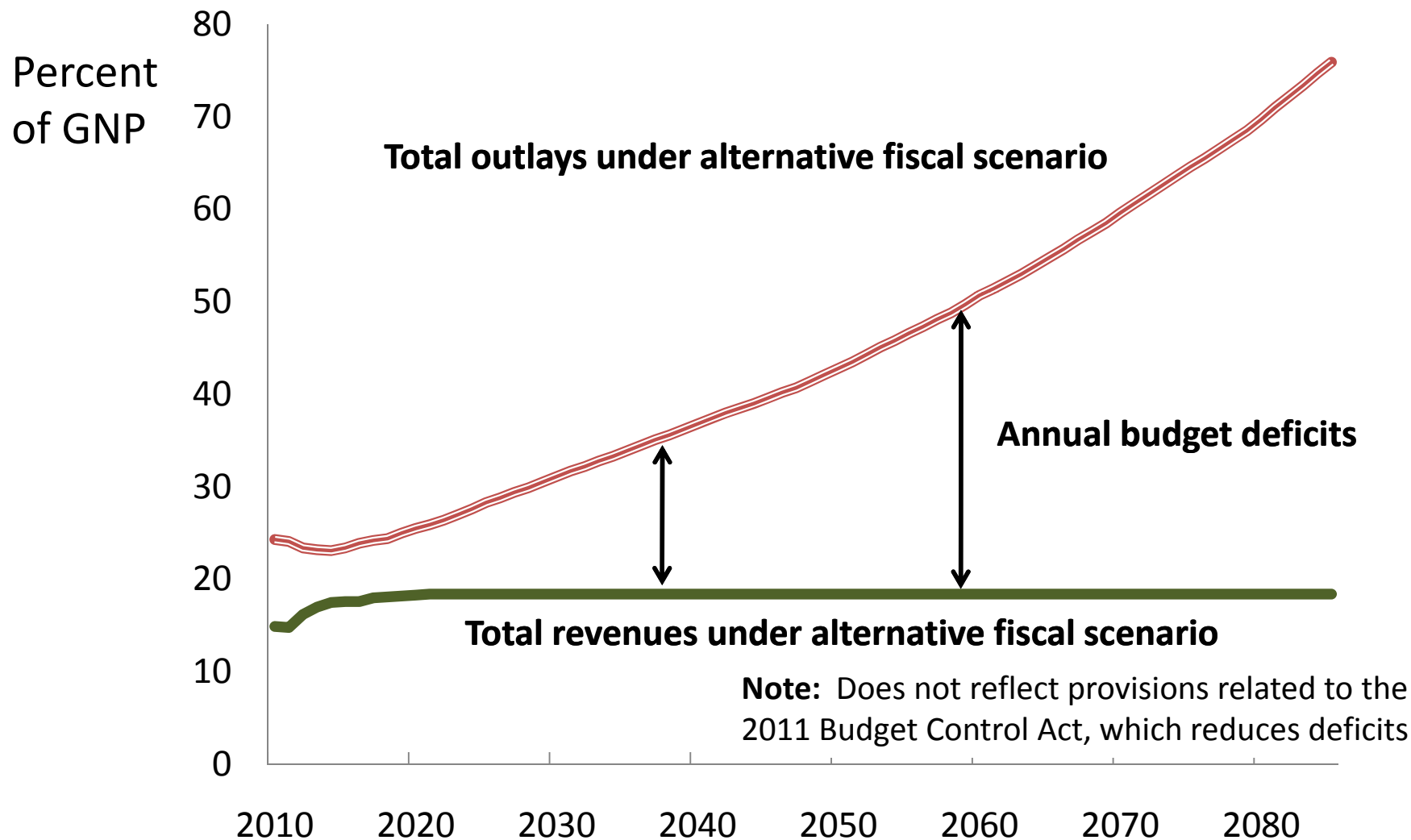
Source: Congressional Budget Office (CBO), “2011 Long-Term Budget Outlook”, Aug. 2011 34

The Alternative Fiscal Scenario: Current Policy

- Policy actions under CBO's alternative fiscal scenario would result in a large and growing mismatch between revenues and outlays, regardless of how strongly the economy grows
 - Outlays grow rapidly with our aging population, rising health-care expenditures, and spiraling interest payments on debt
 - Tax revenues are frozen at their historical average level relative to GNP, completely unrelated to the aging population or rising health-care outlays

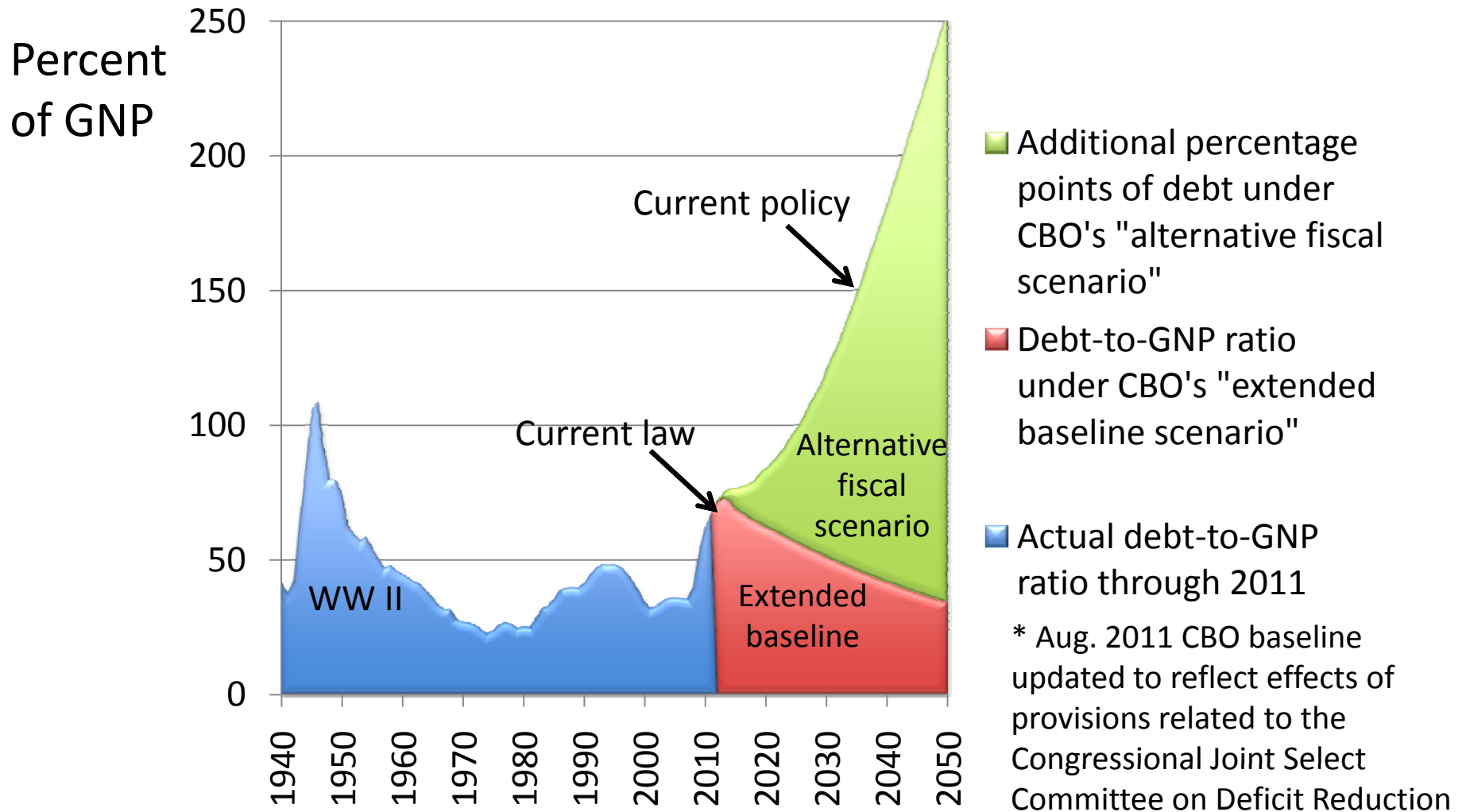
Source: Congressional Budget Office (CBO), "2011 Long-Term Budget Outlook", Aug. 2011 35

