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The Economic and Budget Outlook: An Update

A Report to the Senate and House Committees on the Budget

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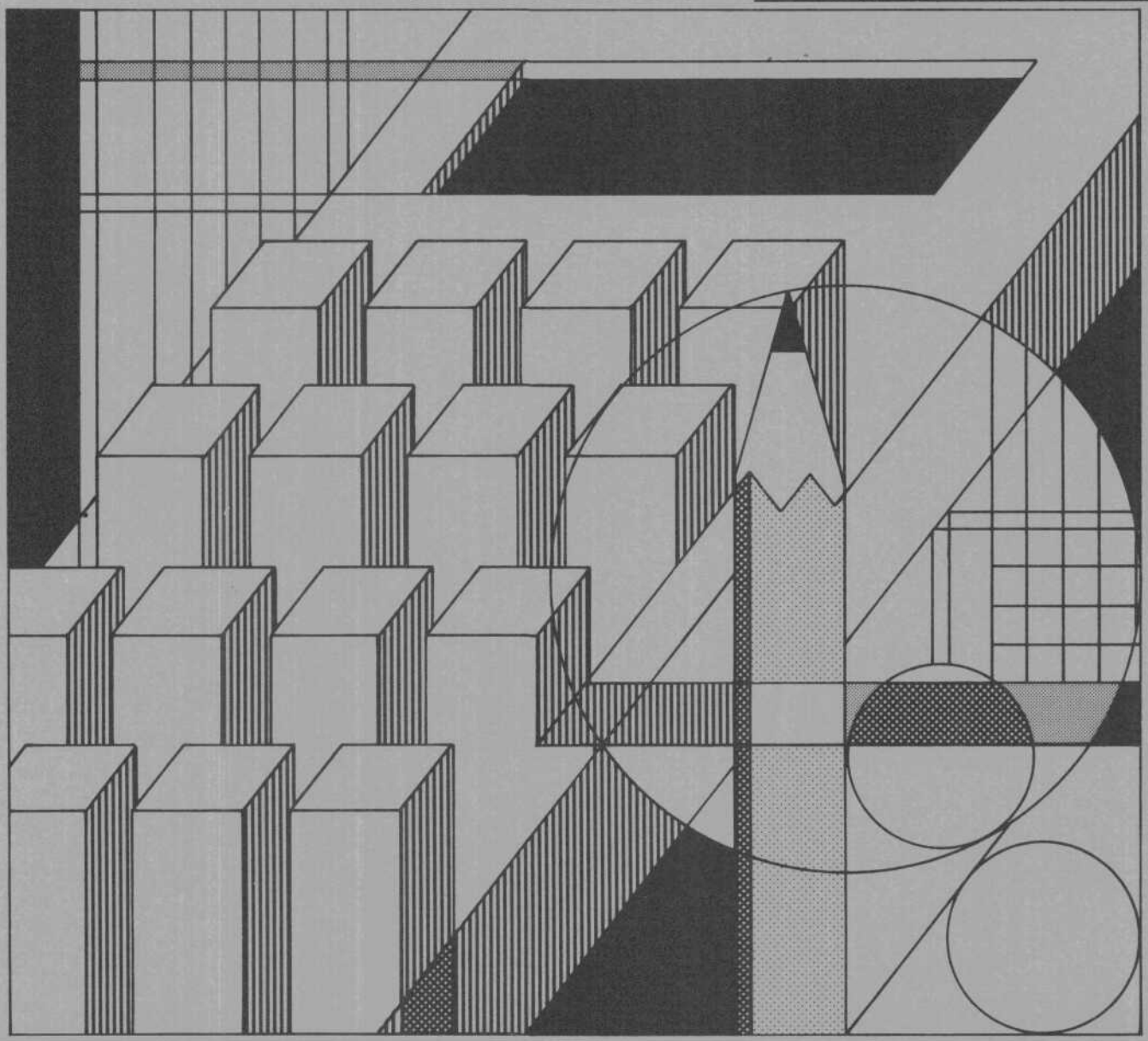

THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise indicated, all years referred to in this report are calendar years.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Details in the text and tables of this report may not add to totals because of rounding.

N.A. = not available.

The figures were produced by the Congressional Budget Office on the basis of data supplied by the agencies listed as sources under each figure.

PREFACE

This volume is one of a series of reports on the state of the economy and the budget issued periodically by the Congressional Budget Office (CBO). In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations.

Chapter I of this report was prepared by the Fiscal Analysis Division under the direction of William J. Beeman and Jacob S. Dreyer, with the assistance of George R. Iden, Frank S. Russek, Jr., Victoria S. Farrell, Martin A. Regalia, Robert A. Dennis, Frederick C. Ribe, Stephen H. Zeller, Matthew A. Salomon, Stephen A. Parker, Christopher D. Kask, Douglas R. Hamilton, Stephan S. Thurman, John R. Sturrock, Lucia S. Foster, Bragi Valgeirsson, Stacy A. Miller, and Jeffrey Steger.

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Paul L. Houts and Francis S. Pierce edited the manuscript, assisted by Nancy H. Brooks. Debra M. Blagburn coordinated the preparation of the report. The authors owe special thanks to Dorothy J. Kornegay, L. Rae Roy, Thelma L. Jones, Paula Gatens, Mechita O. Crawford, and Linda Brockman, who typed the many drafts.

Rudolph G. Penner
Director

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SUMMARY

The U.S. economy has been weaker so far this year than most forecasters anticipated. In mid-1984, its growth slowed abruptly. Instead of picking up in the first two quarters of this year, growth slowed further to a very sluggish 1 percent average annual rate. This weak growth has kept unemployment quite high by historical standards, and industrial capacity utilization low. Inflation rates, however, remain at the relatively moderate levels achieved soon after the recession.

The slowdown this year resulted from a reduction in inventory investment and a further decline in net exports. Although domestic demands remain strong, foreign competition has made heavy inroads in the goods-producing sector. This deterioration in the competitive position of U.S. producers is related, in part, to the growth in the federal deficit. The deficit undoubtedly contributed to the exceptionally rapid growth in output during the first year and a half of the recovery. But the deficit also pushed up interest rates and attracted inflows of international capital that contributed to the rise in the dollar and the resulting decline in net exports. The decline in net exports appears to have more than offset the expansionary effects of budget deficits during the recent period of weak growth.

