Beyond the Debt-Ceiling Showdown:

Understanding the Implications of U.S. Fiscal Policy for the Long-Term Health of the Economy

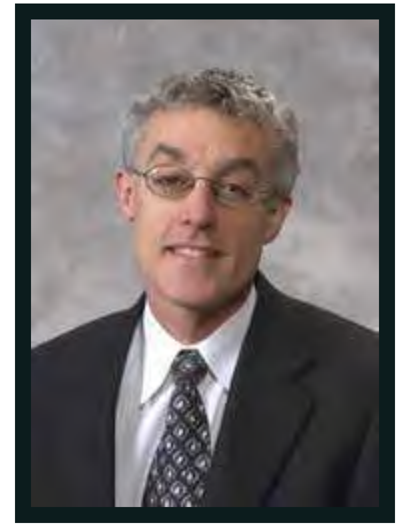
William R. Emmons, Assistant Vice President

Federal Reserve Bank of St. Louis

July 13, 2011

Bill Emmons

- **Bill Emmons** is an Assistant Vice President and Economist in the Division of Banking Supervision and Regulation at the Federal Reserve Bank of St. Louis. He carries out research and policy analysis in the areas of banking, financial markets, and financial regulation.
- Mr. Emmons also serves as an Adjunct Professor of Finance in the John M. Olin School of Business at Washington University in St. Louis, and as a Lecturer in the St. Louis University School of Law.
- Prior to joining the Division of Banking Supervision and Regulation, Mr. Emmons served as an Economist in the Research Division of the St. Louis Fed. Previously, he was on the faculty of the Amos Tuck School of Business at Dartmouth College, in Hanover, New Hampshire.
- Mr. Emmons received a PhD degree in Finance from the J.L. Kellogg Graduate School of Management at Northwestern University. He received bachelors and masters degrees from the University of Illinois at Urbana-Champaign.



The views expressed in this presentation are those of the speaker alone, and do not necessarily represent the views of the Federal Reserve Bank of St. Louis or of the Federal Reserve System.

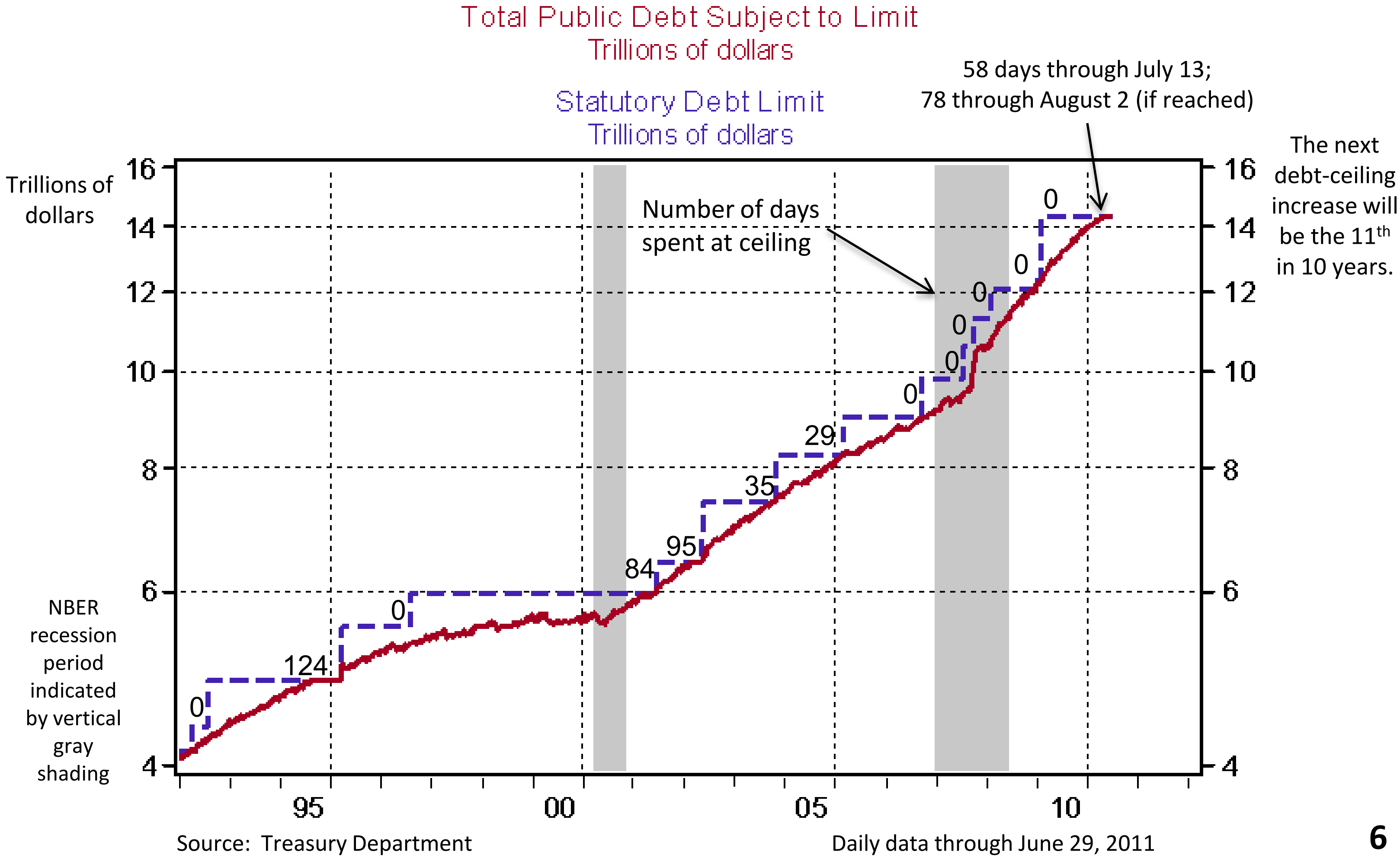
Agenda

I. The federal debt-ceiling impasse
II. Are we facing a major debt crisis in the United States?
III. Economists' views on cutting our large structural budget deficit
IV. Restoring U.S. fiscal policy to long-run health

I. The Federal Debt-Ceiling Impasse

- **Federal debt ceiling first imposed during World War I**
  - Enacted by Congress in 1917
  - Since 1960 alone, the legal limit has been increased 78 times
    - 49 times under Republican presidents
    - 29 times under Democratic presidents
- **Debt subject to limit includes:**
  - Treasury debt held by the public, about $9.7 trillion
  - Intra-governmental holdings of Treasury debt, about $4.6 trillion
    - For example: Government trust funds
- **Treasury often changes cash-management procedures at or near the ceiling, which has been hit five times since 2002**
  - Draw down operating cash balances; issue cash-management bills; adjust Treasury securities auctions to delay cash requirements
  - Defer federal pension investments; swap balances in various government accounts
- **Treasury's best guess about when these procedures no longer will be sufficient to avoid default: August 2, 2011**
  - Need to pass a budget deal by July 22 in order to write and pass the legislation

Federal Debt Ceiling Has Been Increased Ten Times During Last Ten Years



Two Myths About the Debt Limit
(According to the Treasury Department)

Myth 1:

Failure to raise the debt ceiling by July 22, 2011, would cause no greater problems than a government shutdown.

- Without greater borrowing authority, the Treasury would have to stop, limit, or delay payments on a broad array of legal obligations, including Social Security, Medicare, military salaries, interest on the debt, tax refunds, etc.
- Beyond the hardship caused for those directly affected, the faith of investors around the world in U.S. creditworthiness would be shaken.
- A global financial crisis would become likely.

http://www.treasury.gov/initiatives/Documents/Debt%20Limit%20Myth%20v%20Fact%20FINAL.pdf

How Serious Would A Default Be?