Projected Federal Outlays and Revenues Under CBO's Alternative Fiscal Scenario



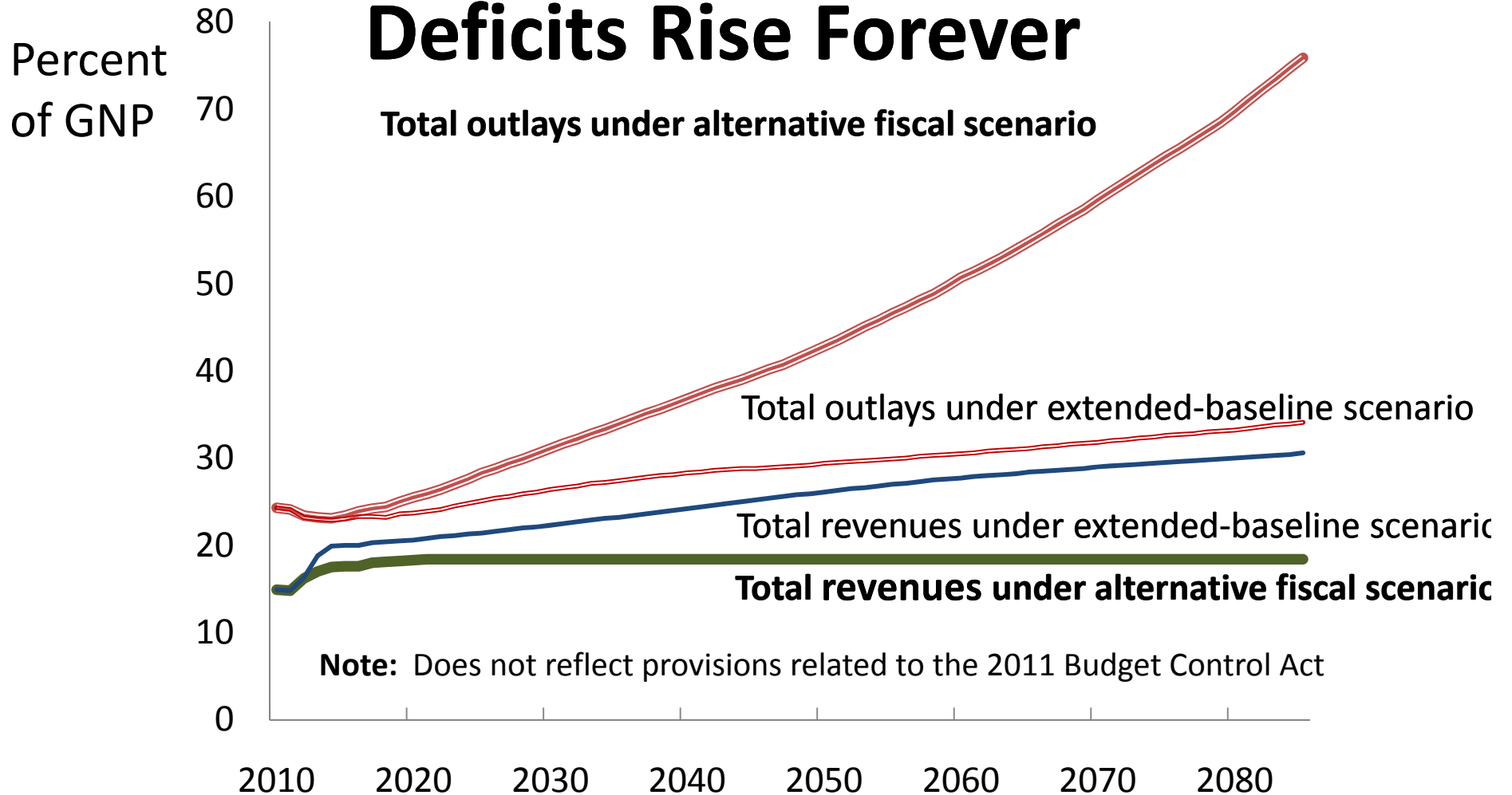
Source: Congressional Budget Office (CBO) 36

Current Policy: Debt Could Exceed WW II Levels Within 20 Years



Sources: Office of Management and Budget (OMB), Congressional Budget Office (CBO) 37

Extended Baseline: Tax Burden Rises Forever; Alternative Scenario: Budget Deficits Rise Forever



Source: Congressional Budget Office (CBO) 38

Conclusions About The Long-Term Federal Budget Outlook

1. The “extended baseline scenario”—current law—would stabilize our long-term fiscal situation within the next few years. But these actions might hamper the economy, both in the short-term and long-term.
2. The “alternative fiscal scenario”—a continuation of current policies—would result in large and growing future budget deficits and debt.
3. Neither scenario is likely to play out as described.

Part 2

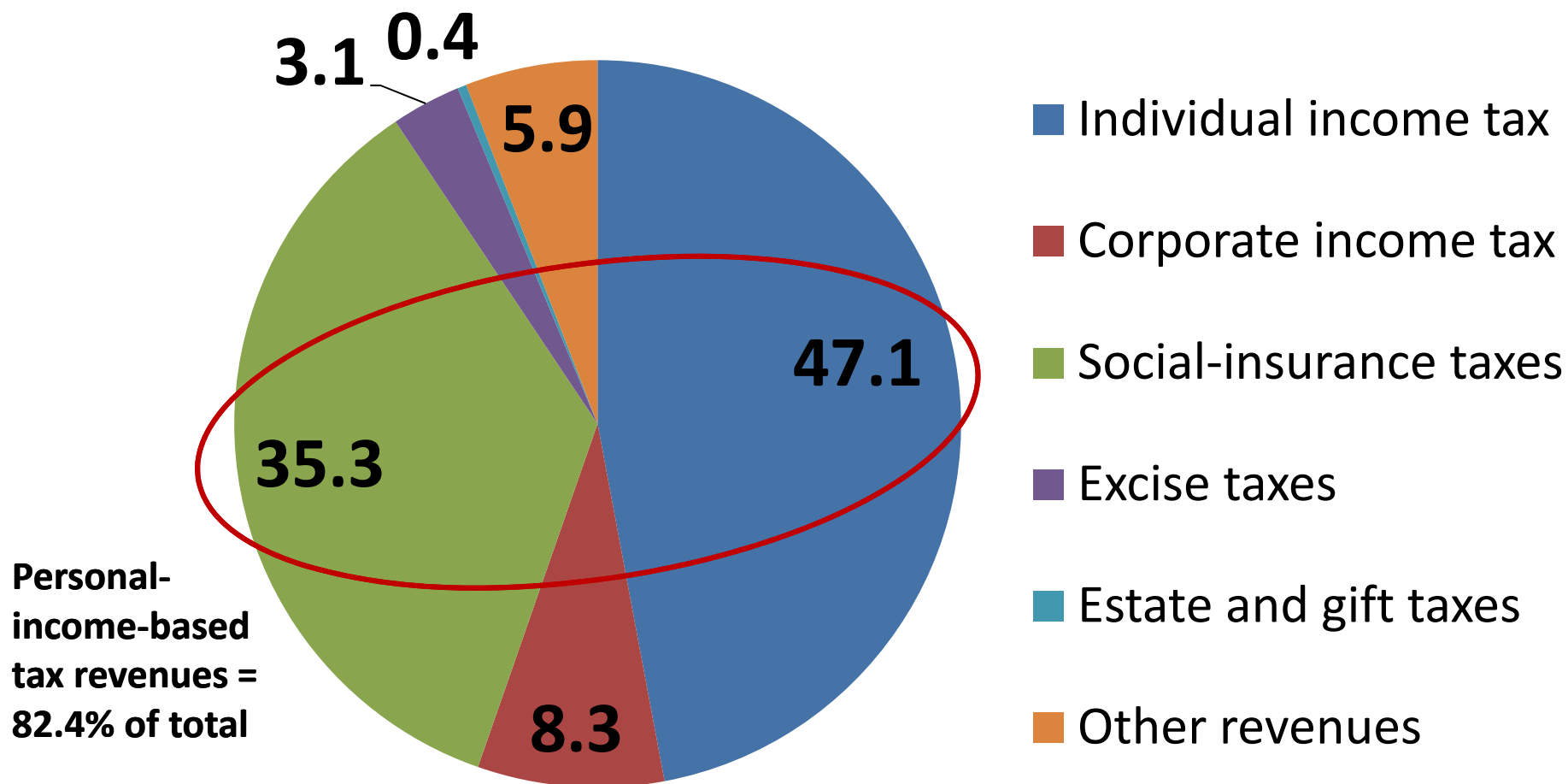
- Bringing future deficits under control

