Minutes of the Economic Advisory Panel

Meeting of November 16, 2012

Present: External advisors: Robert Barro, Alan Blinder, Jacob Frenkel, Mark Gertler, Marvin Goodfriend, Austan Goolsbee, Jan Hatzius, Peter Hooper, Glenn Hubbard, Anil Kashyap, Greg Mankiw, Kenneth Rogoff, Michael Woodford. Internal Staff: Christopher Sims, Christine Cumming, Sarah Dahlgren, William Dudley, Krishna Guha, Tom Klitgaard, Sandy Krieger, Jamie McAndrews, Thomas Baxter, Jonathan McCarthy, Margaret McConnell, Patricia Mosser, Richard Peach, Paolo Pesenti, Simon Potter, Argia Sbordone, Kevin Stiroh, Joseph Tracy, Lorie Logan, Beverly Hirtle, Marc Giannoni.

The meeting started with a discussion of the US fiscal situation, and the pending fiscal cliff. We concluded with a discussion of monetary policy.

Panel discussion of fiscal policy

The meeting began with a discussion of the US fiscal situation and the pending fiscal cliff. As background for this discussion, the FRBNY staff had distributed to members of the Panel an overview of the various federal tax increases and spending reductions that, under current law, would become effective in 2013 unless an alternative agreement on fiscal policy is reached over the few remaining weeks of 2012.

The list of tax and spending provisions was divided into two groups. The first group consisted of items that most US macroeconomic forecasters had already incorporated into their projections for 2013—the so-called "baseline provisions". Included in this group were the expiration of the two percentage point reduction of the OASDI payroll tax, which has been in effect for 2011 and 2012, and the expiration of the emergency unemployment benefits in effect since 2008. Also in this group were partial expensing of qualified investments and reductions of discretionary spending prescribed by the discretionary spending caps enacted as part of the Budget Control Act of 2011. Combined, the provisions in this first group represent nearly two percent of GDP and would impose a drag of between 3/4 and 1 ¼ percent on the growth rate of GDP in 2013, depending on the size of the relevant fiscal multipliers.

While there is always uncertainty regarding the size of fiscal multipliers, under current circumstances that uncertainty is greater than normal. With the Federal Reserve operating at the zero lower bound, there are, in view of FRBNY staff, open questions on how much monetary policy can do to offset the restraint on growth from a tightening of fiscal policy.

The second group consisted of the remaining tax and spending provisions that under current law would become effective in 2013 absent an agreement—the additional provisions of the full fiscal cliff. Largest among these are the 2001-2003 tax cuts which, if allowed to expire, would raise tax revenue by nearly $300 billion or about 1.8 percent of GDP. Another relatively large item is nearly $90 billion of additional reductions of spending under the sequestration process prescribed

by the Budget Control Act. Combined, this second group represents about 2 ¾ percent of GDP and would impose another 1 to 1 ¾ percent of drag on 2013 GDP growth.

The implications of the information provided by the FRBNY staff were that a significant tightening of fiscal policy in 2013 was possible. Moreover, there was a risk that negotiations could break down, resulting in a severe tightening of fiscal policy.

With this information as background, some members of the Panel with substantial knowledge of fiscal policy issues and with experience in the fiscal policy arena were asked to comment on the fiscal challenges facing the country and the prospects for reaching an agreement that would prevent the more extreme fiscal tightening from occurring. The first presenter noted that under current policies the US was on an unsustainable fiscal path, meaning that the debt of the federal government expressed as a share of GDP would rise indefinitely, eventually rising at an increasing rate as higher interest costs became a larger and larger share of total outlays. In this presenter's opinion, the main reason for this unsustainable fiscal position was rapidly rising social welfare spending on programs such as Social Security, Medicare, and Medicaid, driven by demographic trends, increases in life expectancy, and rapid increases in technological innovation in the field of medicine. One resolution of this problem was suggested, namely to make policy changes to gradually raising the retirement age, progressively index Social Security benefits, and put in place a progressive premium structure under Medicare. This presenter noted that the policy change currently being advocated by the President, an increase of marginal tax rates on the highest income taxpayers, and, in his opinion, would do very little to address our fiscal challenges. He noted that research suggests that fiscal consolidations that have successfully put economies back on a sustainable fiscal path have overwhelmingly been centered on reductions in public expenditures, especially transfer payments. He then argued that if additional revenues are to be raised, it would be preferable to do so by raising average tax rates but not marginal tax rates. This could be achieved through broadening of the tax base by scaling back many existing exemptions and deductions.