- **"The full consequences of a default – or even the serious prospect of default – by the United States are impossible to predict and awesome to contemplate. Denigration of the full faith and credit of the United States would have substantial effects on the domestic financial markets and the value of the dollar."**

  – Former President Ronald Reagan, in a November 1983 letter to Senate Majority Leader Howard H. Baker, Jr.

Two Myths About the Debt Limit
(According to the Treasury Department)

Myth 2:

The Treasury could prioritize interest and principal payments on the debt to avoid default.

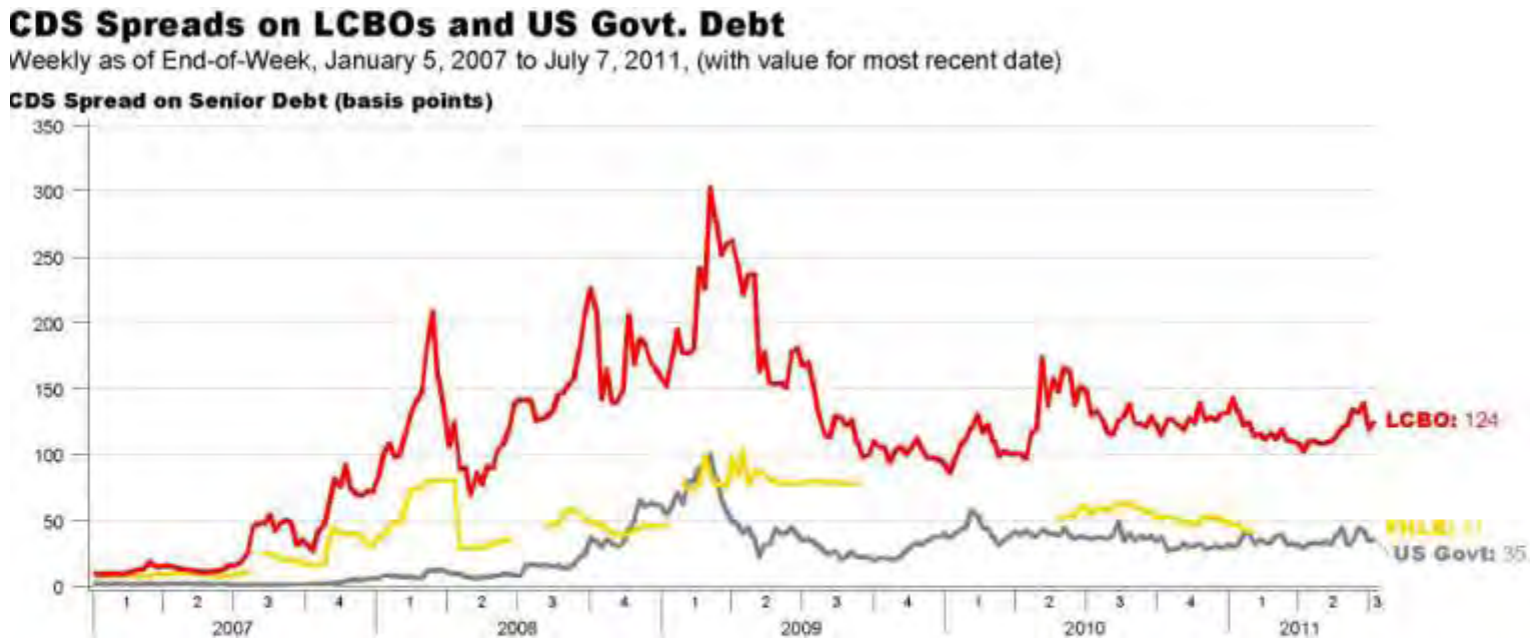
- Failure to pay any of the U.S. Government's legal obligations would constitute default and would be recognized as such by investors, rating agencies, and other parties.
- As a practical matter, the variability of day-to-day Treasury cash inflows and outflows makes strict prioritization of payments impossible.

http://www.treasury.gov/initiatives/Documents/Debt%20Limit%20Myth%20v%20Fact%20FINAL.pdf

Recent Rating-Agency Statements

Rating agency	Date	What they did	Why
Standard and Poor's	April 18, 2011	**Revised their outlook on the long-term debt rating from "stable" to "negative"**	▪ The path to addressing very large budget deficits and rising indebtedness is not clear ▪ There is a material risk that U.S. policymakers might not reach an agreement on how to address medium- and long-term budgetary challenges by 2013 ▪ Did not mention the debt ceiling
Moody's Investors Service	June 2, 2011	**Warned that US Government's rating could be placed on review for downgrade**	▪ Very small but rising risk of a short-lived default ▪ AAA rating will be maintained if ceiling raised ▪ Rating outlook will depend on the outcome of negotiations on deficit reduction
Fitch Ratings	June 8, 2011	**Warned that US Government's rating could be down-graded to "junk" if a "technical default" occurs**	▪ Even a so-called "technical default" would suggest a crisis of governance from a sovereign credit and rating perspective ▪ The political signals coming from Washington are a source of concern ▪ Ratings would go up after all debt obligations were met, but probably not back to the AAA level

Markets Don’t Expect U.S. Default



CDS spreads	USA	Switzerland	Germany	Canada	France	China	Japan	Spain	Greece
July 7, 2011	35 basis points	35	44	53	87	88	90	300	2300