Most forecasters, including the Congressional Budget Office (CBO), now expect a speedup in output growth in the second half of this year, followed by moderate growth in 1986. The reason for this optimism is that interest rates have fallen sharply, partly in response to an expansive monetary policy. Long-term interest rates may also have declined in anticipation of reduced future credit demands resulting from the expectation that the Congress will slow the growth of federal spending. Whatever the reason for the decline, lower interest rates are expected to encourage growth in interest-sensitive sectors such as residential construction and business investment.

The dollar has also declined recently, thereby improving the prospect for halting the deterioration of net exports early next year. Nevertheless, the economic outlook remains very uncertain. So far, there are few clear signs that the projected pickup in growth has begun.

The recently enacted Congressional Budget Resolution for Fiscal Year 1986 significantly reduces the size of future budget deficits (see Summary Table 1). According to CBO estimates, the budget resolution would reduce

SUMMARY TABLE 1. ECONOMIC ASSUMPTIONS AND BUDGET PROJECTIONS

Economic Variable	Actual 1984	1985	1986	1987	1988	1989	1990
Economic Assumptions (By calendar year)							
Real GNP (percent change)	6.8	2.6	3.6	3.4	3.5	3.5	3.5
CPI-U (percent change)	4.3	3.7	4.5	4.4	4.2	4.2	4.2
Civilian Unemployment Rate	7.5	7.2	7.0	6.8	6.6	6.5	6.3
Three-Month Treasury Bill Rate	9.5	7.6	7.4	7.2	7.2	7.2	7.2
Budget Projections (By fiscal year, in billions of dollars) a/							
Revenues	666	737	790	858	939	1013	1094
Total Outlays	852	946	965	1021	1082	1145	1214
Total Deficit	185	210	175	163	143	132	120
Percent of GNP	5.2	5.5	4.2	3.7	3.0	2.5	2.1

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Congressional Budget Office.

a. CBO estimates based on policies of the Congressional Budget Resolution for Fiscal Year 1986 (extrapolated to 1989 and 1990).

the deficit by $203 billion over the next three years, relative to projections of current laws and policies. The deficits would decline sharply each year from 5.5 percent of GNP this fiscal year to 2.1 percent of GNP in fiscal year 1990.

RECENT ECONOMIC DEVELOPMENTS

The economy has recorded only 2.0 percent growth in real gross national product (GNP) over the last year and a very sluggish 1.0 percent average increase, at annual rates, for the first two quarters of 1985. Unemployment

has held steady for a year at rates slightly above 7 percent (see Summary Table 2).

The slowdown in output growth in the first half of this year resulted from further deterioration in net exports and a decline in inventory accumulation rather than from weak domestic demands. In fact, private demands have been quite strong (see Summary Figure 1). Real final sales to domestic purchasers grew at a 4.8 percent rate during the first half of this year, with consumer spending rising at a 5.2 percent rate and business fixed investment at a 5.8 percent rate.

SUMMARY TABLE 2. RECENT ECONOMIC INDICATORS

	1983	1984	1984 III	1984 IV	1985 I	1985 II
Real GNP (percent change)	3.7	6.8	1.6	4.3	0.3	1.7
Real final sales to domestic purchasers	4.4	6.8	2.9	4.3	3.4	6.3
Personal consumption expenditures	4.8	5.3	0.7	3.6	5.2	5.2
Business fixed investment	2.5	19.8	13.7	8.5	-1.6	13.6
Residential investment	41.7	12.2	-4.6	-5.5	5.3	14.3
Government purchases	-0.3	3.5	5.4	5.9	0.3	3.9
Inventory change (billions of 1972 dollars)	-3.6	24.8	30.6	16.8	19.1	5.8
Industrial Production (percent change)	5.9	11.5	6.4	-0.6	2.1	2.2
Civilian Unemployment Rate	9.6	7.5	7.5	7.2	7.3	7.3
Consumer Price Index, Urban Consumers (percent change)	3.2	4.3	3.7	3.5	3.3	4.2
Three-Month Treasury Bill Rate	8.6	9.5	10.3	8.8	8.2	7.5
Corporate Bond Rate	12.0	12.7	13.0	12.4	12.3	11.6

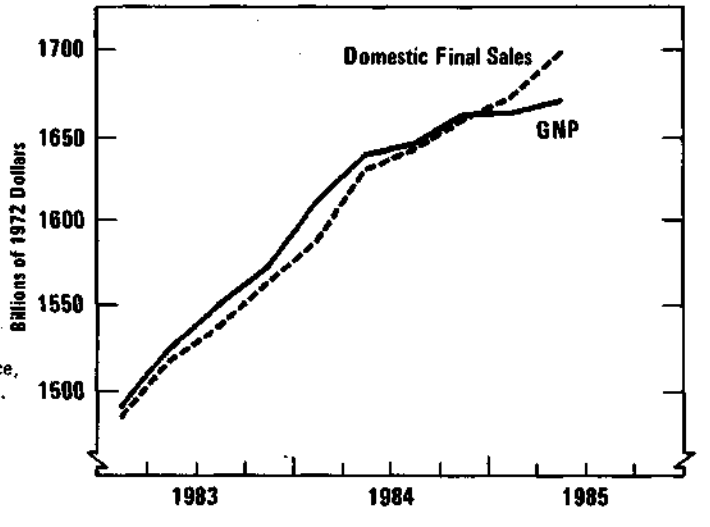
SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statitics; Federal Reserve Board.

The depressed trade sector has had severe effects on the output of industries producing tradeable goods. The purchases-based goods component of GNP declined in the first half of this year, suggesting a decline in GNP goods output. Moreover, industrial production rose only at a 2.1 percent annual rate. Payroll employment data indicate that employment in goods-producing industries has declined by 91,000 people since the beginning of the year, while employment in service-producing industries, which are not threatened significantly by foreign competition, has risen by 1.4 million.