Our Apparent Fiscal Dilemma: Higher Taxes or Higher Debt?

- Higher taxes: The extended-baseline scenario
 - Most households' income-tax burdens would rise over time under current law
 - Incentives to work, save, and invest could be harmed

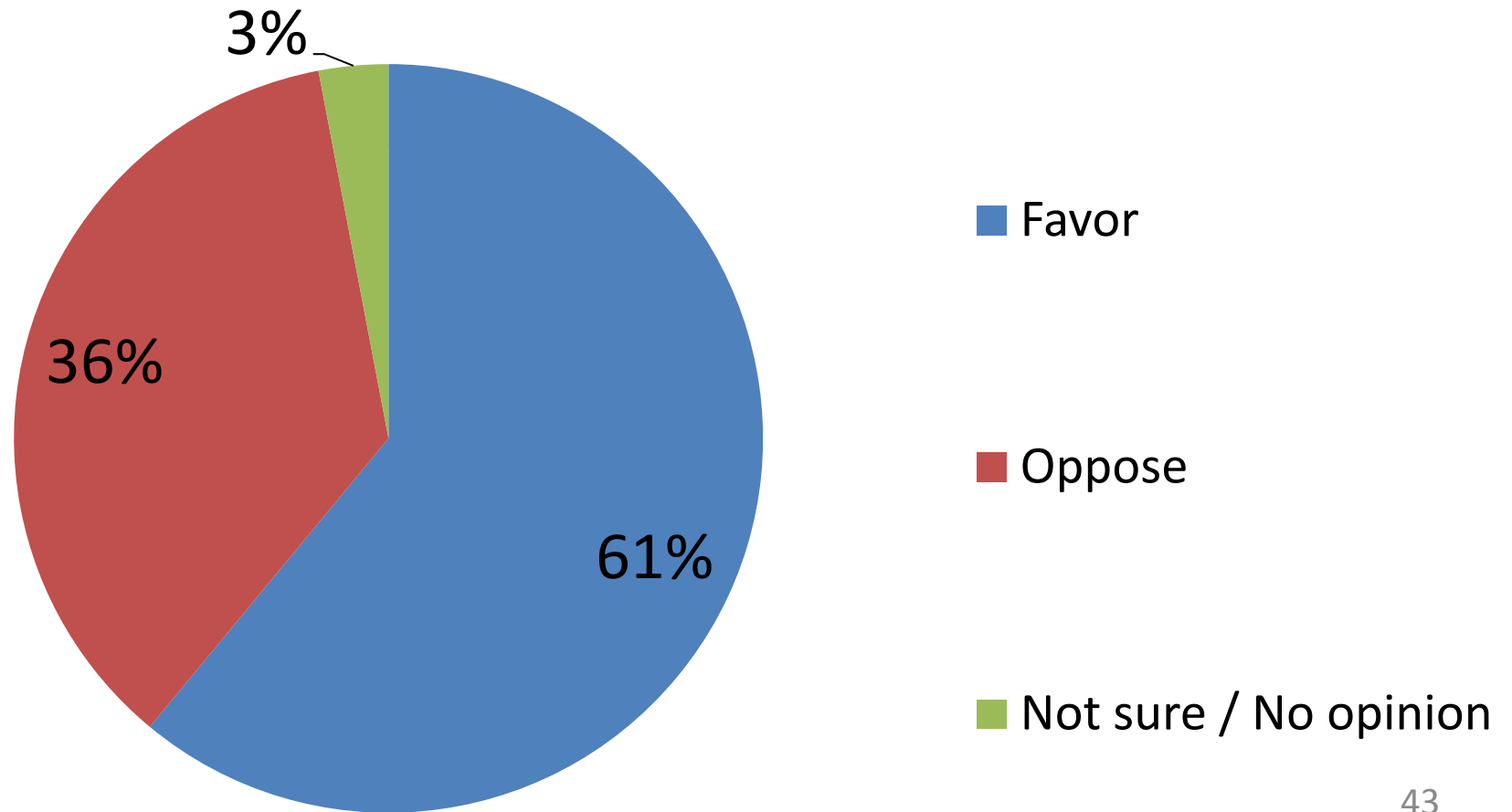
Current Federal Revenue Sources

Percent of federal revenues, fiscal year 2011



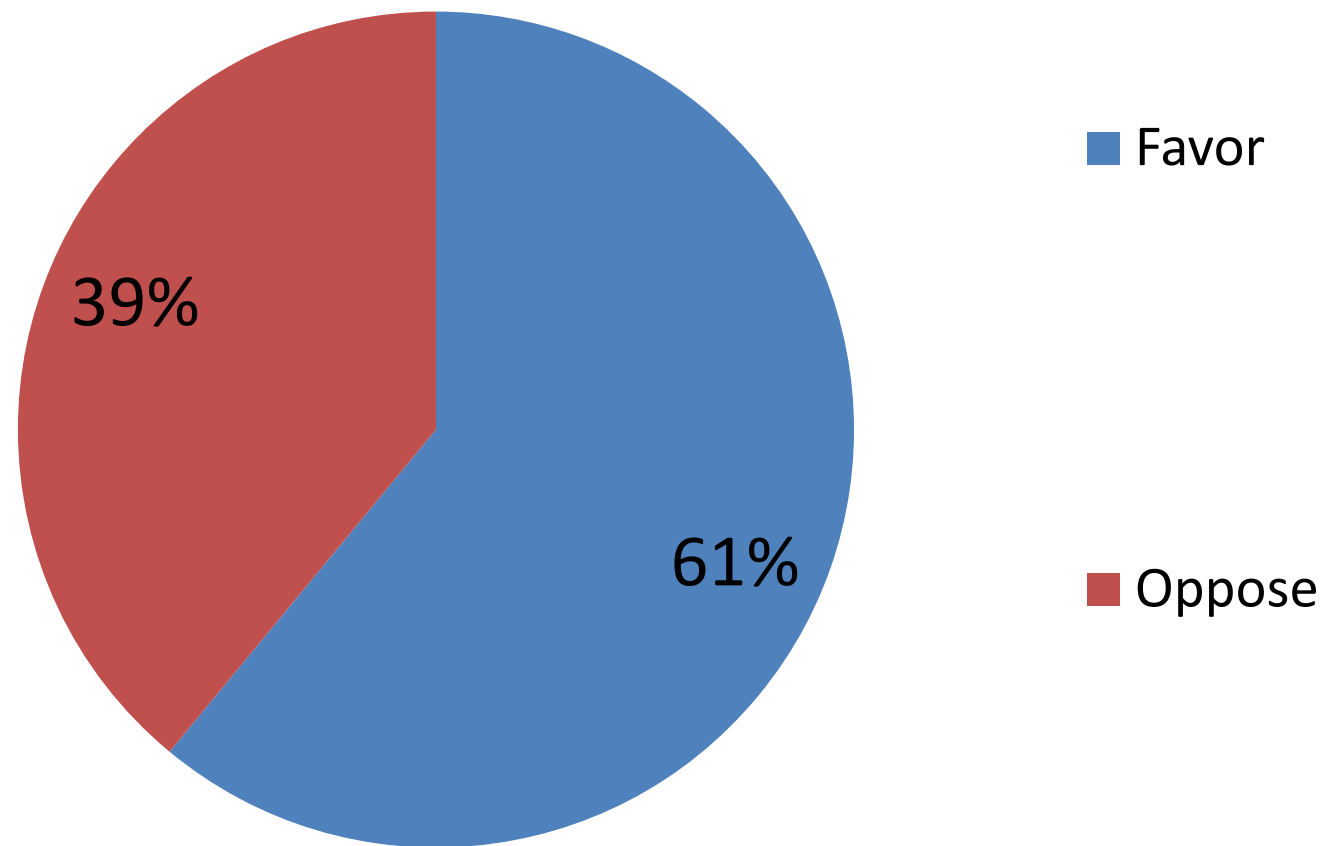
Pre-Event Survey:

Do you favor raising the tax burden on all citizens to help reduce the federal deficit?



Pre-Event Survey:

Would you favor or oppose raising revenues by limiting tax deductions for households with incomes above \$250K?

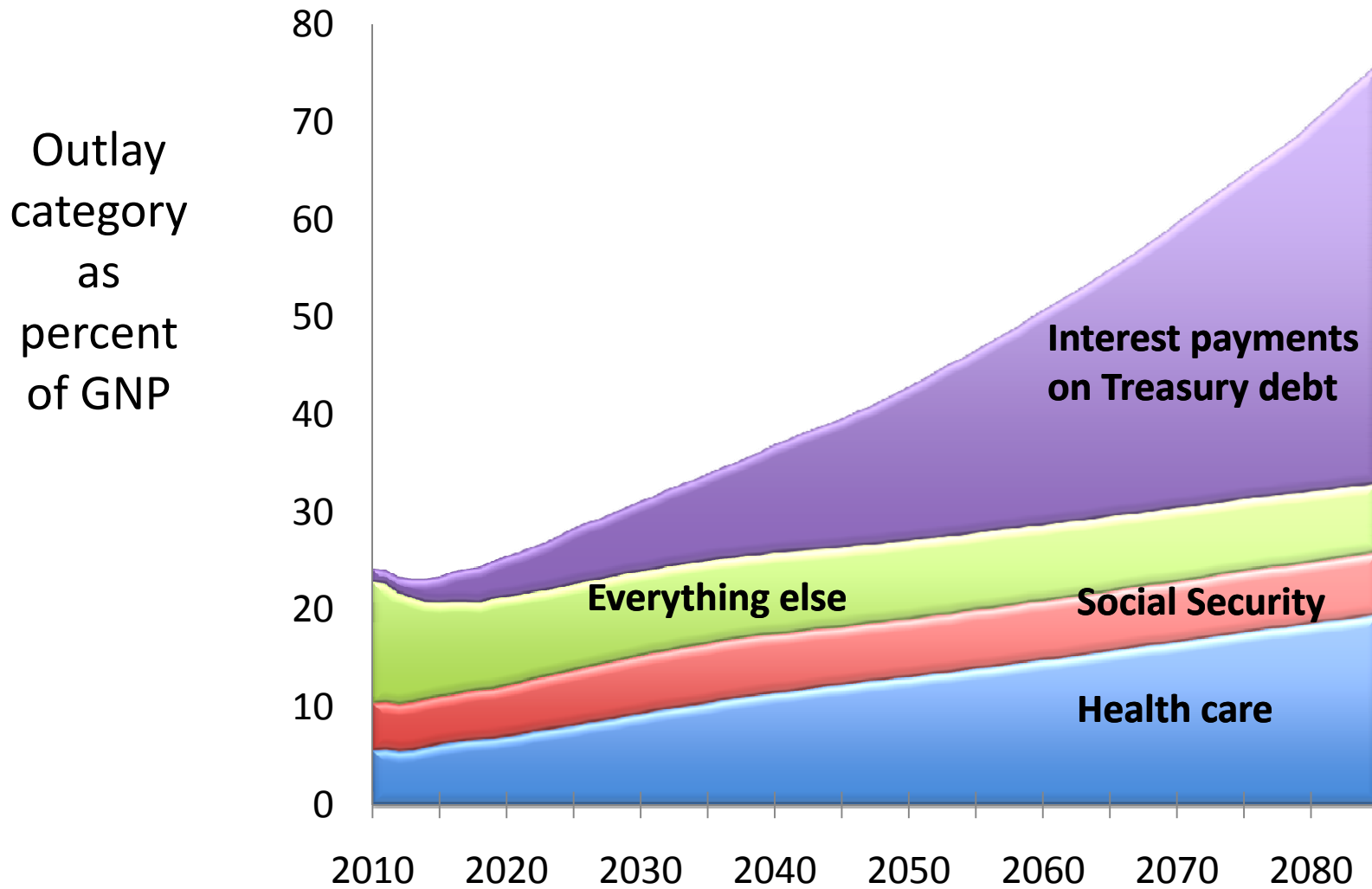


Our Apparent Fiscal Dilemma: Higher Taxes or Higher Debt?

- Higher debt: The alternative fiscal scenario
 - Budget deficits and debt rise forever if current policies are continued
 - At some point, investors might refuse to buy the expanding stock of Treasury debt, resulting in a debt crisis, which could push interest rates sky high
 - If the Treasury cannot roll over its debt, the Federal Government must raise taxes and/or cut spending