Source: Markit

Austria, United Kingdom

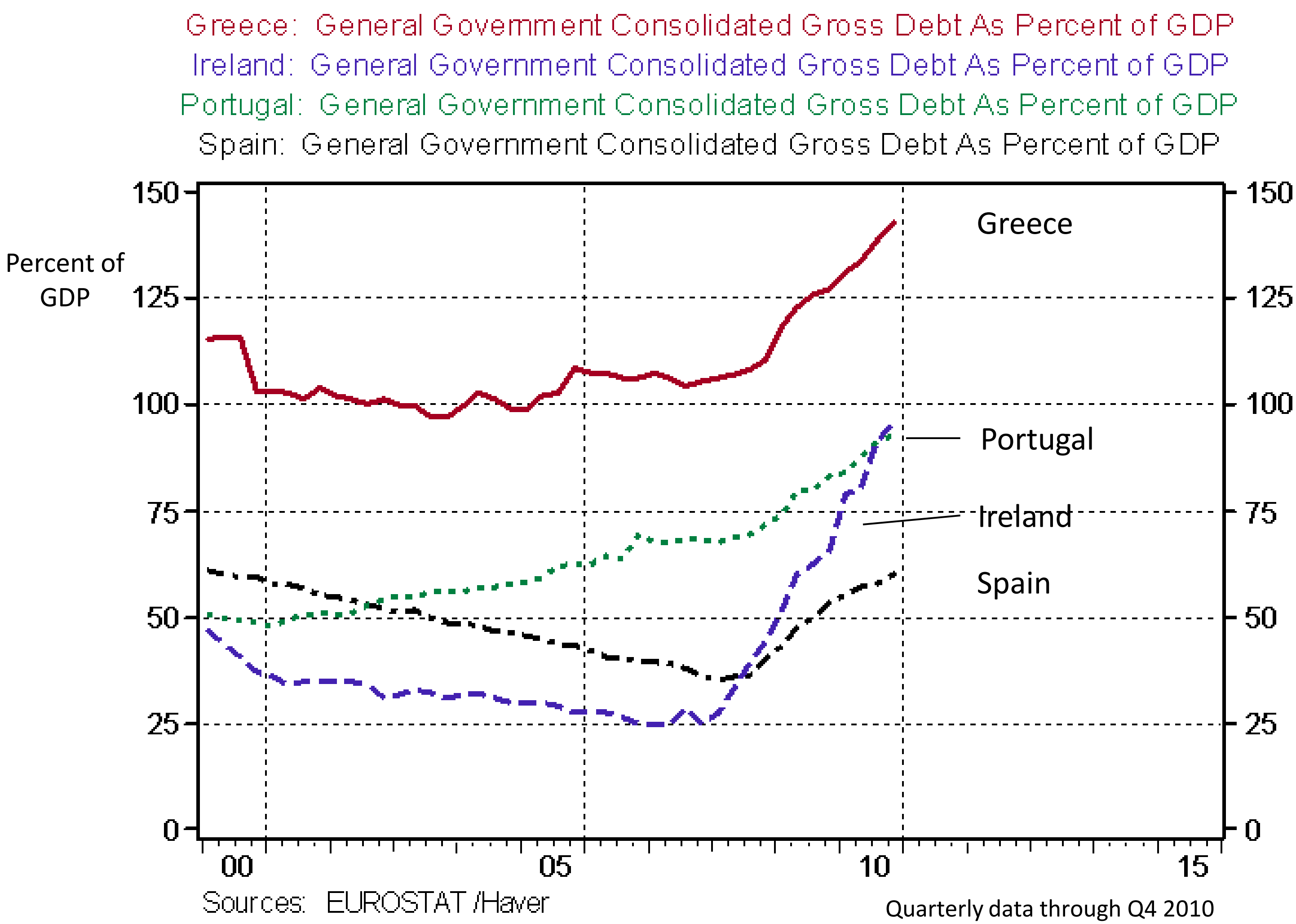
Brazil, Colombia, Italy, Mexico, Russia

Argentina, Ireland, Portugal

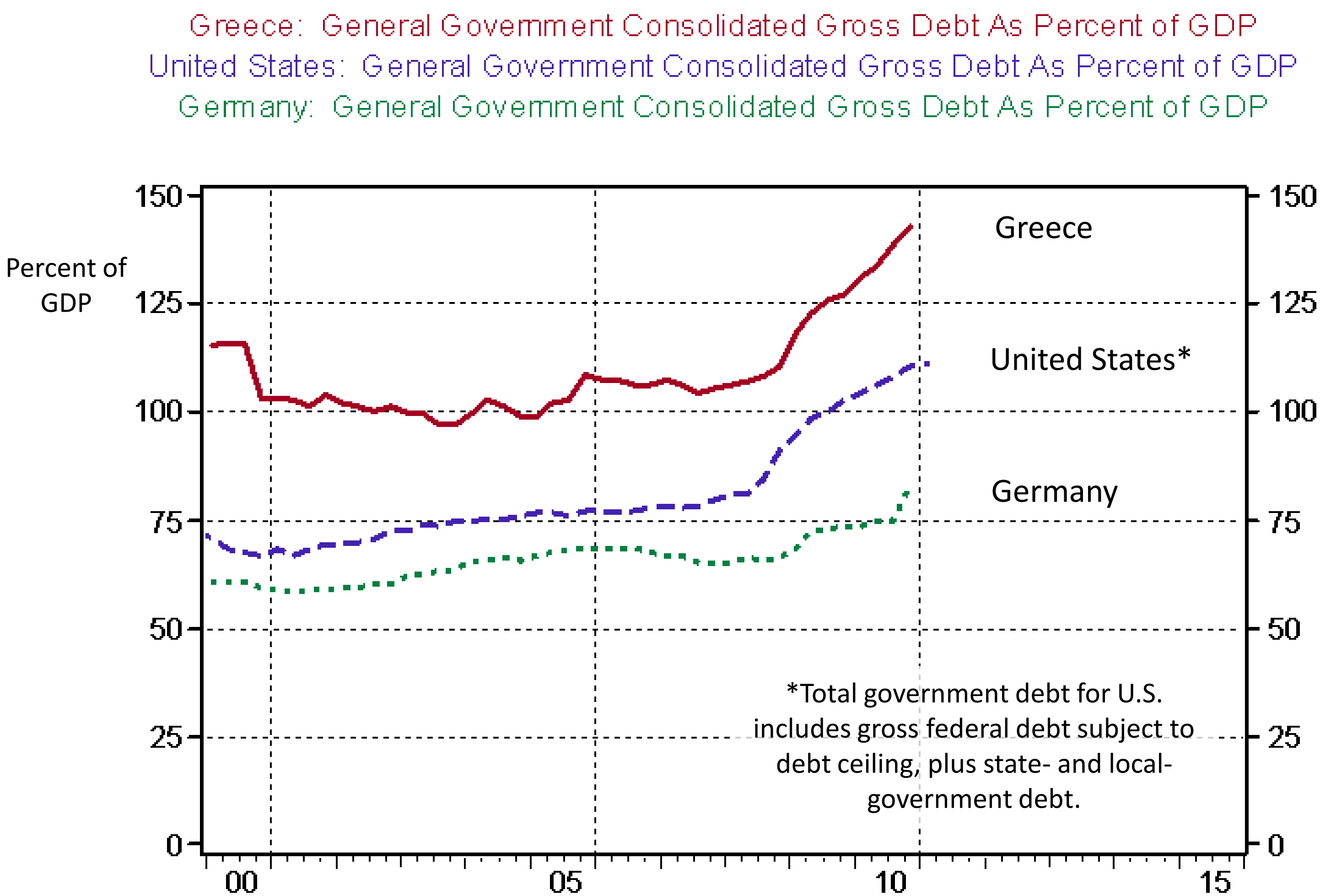
In Sum: The Federal Debt Ceiling

- **The federal debt ceiling has been raised many times since 1917**
- **Failure to raise the ceiling by July 22 likely would cause severe problems in financial markets and the economy**
- **No changes have been announced to regulatory guidance on bank holdings of Treasury obligations**
  - Market-based measures suggest little concern about value impairment to date
  - An actual default likely would be followed promptly by updates from federal and state banking regulators