Inflation rates in the first half of this year were about the same as for 1984 as a whole. The Consumer Price Index rose about 3.7 percent from December to June, while the Producer Price Index for finished goods increased about 1.4 percent. Factors contributing to the moderate inflation were: the high dollar, which cuts the price of imports and restrains price increases for import-competing products; abundant farm crops and low food prices; and low average wage increases. Given the current slack in the economy and the likelihood of further declines in oil prices, most forecasters do not expect inflation rates to rise significantly above current levels during the next several months.

Both real and nominal interest rates continued to ease during the first half of this year. The dollar rose early in the year and then declined sharply in the last few months to levels recorded about a year ago. The three-month Treasury bill rate has fallen three percentage points since last summer, and long-term Treasury bond rates are also down sharply. While the weakened state of the economy undoubtedly was a factor in this decline in rates, it also reflected a more expansive monetary policy and, perhaps, the expectation of reduced future credit demands on the part of the federal government.

Summary Figure 1.
Domestic Demand and GNP



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: Domestic final sales is GNP less both inventory change and net exports.

The continued moderate inflation, reduced interest rates, and the recent decline in the dollar have significantly improved the prospects for a pickup in economic activity during the second half of this year. At the time this report goes to press, however, the near-term outlook is very uncertain. Indicators of domestic output are mixed and, given the unpredictability of changes in the value of the dollar, the outlook for the foreign trade sector is particularly uncertain.

THE CBO ECONOMIC PROJECTION

CBO's economic projection that is used to construct budget estimates consists of: (1) an economic forecast through 1986, which is conditional on specific budgetary and monetary policy assumptions; and (2) medium-term economic projections through 1990 based on historical growth trends.

The Forecast for 1985 and 1986

The short-run CBO forecast shown in Summary Table 3 incorporates the following assumptions:

SUMMARY TABLE 3. THE CBO FORECAST FOR 1985 AND 1986

	Actual		Forecast	
	1983	1984	1985	1986
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	10.4	9.5	7.0	7.8
Real GNP	6.3	5.7	2.6	3.4
Fixed-Weight GNP Deflator	4.0	4.2	4.1	4.3
Consumer Price Index				
Urban consumers	3.3	4.1	3.9	4.8
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.6	7.5	7.2	7.0
Three-Month Treasury Bill Rate	8.6	9.5	7.6	7.4
Corporate Bond Rate				
(Moody's AAA)	12.0	12.7	11.5	10.7

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Congressional Budget Office.

- Federal budget policies are assumed to be those incorporated in the Congressional Budget Resolution for 1986.

- The money aggregate M1 is assumed to grow at the midpoint of the Federal Reserve's announced target--a 5½ percent annual rate from the second quarter of 1985 through the end of 1986.

- Food prices are assumed to rise less than prices in general, and oil prices are assumed to decline by about $2.50 per barrel from calendar year 1984 to 1986.

- The average value of the dollar in international exchange markets is assumed to remain roughly stable at today's levels.

With these assumptions, CBO forecasts real GNP growth of 2.6 percent over the four quarters of 1985 and 3.4 percent during the next year. Inflation, as measured by the Consumer Price Index (CPI-U), is expected to be 3.9 percent during this year and 4.8 percent over the four quarters of 1986. The increase in CPI-measured inflation from 1985 to 1986 reflects a lagged response to the decline in the dollar and exceptionally low inflation in food prices so far in 1985. The civilian unemployment rate is projected to decline gradually from current levels. The three-month Treasury bill rate is expected to average 7.6 percent in 1985 and 7.4 percent next year--about two percentage points below last year's average rate. Corporate bond rates are projected to fall about a percentage point in 1985, to 11.5 percent, and still further in 1986 to 10.7 percent.