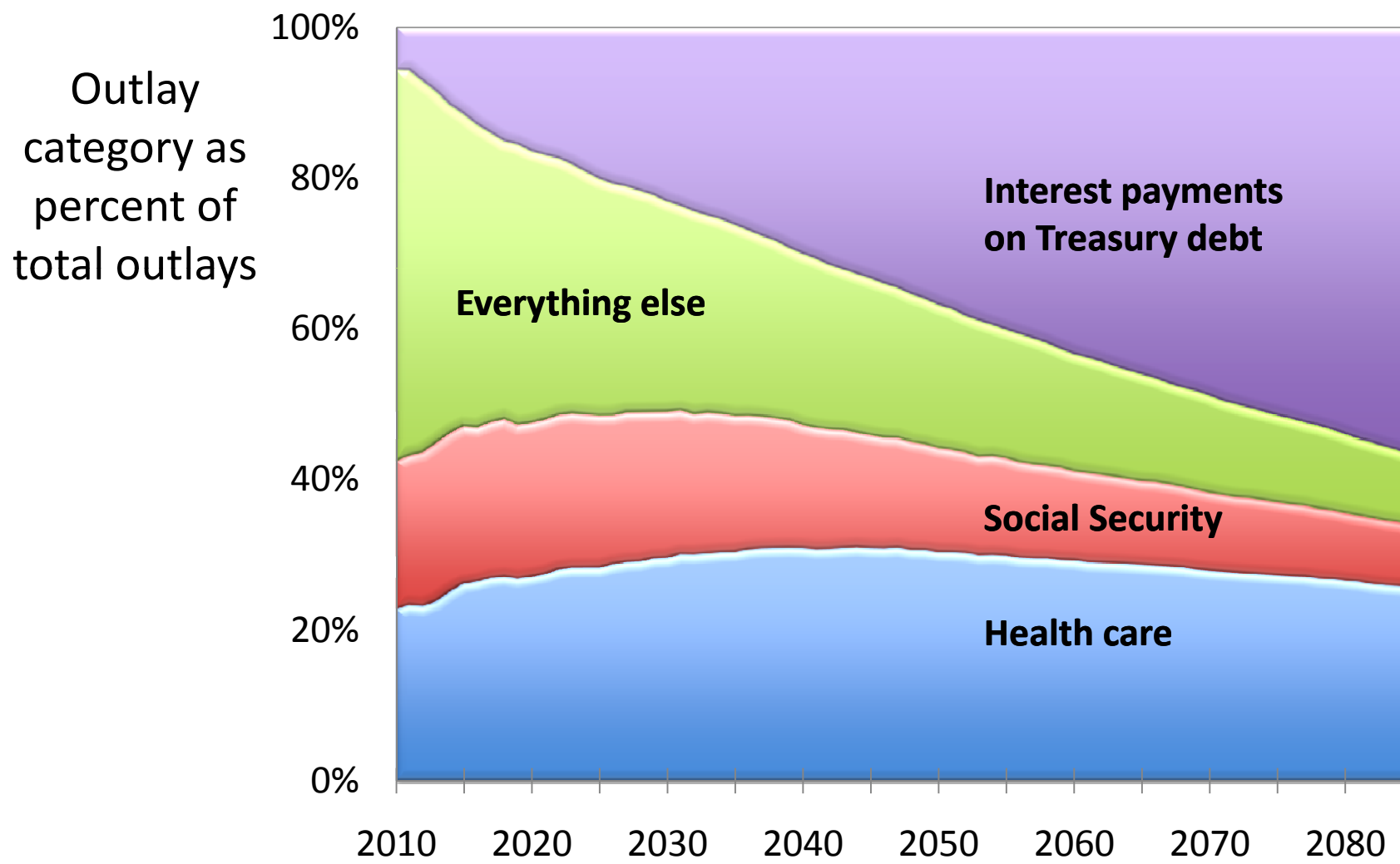
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Projected Composition of Federal Outlays Under CBO's Alternative Fiscal Scenario



Source: Congressional Budget Office (CBO) 46

Projected Shares of Federal Outlays Under CBO's Alternative Fiscal Scenario



Source: Congressional Budget Office (CBO) 47

Is There Any Alternative To Ever-Rising Taxes Or Ever-Rising Debt?

Should a plan to reduce the federal budget deficit include only tax increases, only spending cuts, or a combination of both?

1. Only tax increases
2. Only spending cuts
3. Combination
4. Not sure/no opinion

Raise Taxes Only, Cut Spending Only, Both?

"Do you think any plan to reduce the federal budget deficit should include only tax increases, or only spending cuts, or a combination of both tax increases and spending cuts?"

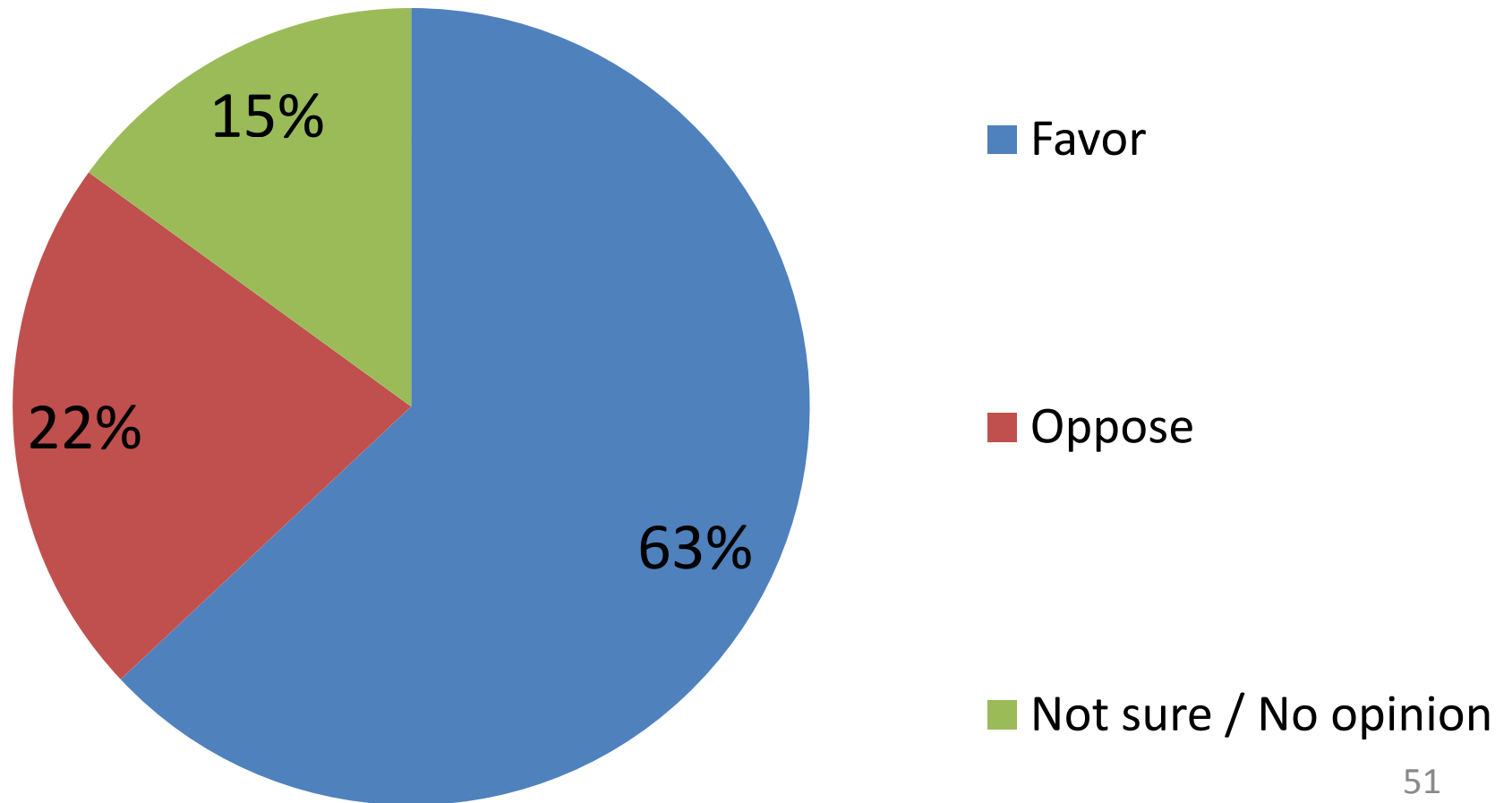
Poll: CBS News/New York Times, Sept. 10-15, 2011;
1,452 adults nationwide, margin of error plus or minus 3 percentage points

Percent responding:	Only tax increases	Only spending cuts	Combination	Unsure
All respondents	3	21	71	5
Republicans	1	39	57	3
Democrats	7	9	82	2
Independents	1	19	70	10

Source: Pollingreport.com, "Budget, Taxes, Economic Policy",
<http://www.pollingreport.com/budget.htm>

Pre-Event Survey:

Would you favor or oppose cutting Social Security to help reduce the federal deficit?