The next presenter came to a similar conclusion regarding the fundamental cause of our long run fiscal sustainability issue. He also noted that promises of future retirement and medical benefits to those currently working will be very difficult to fulfill due to the changing age structure of the population combined with increases in longevity. However, while acknowledging that addressing this issue through increased taxes alone would require a very significant increase in tax burdens that could potentially have adverse impacts on economic growth, he stated that addressing the issue through the scaling back of benefits alone would impose substantial hardship, particularly on lower income households. He advocated a combination of revenue increases and spending reductions, with the spending reductions achieved through a scaling back of the indexation of future benefits. In that way the reductions of outlays would occur gradually but would be quite significant over the long run. He believed that a "grand bargain" was achievable provided it included $1 to $2 trillion of additional revenue over the next decade. He cautioned, however, that for fiscal consolidation to be expansionary, it must induce a significant reduction of interest rates. With monetary policy at the zero lower bound and long term interest rates already quite low, that is unlikely to occur in the current setting.

Following these two presentations, other members of the Panel were asked to comment on them. The first discussant indicated that he believed the economy needed additional fiscal stimulus at this time. He also said that he believed that all of the 2001-2003 tax cuts would ultimately have to be rolled back at some point to pay for the rapid increases in outlays for Medicare and Medicaid. With that as background, he concluded that, in his opinion, the probability of a fiscal crisis in the US had increased. He noted that, as the previous two presentations demonstrated, there is fairly broad agreement on what should be done. Many economists contend that revenues need to be raised by broadening the tax base while outlays need to be reduced over the long run by scaling back benefits, particularly in Medicare and Medicaid. The problem is achieving the political consensus needed to make those changes

The next discussant focused primarily on near term political dynamics. He also indicated that he was doubtful of existing mechanisms to slow the rate of growth of spending under Medicare and Medicaid, such as the scaling back of reimbursement rates to providers. Congress has enacted such provisions in the past, and then consistently backed off implementing them under pressure from their constituents. In his opinion, the only way to dampen the growth rate of such outlays is to fundamentally alter the incentive structures inherent in these programs, such as through a "premium support" approach.

At this point the discussion was opened up to the full Panel. Some members questioned the relevance of evidence from the academic literature suggesting that successful fiscal stabilizations are weighted heavily toward expenditure reduction. Such episodes typically were associated with a decline of interest rates which is not likely to occur in the current setting. Several members noted that a value added tax should be carefully considered as it could potentially raise a substantial amount of revenue without distorting incentives to either work or invest. Finally, some members noted that the economy had not fully recovered and that the negative shock to consumer and business confidence should an agreement not be reached would likely be quite severe.

Panel discussion of monetary policy

The meeting then proceeded with a discussion of monetary policy. As background, the FRBNY staff had distributed to members of the Panel excerpts from the September and October FOMC statements and a list of questions. These questions related to the benefits and costs of the Fed's large scale asset purchases and the effectiveness of the FOMC's communication policy regarding the so-called forward guidance about the future path of the federal funds rate.

Several members of the Panel noted and welcomed the innovations in the September FOMC statement. The Panel members had diverging views regarding the efficacy and costs of the asset purchases. However, most members found it useful that the FOMC described its policy more explicitly in relation to the state of the economy. Several members remarked that given current economic conditions, it was important that the FOMC had indicated that a highly accommodative stance will remain appropriate for a considerable time after the economic recovery strengthens. Several members suggested that the FOMC could provide even more explicit guidance about the economic conditions warranting a change in policy stance, but recognized the difficulties in doing so. In particular, it was noted that it could be difficult to

specify all relevant conditions in a statement, or that it might be difficult for FOMC participants to agree to the same set of conditions. Other members noted that such conditions should be spelled out in more detail in speeches or in outlets other than the FOMC statement.