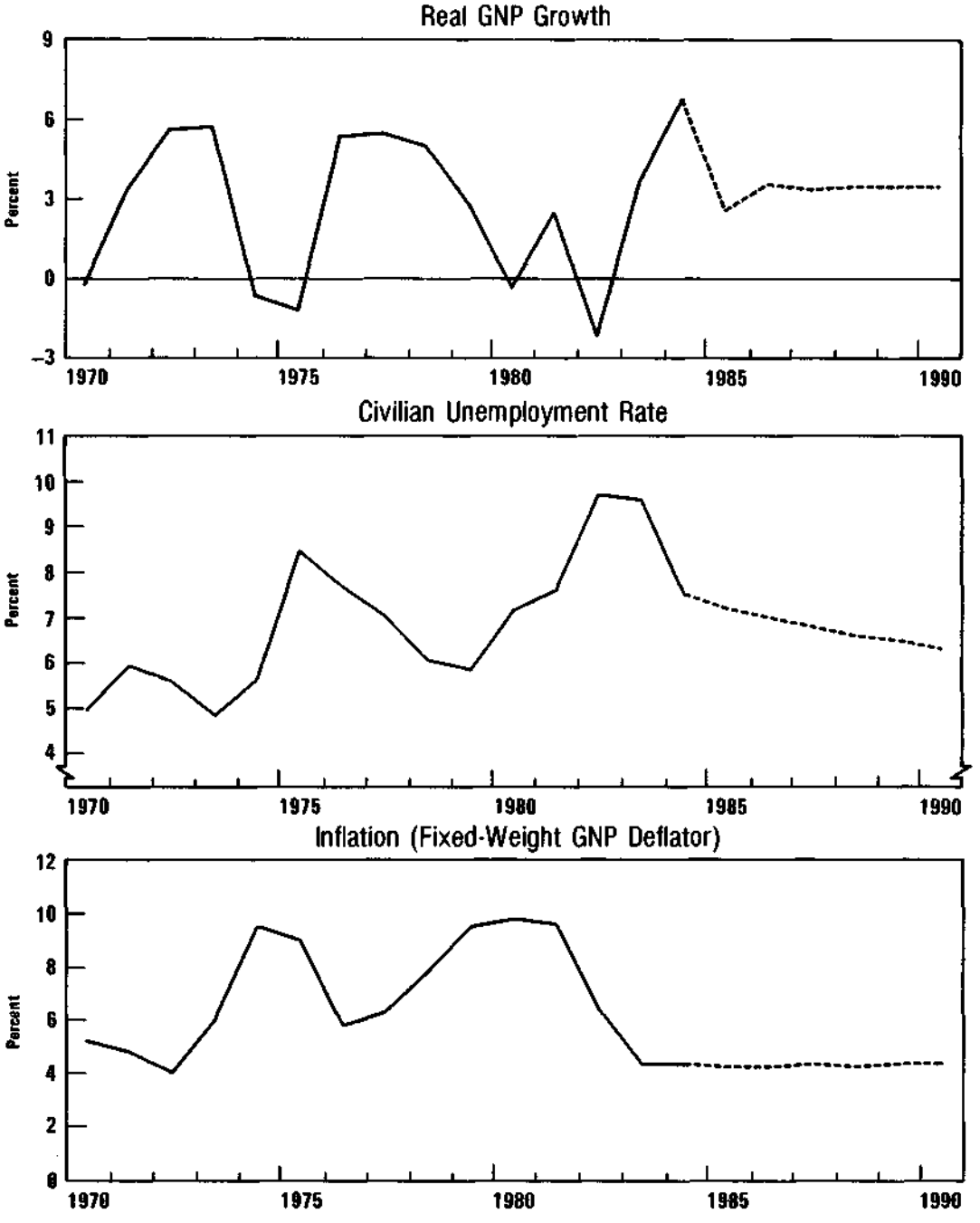
Economic Projections for 1987-1990

The medium-term projections, shown in Summary Table 1 and Summary Figure 2, are based on average historical experience. Specifically, the growth rates for real GNP and productivity from the fourth quarter of 1982 (the recession trough) to the fourth quarter of 1990 are assumed to equal their respective average growth rates in the eight-year periods following earlier postwar recessions. Thus, these growth and interest-rate paths do not necessarily reflect the budget policies incorporated in the Budget Resolution for Fiscal Year 1986. The major characteristics of the 1987-1990 projections are:

- Real GNP grows smoothly at an average 3.5 percent rate;

- The unemployment rate declines gradually to 6.3 percent by 1990;

Summary Figure 2.
Major Economic Assumptions



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.

- Inflation holds at about 4.2 percent, close to current levels; and
- Interest rates also remain flat at 7.2 percent for the Treasury bill rate and 10.2 percent for the corporate bond rate. The inflation-adjusted Treasury bill rate is assumed to be 3 percent, somewhat lower than the real rate assumed last February.

Uncertainty in the Forecast

At present, the greatest uncertainty appears to be related to the following factors: oil prices, the dollar, and financial conditions. Some forecasters expect that oil prices will decline more sharply than assumed by CBO. Such a decline would have a favorable effect on both inflation and economic growth here and in other oil-importing countries. The economic situation is also vulnerable to a sharp shift in the dollar. If the dollar should rise, the U.S. foreign trade position would likely keep deteriorating, perhaps even jeopardizing further expansion. On the other hand, if the dollar were to fall sharply, inflation would be higher in the United States, but the U.S. trade position would become stronger.

Many analysts predict a decline both in the value of the dollar and in energy prices. If this should happen, the deflationary effects of falling energy prices would tend to offset the inflationary effects of a falling dollar. But the effects on real activity might be reinforcing--both tending to increase domestic output.

In regard to financial conditions, two sources of uncertainty now appear paramount. First, the historical relationship between certain monetary aggregates and economic activity appears to be shifting. In the last four years, there have been two periods of unexpected and unprecedented decline in money velocity (the ratio of GNP to money); the most recent decline occurred in the first half of this year. This instability in money velocity appears to make it more difficult for the Federal Reserve to predict the effects of its policy on the economy, which may make sharp policy reversals more likely.

Second, the failure rate of domestic financial institutions is very high. Many farm banks have experienced stress; other savings institutions are very vulnerable to rising interest costs because of a mismatch in the maturities of their assets and liabilities. Debt-burdened developing countries are also vulnerable to a rise in interest rates. A widespread failure of financial institutions or an inability of foreign debtors to service their debt could

create serious economic uncertainty, perhaps having significant budgetary implications, and could force the Federal Reserve to relax its anti-inflationary policy stance.

THE BUDGETARY OUTLOOK

The recently passed Congressional Budget Resolution for Fiscal Year 1986 dramatically lowers spending targets compared with the baseline spending levels projected by CBO. Given the economic assumptions described above, federal deficits would fall absolutely and reach the lowest levels relative to GNP experienced since fiscal year 1979. The estimated deficits described above are, however, somewhat higher than the targets specified in the resolution, largely because CBO's economic assumptions contain lower real growth and higher interest rates than those used by the Budget Committees. CBO projects that the budget deficit would decline from an estimated $210 billion in 1985 to $175 billion in 1986, $163 billion in 1987, $143 billion in 1988, $132 billion in 1989, and $120 billion in 1990 (see Summary Table 4). Compared with CBO's baseline projections, which provide a benchmark for

SUMMARY TABLE 4. CBO BUDGET DEFICIT PROJECTIONS (By fiscal year, including off-budget entities)

	1984	1985	1986	1987	1988	1989	1990
In Billions of Dollars							
Baseline Projections a/	185	210	212	229	243	264	285
Budget Resolution, CBO estimate	185	210	175	163	143	132	120
As a Percent of GNP							
Baseline Projections a/	5.2	5.5	5.1	5.1	5.1	5.1	5.1
Budget Resolution, CBO estimate	5.2	5.5	4.2	3.7	3.0	2.5	2.1

a. Revised CBO February 1985 baseline (see Chapter II).