II. Are We Facing a Major Debt Crisis in the U.S. (Even if We Raise the Ceiling)?



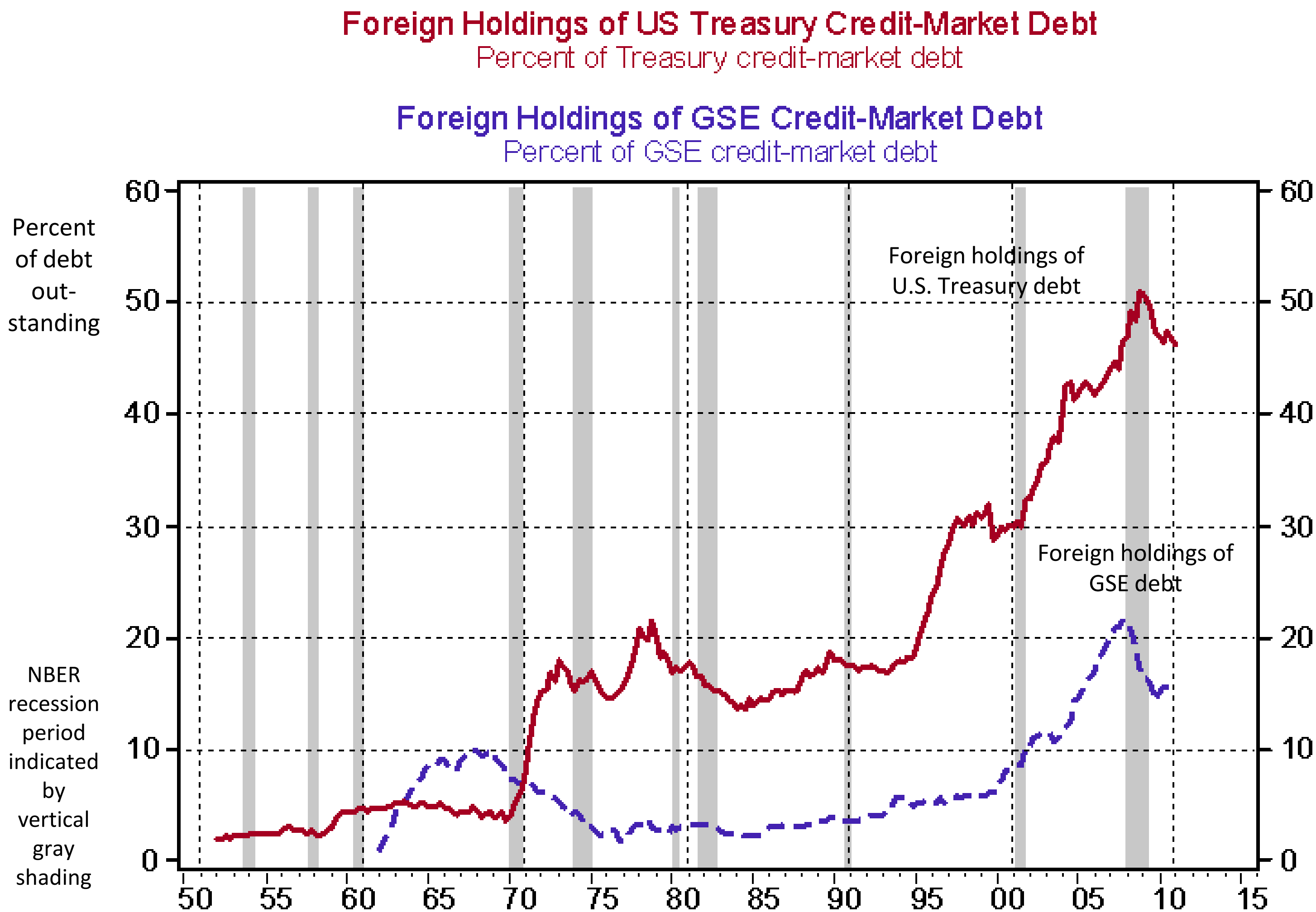
Our Government Debt Burden is as Close to Greece's as it is to Germany's



Sources: Eurostat and U.S. Treasury

Quarterly data through Q4 2010 (Eurozone); Q1 2011 (U.S.)

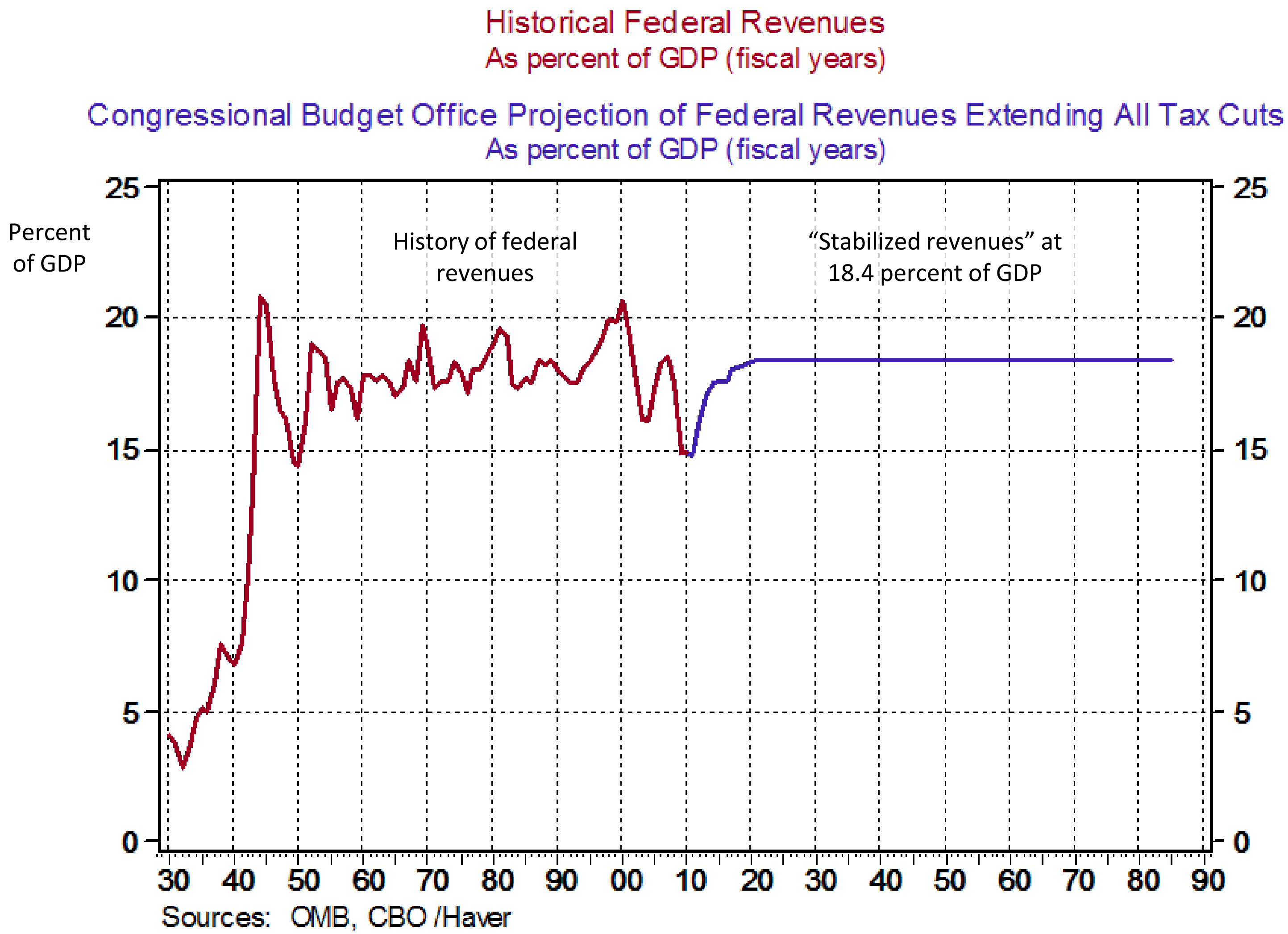
Foreign Investors Own Almost Half of Publicly Held Treasury Debt