Is There Any Alternative?

- Yes, according to the Bowles-Simpson Deficit Commission (Dec. 2010) and many others
- A medium-term strategy should emphasize:
 - Cuts in both mandatory and discretionary spending
 - Health-care cost control
 - Tax reforms that increase revenues and efficiency
 - Enhanced progressivity on taxes and benefits

Fiscal-Reform Principles

Suggested By Fed Chairman Bernanke

1. Over-arching objective: Achieve long-run fiscal sustainability
2. Avoid abrupt fiscal actions that could impede the economic recovery
3. Choose reforms that promote long-term growth and economic opportunity
4. Improve the process for making long-term budget decisions

Source: Ben S. Bernanke, “Economic Outlook and Recent Monetary Policy Actions”, before the Congressional Joint Economic Committee, Oct. 4, 2011 53

More Specifically: What Some Economists Recommend

- An appropriate medium-term fiscal goal:
Stabilize the debt-to-GNP ratio within five years
 - Achieved by stabilizing the budget deficit at about 2 to 3 percent of GNP

Source: International Monetary Fund 54

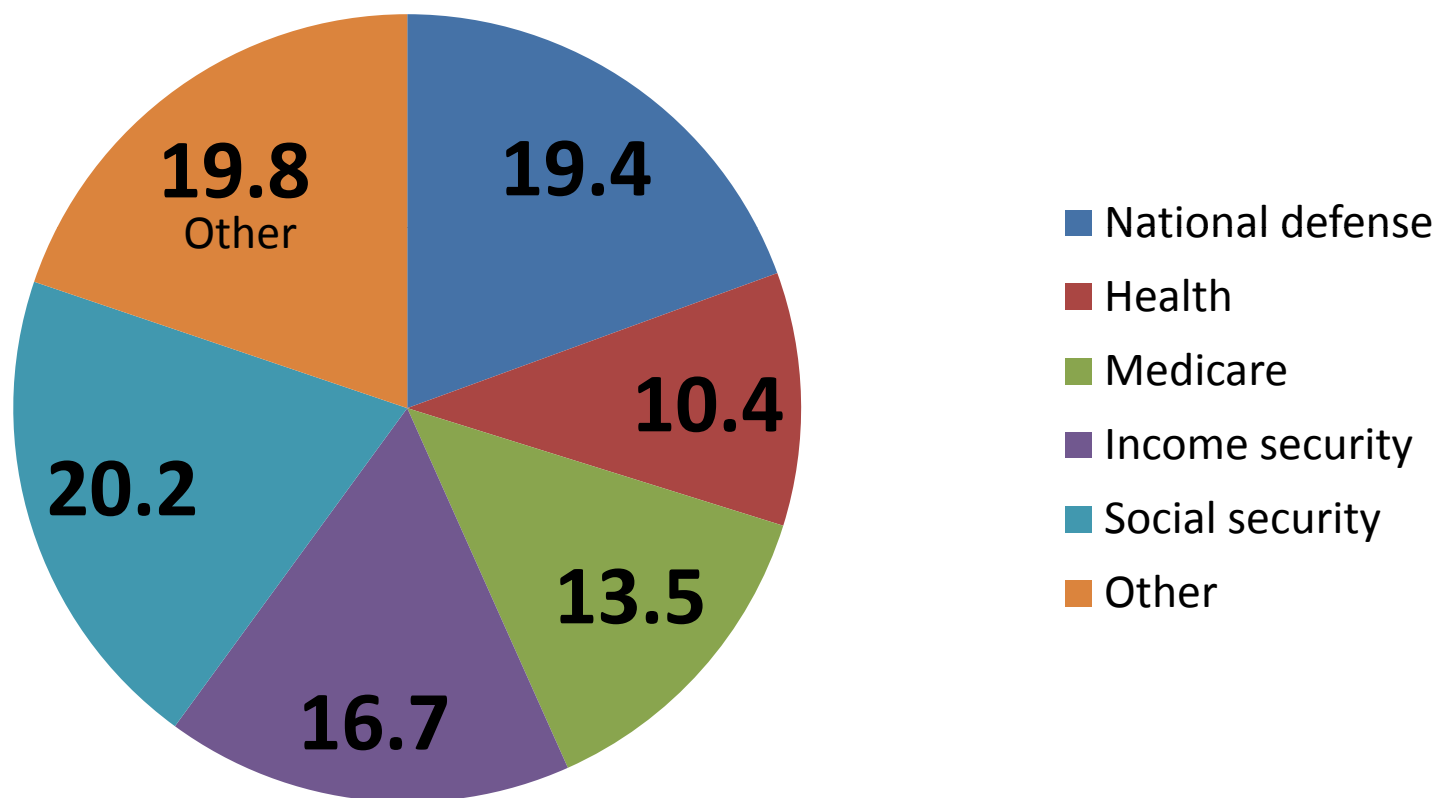
More Specifically: What Some Economists Recommend

- Components of a growth-promoting fiscal-consolidation strategy
 - Cut mandatory spending, including entitlementments
 - Continue planned cuts in discretionary spending
 - Increase revenues and improve the efficiency of the tax system through tax reforms
 - Reduce tax expenditures (deductions, loopholes)
 - Implement a national value-added tax (VAT) or sales tax
 - Consider imposing a carbon tax

Source: International Monetary Fund 55

Current Federal Outlays

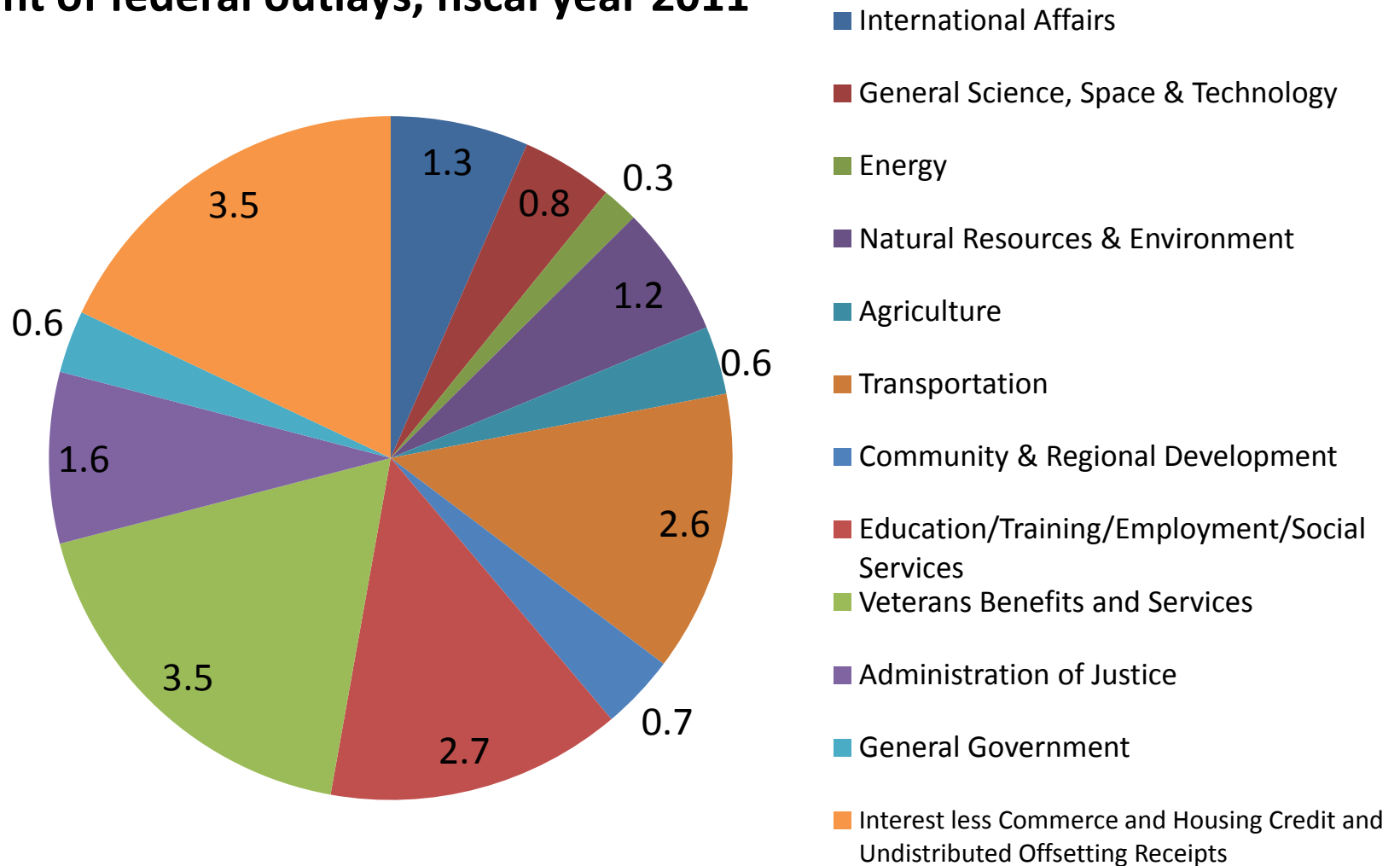
Percent of federal outlays, fiscal year 2011