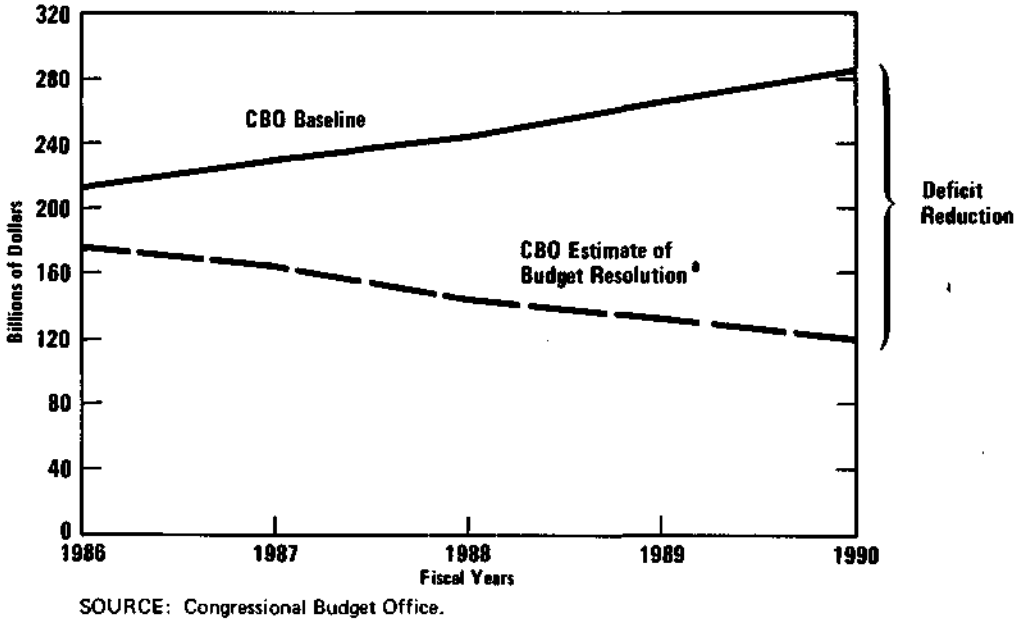
measuring the impact of proposed policy changes, the deficit would be reduced by about $500 billion or 41 percent over the 1986-1990 period (see Summary Figure 3). The deficit would decline from 5.5 percent of GNP in 1985 to 2.1 percent in 1990, given the implementation of the budget resolution. In CBO's updated baseline, which projects 1985 taxing and spending policies without change (that is, without the action anticipated in the budget resolution), the deficit would remain at 5.1 percent of GNP in 1990.

The deficit reductions planned under the budget resolution would slow the growth of federal debt and reduce the government's share of total credit demand. Under CBO baseline assumptions, publicly held federal debt is projected to grow from $1.5 trillion at the end of 1985 to $2.7 trillion by the end of 1990, rising from 39.6 percent of GNP to 49.1 percent (see Summary Table 5). Under the Congressional resolution, debt held by the public would still rise significantly--to $2.0 trillion by 1988--but relative to GNP it would peak at 41.7 percent in 1987 and then decline to 40.2 percent by the end of 1990, as shown in Summary Figure 4.

It must be noted, however, that the dramatic improvement in the deficit and debt picture does not mean that all fiscal problems will disappear. The remaining deficits are still high by historical standards.

The budget resolution relies almost entirely on spending reductions to achieve the lower deficits. Only very small revenue increases from baseline

Summary Figure 3.
Federal Deficit Projections



SOURCE: Congressional Budget Office.

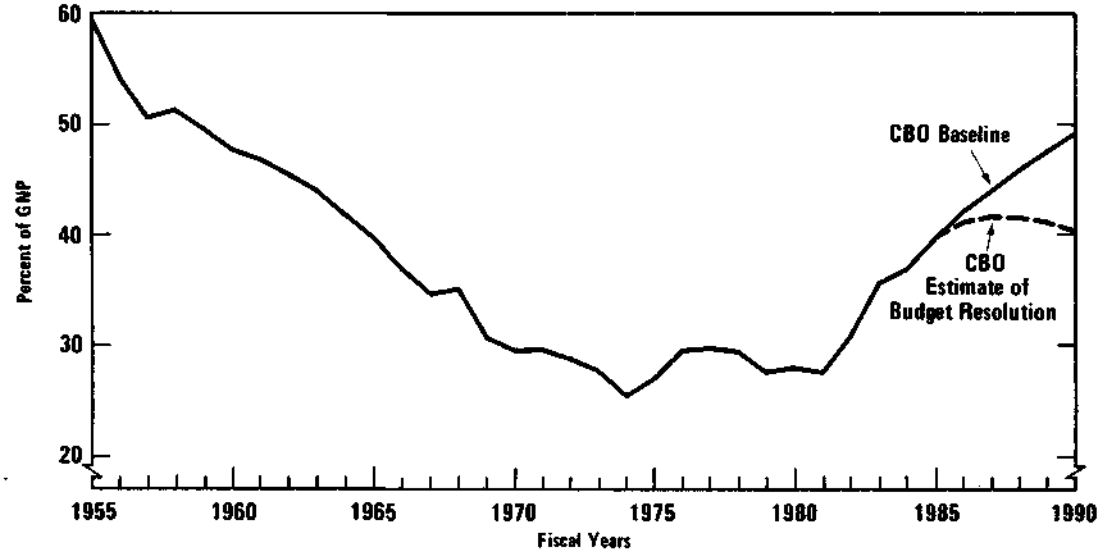
[a] Extrapolated by CBO in 1989 and 1990.

levels are contemplated--$3 billion in 1986, $8 billion in 1988, and, according to CBO's extrapolation of resolution policies, $11 billion in 1990. Spending cuts, on the other hand, total $34 billion in 1986, $92 billion in 1988, and $154 billion in 1990.

The largest spending reductions compared with earlier policy are for national defense--$11 billion in 1986, $41 billion in 1988, and $74 billion in 1990. The budget resolution allows defense budget authority to keep pace with inflation in 1986 and provides for real increases of about 2 percent per year thereafter under CBO economic assumptions. Spending for entitlement programs--notably Medicare, general revenue sharing, and farm price supports--is to be reduced by $7 billion in 1986, $18 billion in 1988, and $20 billion by 1990. Proposed reductions in nondefense discretionary spending amount to $11 billion in 1986, $24 billion in 1988, and $26 billion in 1990. Finally, net interest outlays are lowered by $1 billion in 1986, $10 billion in 1988, and $33 billion in 1990 because of the reductions in projected deficits.