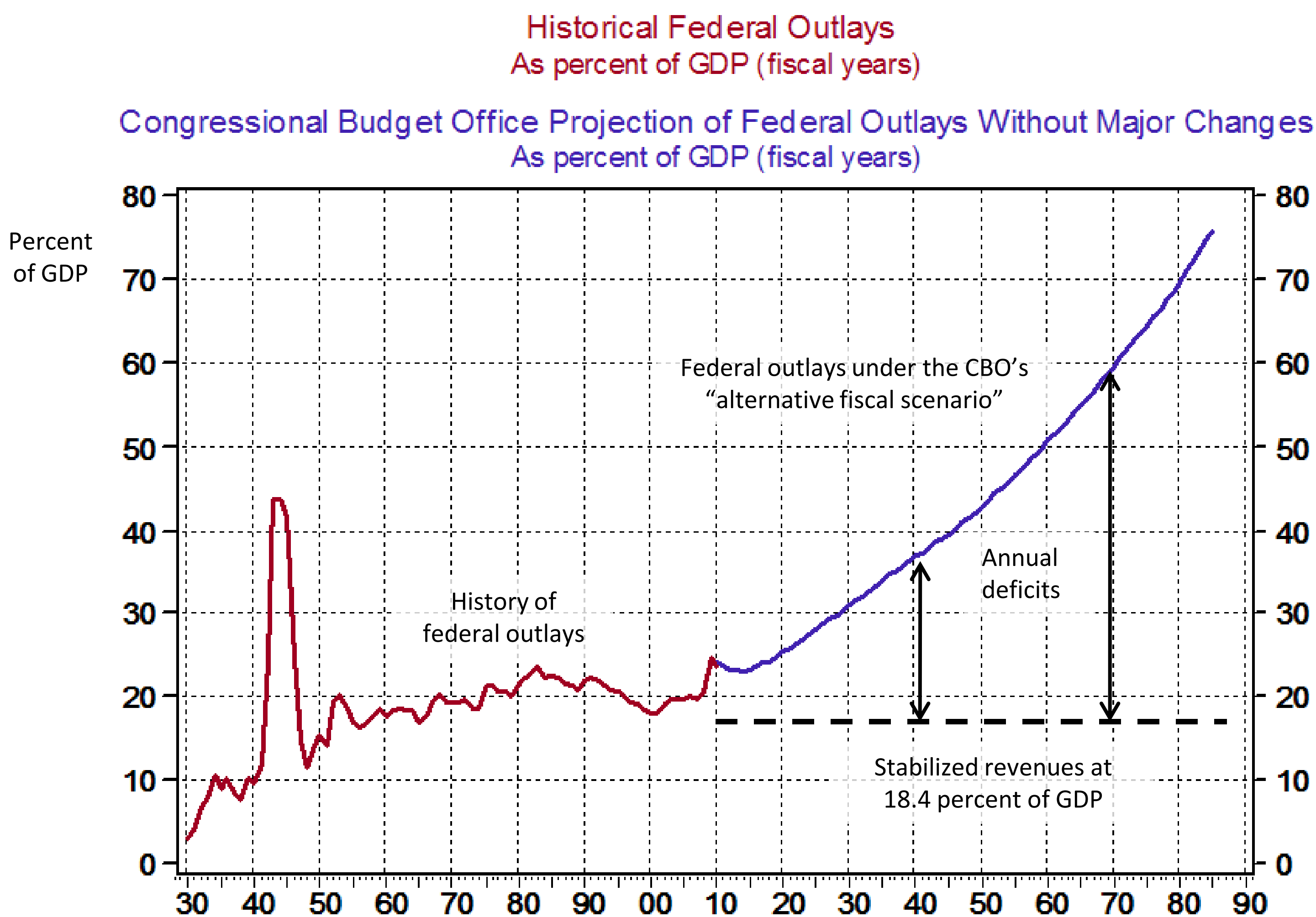
Source: Federal Reserve Flow of Funds Accounts

Quarterly data through Q1.2011

Stabilizing Revenues Near the Historical Average Seems Sensible…



…Until You Compare This to Federal Outlays Likely to Occur



Sources: OMB, CBO /Haver

In Sum: Are We Headed Toward a Major Debt Crisis?

- **The current outlook for U.S. deficits and the accumulating debt is unsustainable over the long run**
- **A major U.S. debt crisis is not inevitable—there is time to undertake needed course corrections**
- **Needed spending and/or tax changes are large and likely to be unpopular**
  - Prudent policy entails a credible lower trajectory for spending and a higher trajectory for revenues
  - A basic principle of economics is to spread any necessary adjustment across multiple margins , i.e., both spending and revenues

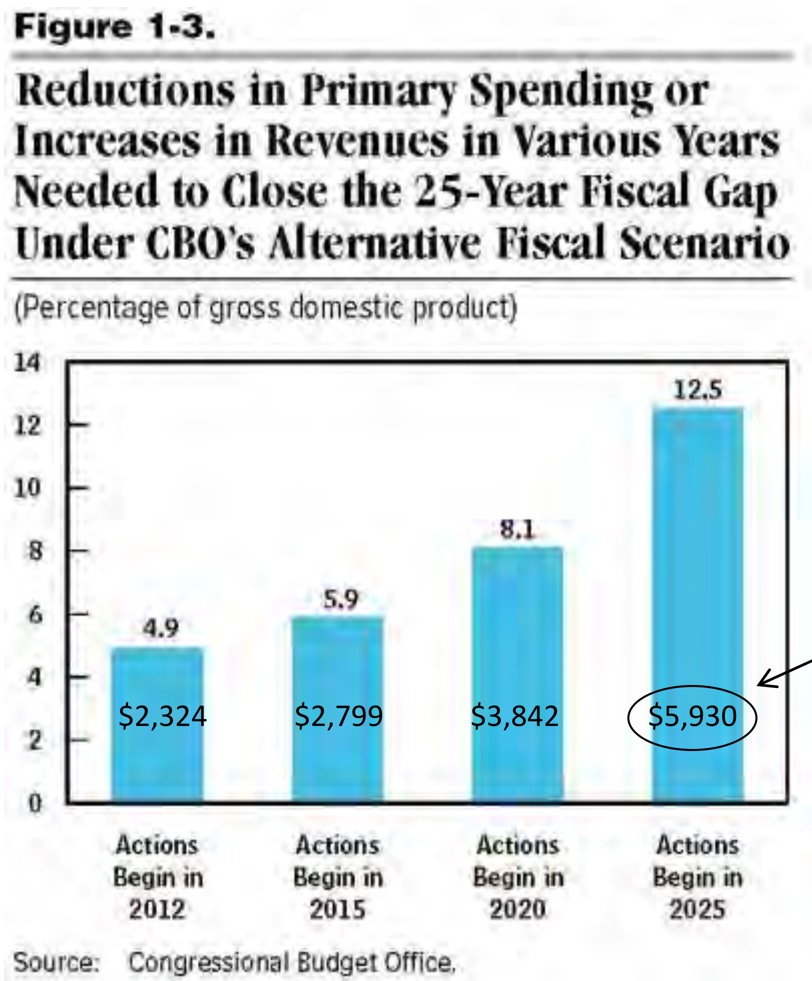
III. Economists' Views On Cutting Our Large Structural Budget Deficit

- **Some principles about which most economists agree**
  - The private sector generally allocates resources more efficiently than the public sector
  - Government is needed for some things, however, and the private sector must pay for what government does
  - Over the business cycle, the federal government can safely incur small average budget deficits (with the "primary deficit"—excluding interest payments—close to balance)
  - Very large, persistent budget deficits are likely to harm the economy
    - Borrowing to pay interest on the growing federal debt crowds out private investment
    - Policymakers lose the flexibility to increase borrowing when the economy is weak
    - The risk of a debt crisis increases

Economists' Policy Recommendations For Cutting Large Structural Budget Deficits

- **Sooner is better than later (but not all right now)**
  - A credible plan decided today to make adjustments over an extended period of time is best
- **Cutting spending generally is better than raising taxes, but some revenue increases would be desirable**
- **Policymakers should distinguish between two key long-term problems in the U.S. fiscal situation**
  - Aging of the Baby Boomers—can't do anything about this except face up to the extra costs they impose on the budget
  - Health-care costs and federal outlays on health care—both are rising much faster than our ability and willingness to pay for them; these can be controlled, in principle

The Cost of Delay: Needed Adjustments Increase At An Increasing Rate



The per-person cost (expressed in terms of 2010 prices and incomes) of eliminating the nation's budget gap through 2035 if the adjustment is begun in a given year

International Evidence on Cutting a Large Budget Deficit: Focus More On Spending Cuts