Source: Congressional Budget Office (CBO) 56

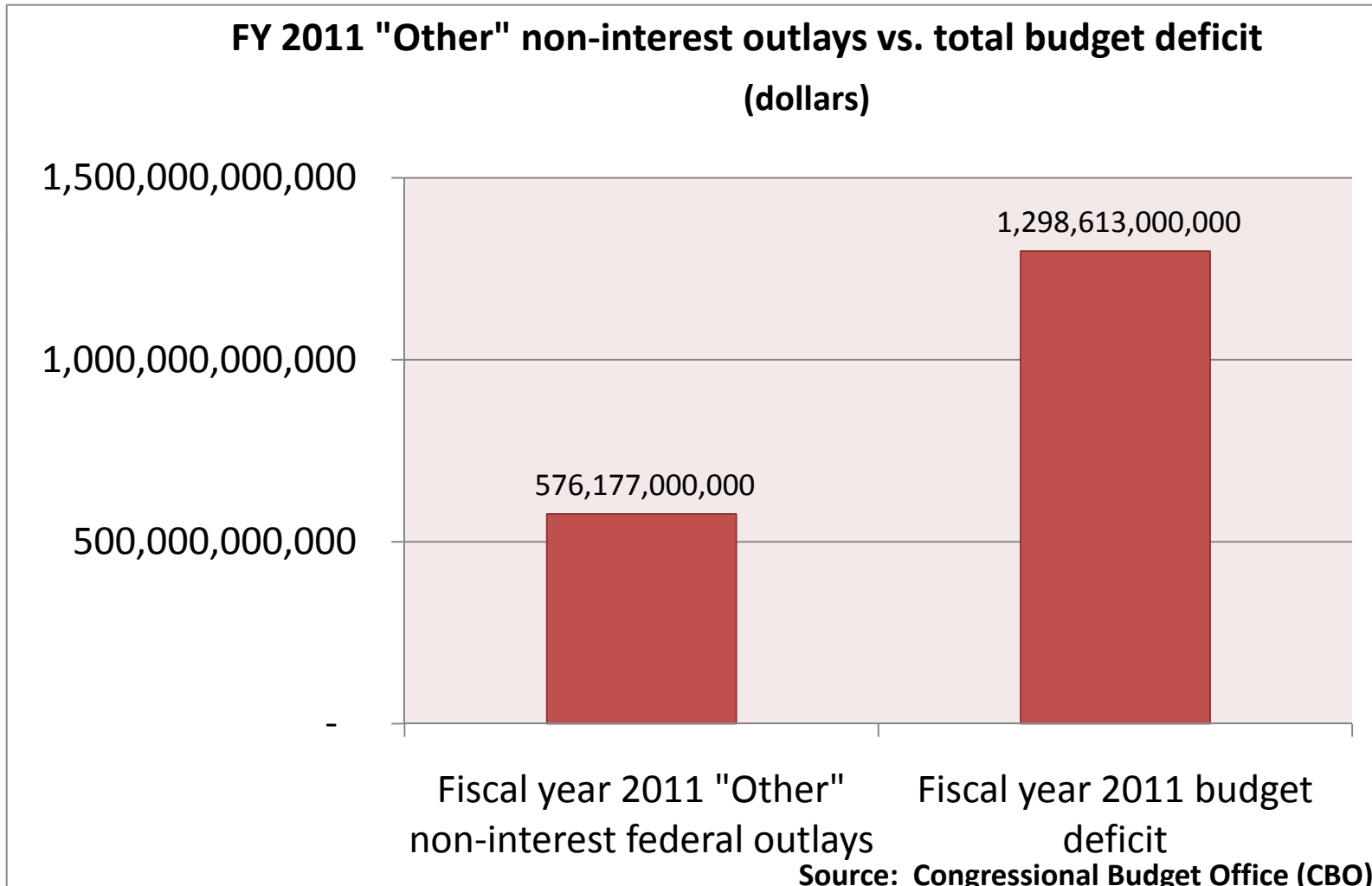
“Other” Federal Outlays

Percent of federal outlays, fiscal year 2011



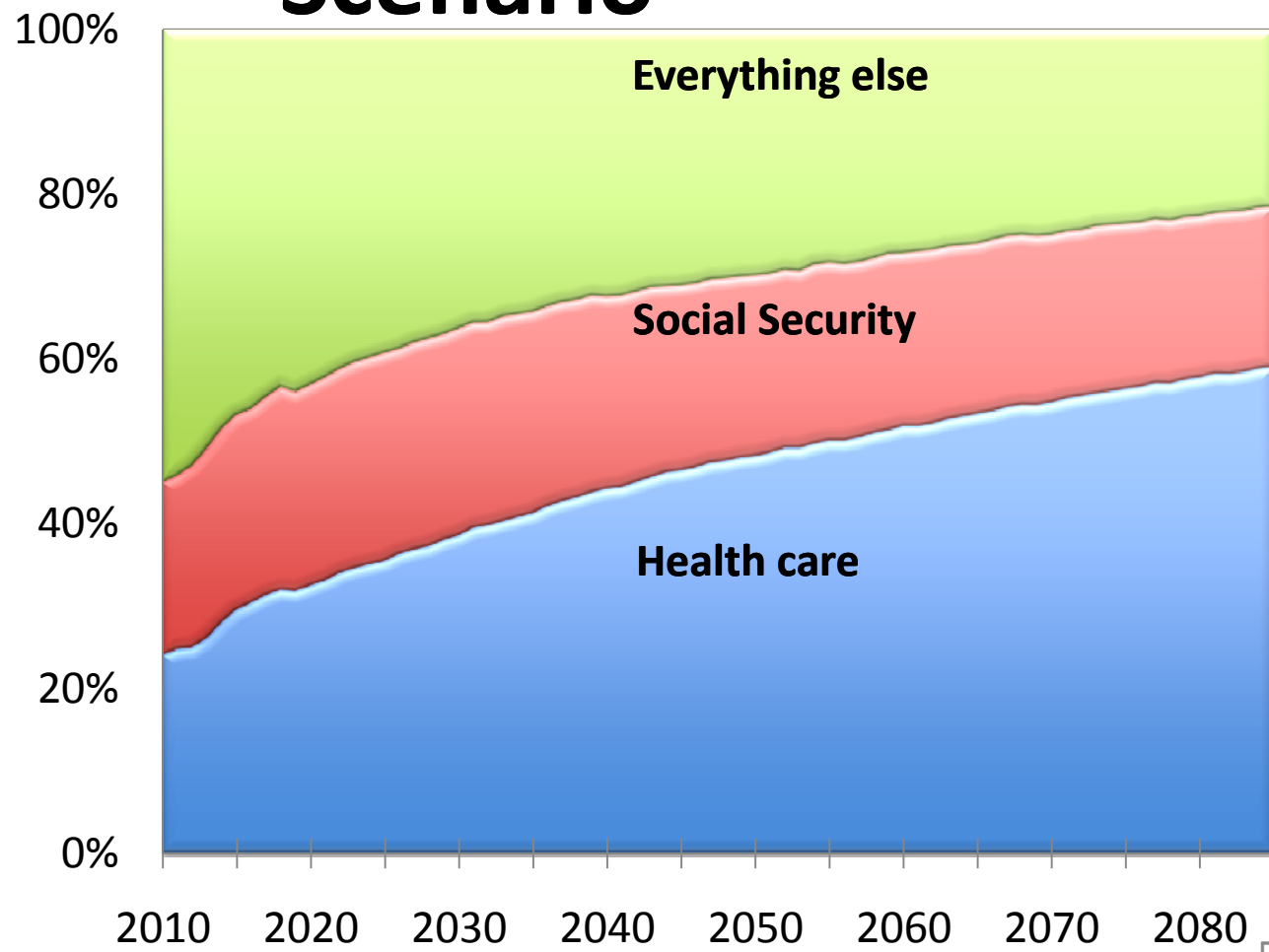
Source: Congressional Budget Office (CBO) 57