The budget estimates are very sensitive to the economic projections. For example, a 1 percent higher interest rate would raise the projected deficit by some $16 billion in 1988 and $23 billion in 1990. Since interest rates and other economic variables seldom move in isolation, however, CBO has again prepared high and low paths for economic growth to demonstrate

Summary Figure 4.
Federal Debt Held by the Public



SOURCE: Congressional Budget Office.

[a]Extrapolated by CBO in 1989 and 1990.

the sensitivity of budget estimates to economic conditions (see Summary Table 6). The high path assumes growth equal to that of the strongest eight-year recovery in the postwar period--that experienced in the 1960s--resulting in a growth rate from 1984 through 1990 that is about 1.2 percent higher than in the CBO economic assumptions. Because of the very rapid growth, inflation and interest rates rise rapidly in the out-years. The low path assumes growth from the end of 1984 to the end of 1990, averaging 1.2 percentage point less than in the CBO economic assumptions. The low path incorporates a recession beginning in mid-1986, which is equal in length and depth to the 1973-1975 recession. The weaker growth results in somewhat lower inflation and lower interest rates than in the CBO economic assumptions.

The high-growth and low-growth economic assumptions, when applied to the same budget policies (those of the Resolution for Fiscal Year 1986), lead to alternative budget projections, shown at the bottom of Summary Table 6. In the high-growth case, the deficit drops swiftly--both in dollar

SUMMARY TABLE 5. CBO PROJECTIONS OF DEBT HELD BY THE PUBLIC

	1985	1986	1987	1988	1989	1990
In Billions of Dollars (End of fiscal year)						
Baseline Projections a/	1522	1733	1961	2203	2466	2750
Budget Resolution, CBO estimate	1522	1701	1861	2002	2133	2252
As a Percent of Fiscal Year GNP						
Baseline Projections a/	39.6	41.9	43.9	45.8	47.5	49.1
Budget Resolution, CBO estimate	39.6	41.1	41.7	41.6	41.1	40.2

a. Revised CBO February 1985 baseline (see Chapter II).

SUMMARY TABLE 6. ALTERNATIVE ECONOMIC AND BUDGET PROJECTIONS

	1985	1986	1987	1988	1989	1990
Economic Projections (By calendar year)						
Real GNP (percent change, year over year)						
High-growth alternative	2.9	4.8	4.8	4.8	4.8	4.8
CBO economic assumptions	2.6	3.6	3.4	3.5	3.5	3.5
Low-growth alternative	2.5	1.8	-3.0	3.6	3.9	3.7
CPI-U (percent change, year over year)						
High-growth alternative	3.7	4.4	5.1	6.1	7.4	9.0
CBO economic assumptions	3.7	4.5	4.4	4.2	4.2	4.2
Low-growth alternative	3.7	4.3	3.4	2.7	2.4	2.3
Civilian Unemployment Rate (percent, annual average)						
High-growth alternative	7.2	6.7	6.2	5.7	5.3	4.9
CBO economic assumptions	7.2	7.0	6.8	6.6	6.5	6.3
Low-growth alternative	7.3	7.6	10.0	9.6	9.1	8.7
Three-Month Treasury Bill Rate (percent, annual average)						
High-growth alternative	7.2	6.7	8.1	9.6	10.9	12.7
CBO economic assumptions	7.6	7.4	7.2	7.2	7.2	7.2
Low-growth alternative	7.9	7.8	6.5	6.1	6.3	6.5
Budget Projections (By fiscal year, in billions of dollars) a/						
Deficit (-) or Surplus						
High-growth alternative	-210	-155	-117	-67	-10	72
CBO economic assumptions	-210	-175	-163	-143	-132	-120
Low-growth alternative	-210	-200	-259	-272	-256	-252

SOURCE: Congressional Budget Office.

a. CBO estimates based on the policies of the Congressional Budget Resolution for Fiscal Year 1986.

terms and as a percent of GNP. It is nearly in balance in fiscal year 1989 and shows a surplus of about 1 percent of GNP in 1990. Under the low-growth assumptions, however, the deficit grows sharply. For example, in fiscal year 1988, the year following the recession incorporated in the low-growth path, the budget deficit is nearly $130 billion above the CBO estimates. Nevertheless, these alternative paths are only illustrative; CBO economic assumptions remain, in CBO's judgment, a more reasonable basis for budget projections.

THE IMPACT OF BUDGET DEFICITS ON THE COMPOSITION OF ECONOMIC ACTIVITY

The current economic expansion is often characterized as "unbalanced" because of the unprecedented weakness of the foreign-trade sector amidst general prosperity. The high dollar has weakened the competitive position of U.S. export and import-competing industries. Many domestic firms report that the loss of international competitiveness has had severe impacts on their profits, employment, and output. In some sectors, there are reports of decisions to relocate production facilities abroad. The large federal budget deficits have clearly contributed to the rise in the dollar and the resulting decline in the competitive position of U.S. industries. The growth in the federal debt has increased the total demand for credit, which in turn has pushed U.S. interest rates above levels that would otherwise prevail. High U.S. interest rates have attracted foreign capital inflows that, in turn, have bid up the dollar exchange rate.

The impact of the high dollar on various segments of society is quite uneven. Consumers benefit from lower prices of imported goods, and some producers benefit from lower costs. On the other hand, many producers of tradeable goods have been hit hard by competition from abroad, and such negative effects have been very pronounced during the past half year. The effects of the high dollar have been particularly adverse for many basic industries, some of which are also suffering from high real interest rates and from secular decline. Despite strong growth in investment spending, domestic output of capital goods has been constrained by strong import growth. Some federal policies, of course, such as the business tax cuts and the increase in defense spending, have partially offset the effects of the dollar on aggregate industrial output.

CHAPTER I

THE ECONOMIC OUTLOOK

In the first half of 1985, economic growth was slower than most forecasters expected: in real terms, the economy grew at a sluggish 1 percent average annual rate. Much of the weakness was concentrated in the goods-producing sector, where industrial production was essentially flat. The slowdown in output was largely the result of rising imports, falling exports, and reduced inventory investment rather than weakness in demand. Real final sales to domestic purchasers grew at an annual rate of 4.8 percent in the first half of the year.