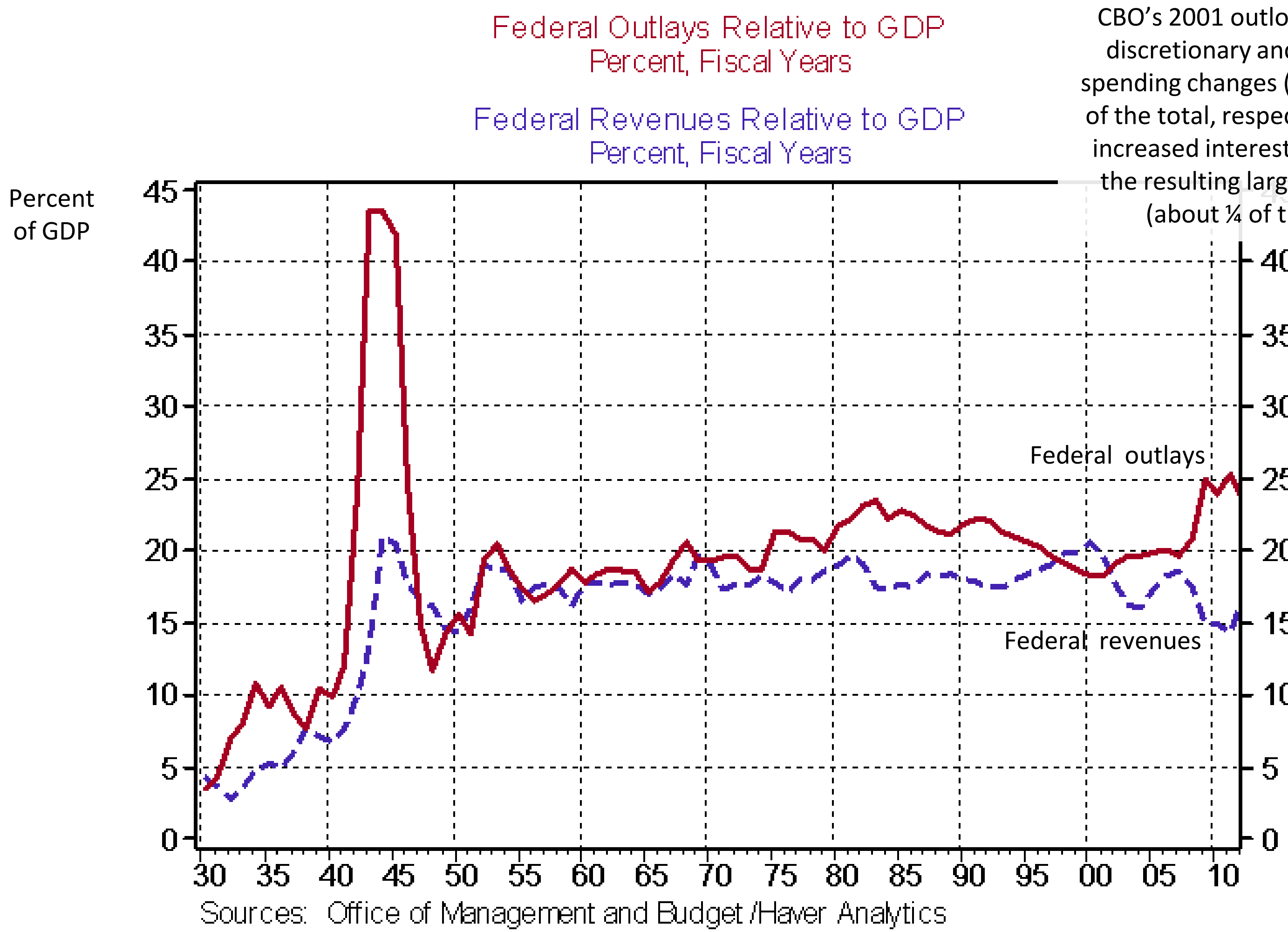
- **"As for fiscal adjustments [i.e., deficit cuts], those based upon spending cuts and no tax increases are more likely to reduce ratios of deficits and debt to GDP than those based upon tax increases [alone].**
- **"In addition, adjustments on the spending side rather than on the tax side are less likely to create recessions."**

  - **"Large Changes in Fiscal Policy: Taxes Versus Spending," Alberto F. Alesina and Silvia Ardagna, National Bureau of Economic Research Working Paper 15438, Oct. 2009, http://www.nber.org/papers/w15438**

IV. Restoring U.S. Fiscal Policy to Long-Run Health

- The budget-deficit facts
- The central role of healthcare costs
- A plan for reaching primary balance (i.e., excluding interest payments), and why it won't work
- The challenge we face

Both Federal Outlays and Revenues Are At Historically Unusual Levels



Increased outlays relative to CBO's 2001 outlook are due to discretionary and mandatory spending changes (about ½ and ¼ of the total, respectively), and to increased interest payments on the resulting larger debt stock (about ¼ of the total).

Revenue deterioration from a decade ago is due in roughly equal measures to tax cuts and recessions.

Budget Facts and Congressional Budget Office (CBO) Budget Scenarios

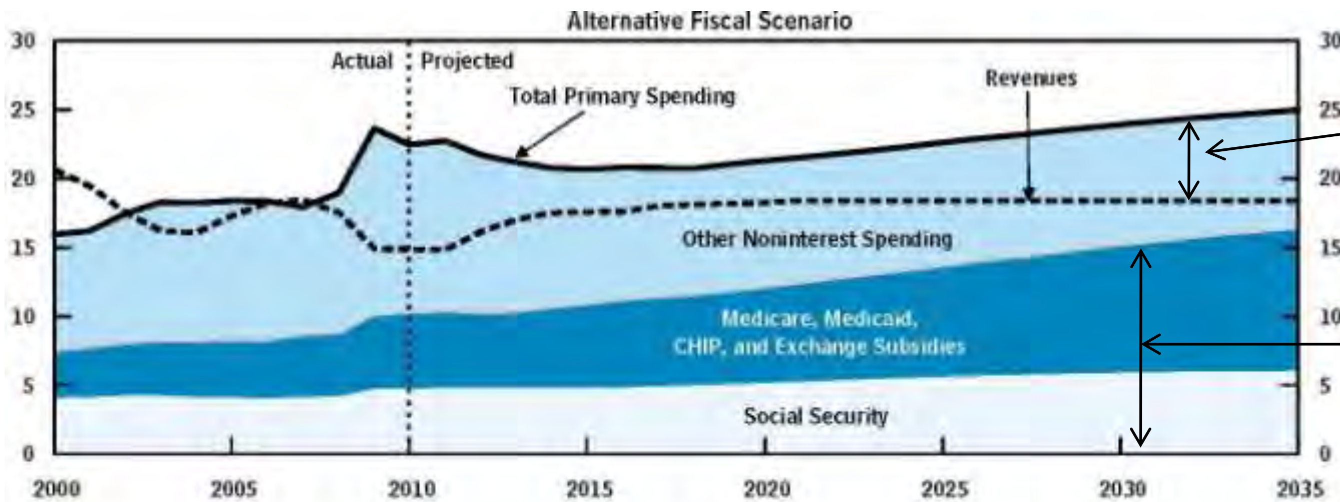
- **Best source for detailed, objective, timely, non-partisan federal budget information, analysis, and projections:**
  - CBO's 2011 Long-Term Budget Outlook, Congressional Budget Office, June 22, 2011 (http://www.cbo.gov/doc.cfm?index=12212)
- **CBO considers two long-range scenarios**
  1. Extended Baseline Scenario
     - "Current law": Budget projections based on laws as written today
     - Mainstream economic forecast; no feedbacks from debt build-up
  2. Alternative Fiscal Scenario (discussed further below)
     - "Current policy": Budget projections based on CBO's expectation that future Congresses and presidents will behave as during the last decade, refusing to implement planned fiscal tightening
     - Mainstream economic forecast; no feedbacks from debt build-up
- **CBO's bottom line (under both scenarios):**
  - "To keep deficits and debt from climbing to unsustainable levels, policymakers will need to increase revenues substantially as a percentage of GDP, decrease spending significantly from projected levels, or adopt some combination of those two approaches."