Axing All "Other" Non-Interest Federal Outlays Cuts Less Than ½ of Deficit



Projected Shares of Non-Interest Federal Outlays Under CBO's Alternative Fiscal Scenario

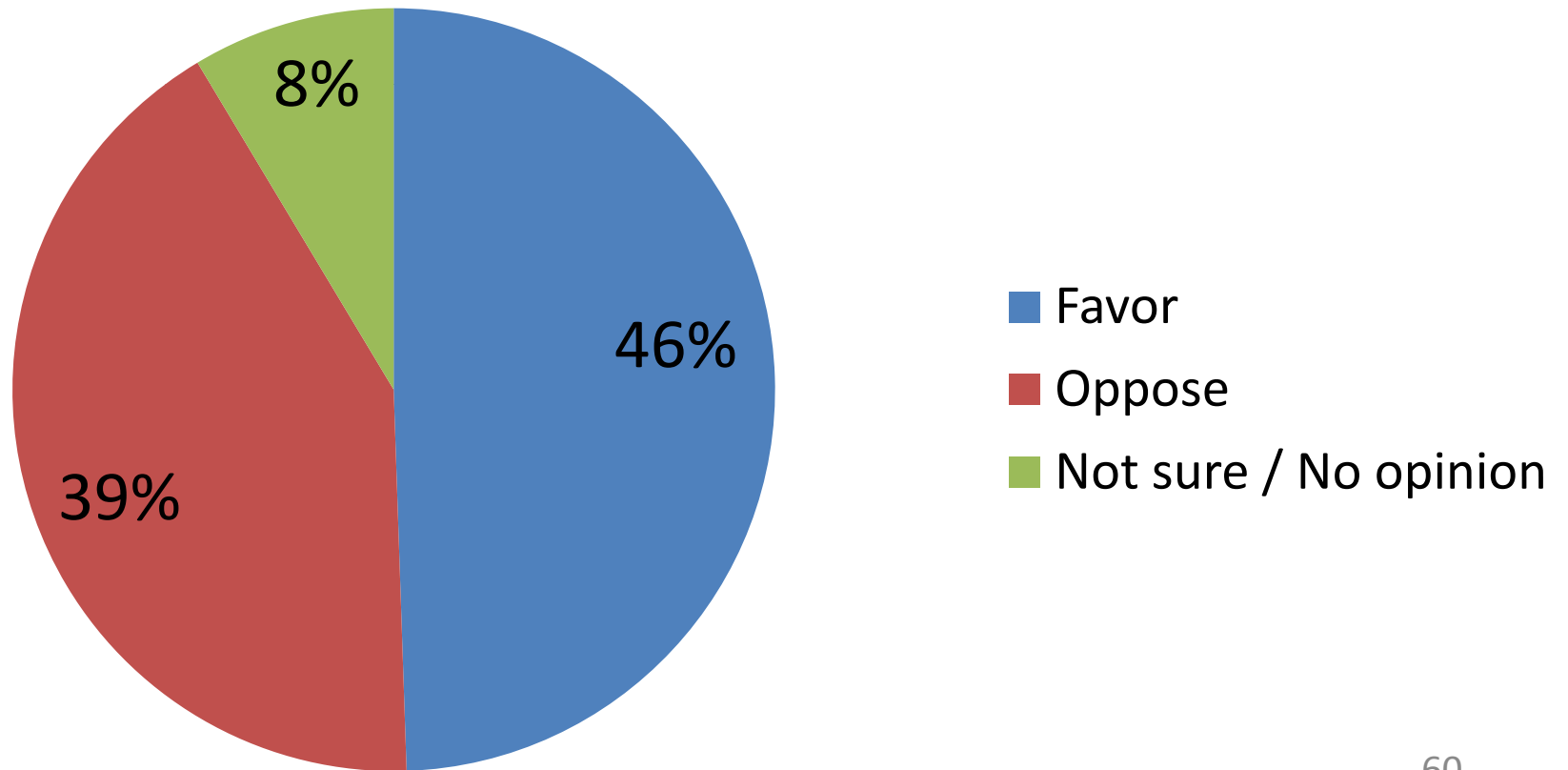
Outlay category
as percent of
total non-
interest outlays



Source: Congressional Budget Office (CBO) ⁵⁹

Pre-Event Survey:

Would you favor or oppose cutting Medicare as a means of reducing the federal deficit?



Controlling Health-Care Spending Will Be Important

- Health-care inflation is expected to continue outpacing most other categories unless significant reforms are instituted
- Both public and private health-care insurance programs have weak cost-control features, at best
- There is mounting evidence that both outcomes and cost-effectiveness of health care can be improved significantly and simultaneously

Improving the Policymaking Process

- Procedural and technical features to increase the likelihood of success
 - Congress should explicitly endorse a medium-term consolidation strategy in its entirety
 - Impose and enforce multi-year expenditure caps as a “failsafe” mechanism to stay on track
 - Use conservative economic assumptions when preparing annual budgets

Source: International Monetary Fund 62

Evidence of A Need For Improvement

- Standard and Poor's (Aug. 5, 2011):

“The downgrade [of long-term U.S. Treasury debt] reflects... our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened.”

Cut Spending *and* Raise Tax Revenues?

The View From the IMF

- International Monetary Fund (Sept. 19, 2011):

“For a country like the United States where... the tax pressure is not particularly high, ... it is necessary that the medium-term fiscal adjustment plans also look at the revenue side given the magnitude of the overall adjustment that is needed....”

Conclusions About Bringing Future Deficits Under Control

1. Neither current law nor a continuation of current policies are palatable outcomes.
2. The Bowles-Simpson Commission (and many others) advocate broad-based spending cuts, including entitlement programs, as well as efficiency- and revenue-enhancing tax reforms.
3. Health-care reforms that reduce cost growth are critical for achieving long-term fiscal sustainability.
4. Budget-process improvements are highly desirable.

Part 3

- Your questions and comments