Economic indicators for the near term are mixed. Although personal income growth has slowed and new orders for nondefense capital goods have been flat, the recent sharp declines in interest rates should stimulate growth in interest-sensitive sectors. The revised forecast of the Congressional Budget Office (CBO) calls for growth to speed up in the second half of 1985 and to continue at a moderate pace through next year.

The current slowdown has generally been attributed to high real interest rates and the loss of markets to foreign competition, the latter resulting from the high dollar. Large budget deficits contributed to these stresses. Recently, however, interest rates and the exchange value of the dollar have fallen sharply. The Federal Reserve has pursued an expansive monetary policy in an attempt to encourage growth, and the expectation of decisive Congressional action on the budget may have helped to reduce the fears of investors about increasing pressures on financial markets from future government borrowing. For these reasons, the revised CBO forecast shows considerably lower real interest rates than it did last February. Moreover, the lower interest rates and the consequent recent decline in the dollar exchange rate will eventually halt the deterioration in the U.S. trade position.

THE ECONOMIC FORECAST AND MEDIUM-TERM PROJECTIONS

CBO's economic forecast, covering the remainder of 1985 and 1986, is based on the following assumptions:

- Federal tax and spending policies are assumed to be those implied by the Congressional Budget Resolution of 1986.

- The money aggregate M1 is assumed to grow at a 5½ percent annual rate from the second quarter of 1985 to the fourth quarter of 1986.

- Food and oil prices are assumed to be weak. Retail prices of food at home are assumed to rise less than the general price level--at 2.0 percent in 1985 and 3.8 percent in 1986 (year over year). The acquisition price of foreign crude oil is assumed to decline by about 10 percent between 1984 and 1986.

- The average value of the dollar in international exchange markets, on a trade-weighted basis, is assumed to remain roughly stable at today's level.

Given these assumptions, CBO expects economic activity to pick up in the second half of this year and to continue at a moderate pace in 1986. Recently, both nominal and real interest rates have eased considerably, and the dollar has declined. The outlook for personal consumption remains generally favorable, with measures of consumer confidence remaining high. The main area of weakness continues to be net exports, though most of the sharp declines may be over. In fact, many observers expect real net exports to begin rising sometime next year.

The CBO forecast is summarized in Table I-1. Real GNP is expected to increase at a rate of 2.6 percent during the four quarters of 1985 and at a higher rate of 3.4 percent during 1986. The civilian unemployment rate is seen as averaging 7.2 percent for the current year, declining gradually to 6.9 percent by the end of next year.

Inflation should continue to be moderate, though slightly higher than it has been recently. The Consumer Price Index (CPI-U) is expected to rise 3.9 percent during this year and 4.8 percent next year. Next year's increase in this index reflects the effects of the recent decline in the value of the dollar--a sharp difference from the 1980-1984 period, when the rising exchange rate held down the rate of consumer price inflation. The fixed-weight GNP deflator is expected to increase less rapidly than the CPI, however, because it is less affected by exchange rate movements.

Interest rates in the forecast are down considerably from last year's levels. The three-month Treasury bill rate averages 7.6 percent in 1985--down almost two percentage points from the average for 1984--and 7.4

percent in 1986. The rate on AAA corporate bonds averages 11.5 percent in 1985, down more than one percentage point from 1984. It averages 10.7 percent in 1986--almost one percentage point lower than in 1985.

Uncertainties in the Forecast

The current recovery/expansion is now almost three years old, and by the end of 1986 it will have run for four years. The early strong momentum has slowed considerably, and indicators for the future are quite mixed. To date, inflation has continued to be moderate with no sign of substantial increase, even though the margin of unused resources has shrunk considerably since the recovery began. The forecast contains more than the

TABLE I-1. THE CBO FORECAST FOR 1985 AND 1986

	Actual		Forecast	
	1983	1984	1985	1986
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	10.4	9.5	7.0	7.8
Real GNP	6.3	5.7	2.6	3.4
Fixed-weight GNP Deflator	4.0	4.2	4.1	4.3
Consumer Price Index				
Urban consumers	3.3	4.1	3.9	4.8
Urban wage and clerical workers	2.9	3.6	3.8	4.8
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.6	7.5	7.2	7.0
Three-Month Treasury Bill Rate	8.6	9.5	7.6	7.4
Corporate Bond Rate (Moody's AAA)	12.0	12.7	11.5	10.7

usual element of uncertainty, partly because the economy has become more susceptible to foreign influences. The major uncertainties are:

- Money Velocity. Growth in M1 velocity has been unstable in recent years. Velocity may continue to behave erratically, and the Federal Reserve may find it difficult to offset these variations.

- Confidence in the Dollar. With continuing large-scale inflows of foreign capital, the economy is vulnerable to sudden changes in confidence in the dollar. A sudden loss of confidence could result in a precipitous decline in its exchange value. That, in turn, would make higher inflation more likely. It could also lead to higher interest rates. One positive result, however, would be an improvement in the trade balance, though this improvement might not occur until some time after the dollar had fallen. The uncertainty associated with the exchange rate also operates the other way. If the dollar strengthens again, the trade sector will be hit harder than implied in the forecast.

- Inflation. Some analysts worry that recent rapid money growth could lead to higher inflation than implied by the forecast. A rapid decline in the dollar would reinforce the inflationary effect of rapid money growth. On the other hand, some analysts expect oil prices to fall more than projected by CBO, and that would be beneficial for inflation. A fall in the price of imported oil would also boost income and real growth in the United States and other oil-importing countries.

- Financial Stress. Interest rates are extremely difficult to forecast. A sharp rise in rates would aggravate stresses on some sectors of the domestic economy, most notably thrift institutions and agricultural banks, as well as on debt-burdened developing countries (see box). Moreover, risks of failures of large numbers of financial institutions could compromise the Federal Reserve's ability to combat an increase in inflation through tighter monetary policy.