Alternative Fiscal Scenario: Legislated Fiscal Tightening Is Always Postponed

Figure 1-1.

Primary Spending and Revenues, by Category, Under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)



Annual primary deficits rise forever

Entitle-ments drive spending growth

Source: Congressional Budget Office.

Notes: Primary spending refers to all spending other than interest payments on federal debt.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period. (For details, see Table 1-1 on page 4.)

CHIP = Children's Health Insurance Program.

Rising Entitlement Spending Drives Deficits and Debt To Extreme Levels

Table 1-2.

Projected Spending and Revenues Under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)

	2011	2021	2035
		Alternative Fiscal Scenario	
Spending			
Primary spending			
Social Security	4.8	5.3	6.1
Medicare[a]	3.7	4.3	6.7
Medicaid, CHIP, and exchange subsidies	1.9	2.8	3.7
Other noninterest spending	12.3	9.1	8.5
Subtotal, primary spending	22.7	21.5	25.0
Interest spending	1.4	4.4	8.9
Total Spending	24.1	25.9	33.9
Revenues	14.8	18.4	18.4
Deficit			
Primary deficit	-7.9	-3.1	-6.6
Total deficit	-9.3	-7.5	-15.5
Debt Held by the Public[b]	69	101	187

Major entitlements

= 10.4

= 12.4

= 16.5

Interest payments would exceed all non-mandatory spending!

Source: Congressional Budget Office.

Notes: Primary spending refers to all spending other than interest payments on federal debt. The primary deficit or surplus is the difference between revenues and primary spending.

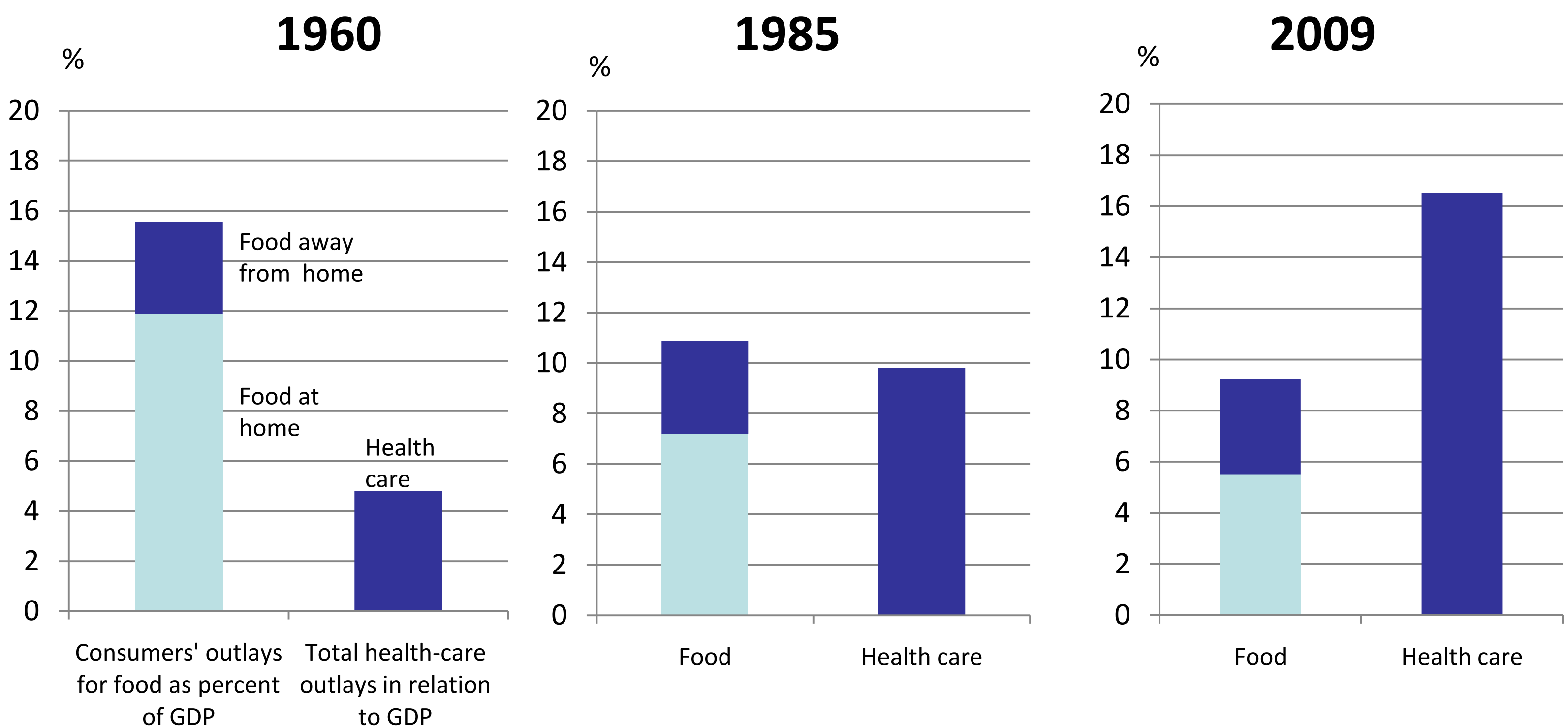
The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period. (For details, see Table 1-1 on page 4.)

CHIP = Children's Health Insurance Program.

a. Spending for Medicare reflects gross amounts. Beneficiaries' premiums and certain other receipts used to offset a portion of spending for Medicare are included in other noninterest spending.

b. At the end of the year.

Outlays for Health Care Growing Much Faster Than Other Categories

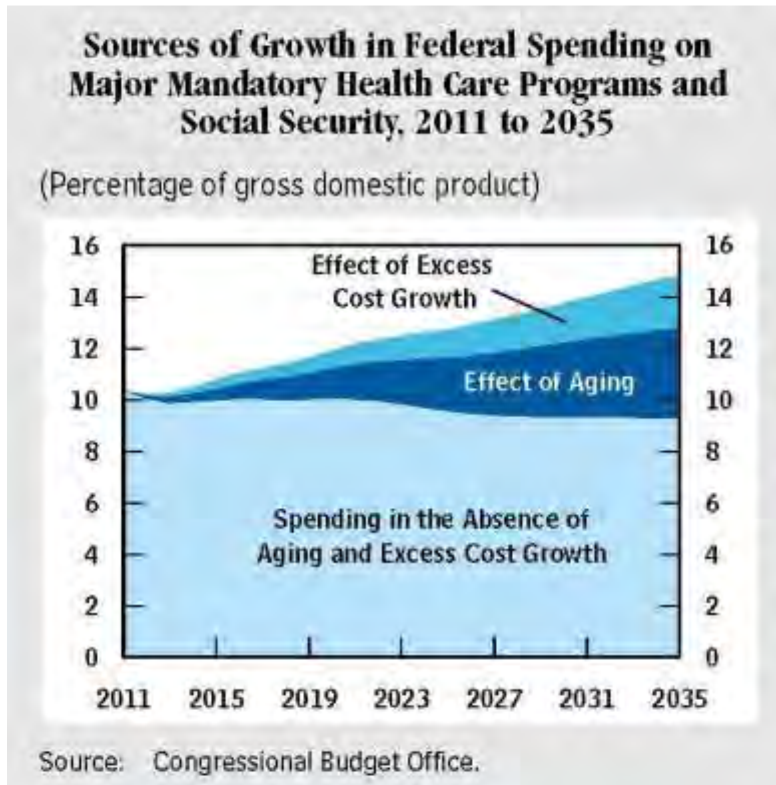


Source: Bureau of Economic Analysis

Why Has Health-Care Spending Grown So Fast?

- **Total health-care spending (public and private) has grown about two percentage points faster each year than the economy itself (i.e., almost double) for several decades.**
  - **This cannot go on forever, or the economy eventually would consist entirely of health care!**
- **Drivers of excess health-care spending growth:**
  - **Medical technologies**
    - Especially at the beginning and end of life
  - **Rising personal incomes**
    - Improved health is a “superior good” (richer people want more)
  - **Increasing scope of health-insurance coverage; poor market discipline**
    - Textbook example of moral hazard: Those who consume and provide health-care services do not pay directly for their choices
    - Both public and private insurance contribute to the cost spiral
  - **Aging population**
    - Interacts with all of the above to drive costs even faster
    - Matters more as Baby Boomers age (thru 2035) than in the long run
  - ➢ **All of these factors suggest higher than historical revenues are needed (the 18.4 percent “stabilized revenues” target is too low)**

Excess Health-Care Cost Growth and Baby-Boomer Aging Are Driving Up Spending on Federal Entitlements



Note: In the 50 years *beyond 2035*, the effect of excess health-care cost growth is expected to continue to increase, while the effect of aging is expected to decrease as the Baby Boomers die.

Mandatory Spending Drives Future Deficits—But the Public May Not Understand That Change Is Necessary

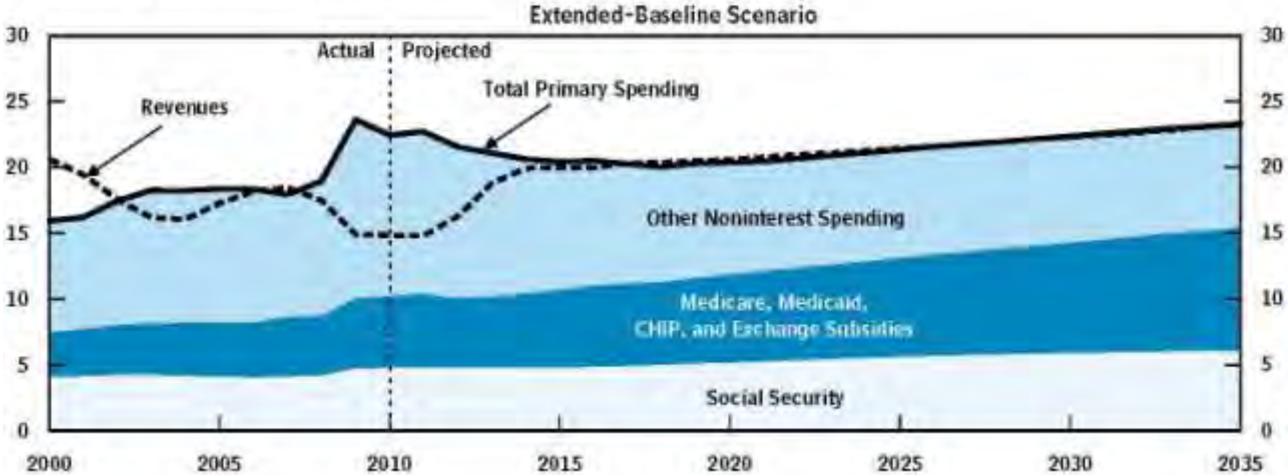
- **Social Security and federal health-care spending are—by far—the biggest expenditure contributors to future primary deficits.**
- **But most Americans think these programs can be spared (from a May 2011 public-opinion poll by Gfk Roper, including 1,001 adults nationwide):**
  - "Do you think it is possible for the federal government to balance its budget without cutting spending on Social Security, or do you think spending on Social Security will have to be cut?“
    - **59% said cuts are not necessary; 2% unsure**
  - "Do you think it is possible for the federal government to balance its budget without cutting spending on Medicare, or do you think spending on Medicare will have to be cut?“
    - **54% said cuts are not necessary; 2% unsure**

A Budget Plan That Reaches Primary Balance by 2017: Current Law

Figure 1-1.

Primary Spending and Revenues, by Category, Under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Notes: Primary spending refers to all spending other than interest payments on federal debt.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period. (For details, see Table 1-1 on page 4.)

CHIP = Children's Health Insurance Program.

Projections Under Current Law: Better For Awhile, But No Long-Term Solution

Table 1-2.

Projected Spending and Revenues Under CBO's Long-Term Budget Scenarios

(Percentage of gross domestic product)

	2011	2021	2035
		Extended-Baseline Scenario	
Spending			
Primary spending			
Social Security	4.8	5.3	6.1
Medicare[a]	3.7	4.1	5.9
Medicaid, CHIP, and exchange subsidies	1.9	2.8	3.5
Other noninterest spending	12.3	8.3	7.8
Subtotal, primary spending	22.7	20.5	23.3
Interest spending	1.4	3.4	4.1
Total Spending	24.1	23.9	27.4
Revenues	14.8	20.8	23.2
Deficit (-) or Surplus			
Primary deficit or surplus	-7.9	0.3	-0.1
Total deficit	-9.3	-3.1	-4.2
Debt Held by the Public[b]	69	76	84

Major entitlements

= 10.4

= 12.2

= 15.5

Only slightly less than under alternative fiscal scenario (16.4%)

Revenues are much higher than under AFS (18.4%)

Less severe by 2035 than under AFS, but headed in the same unsustainable direction

Source: Congressional Budget Office.

Notes: Primary spending refers to all spending other than interest payments on federal debt. The primary deficit or surplus is the difference between revenues and primary spending.

The extended-baseline scenario adheres closely to current law, following CBO's 10-year baseline budget projections through 2021 and then extending the baseline concept for the rest of the long-term projection period. The alternative fiscal scenario incorporates several changes to current law that are widely expected to occur or that would modify some provisions that might be difficult to sustain for a long period. (For details, see Table 1-1 on page 4.)

CHIP = Children's Health Insurance Program.

a. Spending for Medicare reflects gross amounts. Beneficiaries' premiums and certain other receipts used to offset a portion of spending for Medicare are included in other noninterest spending.

b. At the end of the year.

Why Won't Current Law Fix The Problem?

- **Current law requires harsh adjustments that Congress has not been willing to make in recent years**
  - **Spending decreases**
    - For example, Medicare payments to physicians are scheduled to decline by 30% in Jan. 2012, with further decreases scheduled later
    - Congress repeatedly has deferred this change
  - **Revenue increases**
    - For example, most of the Bush- and Obama-era tax cuts are scheduled to expire in 2012 or 2013
    - The Alternative Minimum Tax (AMT) is not indexed for inflation
    - Together, these and other provisions of current law would raise about $700 billion of additional revenue annually by 2035 (in today's terms)
    - Congress did not allow any of the scheduled revenue raisers to take effect in 2010-11
- **Even if current laws were implemented as written, it would not eliminate the long-term deficit problem due to excess health-care cost growth and population aging**

In Sum: Restoring U.S. Fiscal Policy To Long-Run Health

- **U.S. politicians generally do what their constituents want them to do**
  - Leave Social Security and Medicare alone
  - Keep taxes low
- **But our long-term fiscal imbalance cannot be resolved without major adjustments in entitlements and/or taxes**
  - We need higher revenues to accommodate the needs of the Baby Boomers and improved health care for the next few decades
  - The federal budget and the economy itself both need to bring health-care cost growth and health-care outlays under control

Overall Summary and Conclusions

Congress is under pressure to lift the federal debt ceiling by July 22; lack of action has the potential to spark a renewed financial crisis

The U.S. is on the path to a major debt crisis, but there is time to avoid one

Most economists recommend prompt action to durably reduce federal spending, especially on health care

The U.S. political system—including both elected officials and the public—faces a major challenge to restore our long-term fiscal health

Thanks for joining us.