If both the value of the dollar and oil prices decline, the impacts on inflation would be offsetting. A declining dollar would make imports and import-competing products more expensive, thus adding to inflation, while a decline in oil prices would have the opposite effect. Nevertheless, their favorable impacts on economic activity might be reinforcing. The decline in

TROUBLED FINANCIAL INSTITUTIONS

Savings and loan associations (S&Ls), which are very sensitive to interest-rate movements, have seen their net worth seriously eroded by the high interest rates prevailing in recent years. Over the 1980-1984 period, the number of institutions shrank by almost 25 percent with 510 failures and another 325 mergers. At the end of 1984, another 877 institutions, holding about 31 percent of the assets of all FSLIC-insured institutions, had net worth (as defined by the Federal Home Loan Bank Board) of less than 3 percent of their liabilities--and 71 institutions had zero or negative net worth. (For a more detailed discussion of these issues, see two recent papers by James R. Barth, R. Dan Brumbaugh, Jr., Daniel Sauerhaft, and George H.K. Wang, "Thrift-Institution Failure: Causes and Policy Issues," Research Working Paper No. 117, Office of Policy and Economic Research, Federal Home Loan Bank Board, processed, May 1985, and "Insolvency and Risk-Taking in the Thrift Industry: Implications for the Future," prepared for presentation at the annual meeting of the Western Economic Association, processed, June 30-July 4, 1985.)

Short-term interest rates have lately fallen sufficiently to allow profitable interest rate spreads between savings and loan assets and liabilities. If rates remain in their current range for some time, many institutions could recoup some of their losses incurred since 1980. On the other hand, if interest rates rise, the losses will recur because many S&Ls have done little to address their interest rate sensitivity, turning instead to higher yielding but more risky assets to increase their earnings. The shift toward riskier assets has led to a greater number of defaults on loans and other investments and in some cases contributed to institutions failing. Thus, S&Ls not only remain highly sensitive to interest rate movements but are now besieged by the increasingly poor credit quality of many of their assets.

Agricultural or farm banks are another sector of the financial services industry that has recently been beset by problems. High interest rates and falling prices of farm land and farm products in recent years have led to loan defaults and some bank failures. Although the problems associated with these banks are not as readily traceable to high interest rates as those of S&Ls, a marked increase in interest rates would make it harder for farmers to meet their financial obligations, and would be likely to result in increased loan defaults and subsequent bank failures.

the dollar would stimulate net exports; lower oil prices would raise U.S. real incomes, tending to raise growth.

The Medium-Term Economic Projections

CBO's revised medium-term projections for the 1987 through 1990 period (see Tables I-2 and I-3) were constructed in the same way as those that appeared in its February report. 1/ GNP growth and interest rate paths do not necessarily reflect the policies incorporated in the Budget Resolution for Fiscal Year 1986. The main characteristics of these projections are:

- Real economic growth averages 3.5 percent a year in the 1987-1990 period.
- The civilian unemployment rate declines gradually to an average of 6.3 percent in 1990--a level that many economists consider to be close to that at which inflationary wage pressures are likely to develop.
- Inflation and real interest rates remain essentially flat in the CBO projection for the outyears. The Consumer Price Index (CPI-U) increases about 4.2 percent per year in 1987-1990, and the fixed-weight GNP deflator rises at approximately the same rate. The interest rate on three-month Treasury bills averages 7.2 percent each year in 1987-1990. Long-term rates, as indicated by rates on high-quality corporate bonds, average 10.2 percent each year.

RECENT ECONOMIC DEVELOPMENTS

Moderate inflation and sluggish growth continued in the first half of the year, with the unemployment rate holding steady above 7 percent. At the same time, both nominal and real interest rates have eased considerably, which suggests that growth prospects for interest-sensitive sectors will improve. Trouble spots remain, however, notably the very large trade deficit and evidence of stress in certain financial institutions.

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1. Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1986-1990* (February 1985), pp. 39-46.

TABLE I-2. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1987-1990

Economic Variable	Actual 1984	Forecast 1985	Forecast 1986	Projected 1987	Projected 1988	Projected 1989	Projected 1990
GNP (billions of current dollars)	3663	3906	4217	4548	4905	5289	5704
Nominal GNP Growth (percent change, year over year)	10.8	6.6	8.0	7.9	7.9	7.8	7.9
Real GNP Growth (percent change, year over year)	6.8	2.6	3.6	3.4	3.5	3.5	3.5
Fixed-Weight GNP Deflator (percent change, year over year)	4.3	4.2	4.2	4.3	4.2	4.3	4.3
CPI-U (percent change, year over year)	4.3	3.7	4.5	4.4	4.2	4.2	4.2
Civilian Unemployment Rate (percent, annual average)	7.5	7.2	7.0	6.8	6.6	6.5	6.3
Three-Month Treasury Bill Rate (percent, annual average)	9.5	7.6	7.4	7.2	7.2	7.2	7.2
Moody's AAA Corporate Bond Rate (percent, annual average)	12.7	11.5	10.7	10.2	10.2	10.2	10.2
Corporate Profits (percent of GNP)	7.8	7.8	8.1	8.1	8.1	8.0	7.9
Wage and Salary Disbursements (percent of GNP)	49.3	49.4	48.9	48.8	48.6	48.5	48.5
Other Taxable Income (percent of GNP)	19.9	19.9	19.9	19.9	19.8	19.6	19.4

SOURCE: Congressional Budget Office.

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TABLE I-3. MEDIUM-TERM ECONOMIC PROJECTIONS FOR FISCAL YEARS 1987-1990

Economic Variable	Actual 1984	Forecast 1985	1986	1987	1988	1989	1990
GNP (billions of current dollars)	3581	3840	4138	4462	4813	5190	5597
Nominal GNP Growth (percent change, year over year)	11.1	7.2	7.8	7.8	7.9	7.8	7.8
Real GNP Growth (percent change, year over year)	7.0	3.3	3.4	3.4	3.5	3.5	3.5
Fixed-Weight GNP Deflator (percent change, year over year)	4.3	4.1	4.1	4.4	4.2	4.3	4.3
CPI-U (percent change, year over year)	4.1	3.8	4.2	4.6	4.2	4.2	4.2
Civilian Unemployment Rate (percent, annual average)	7.8	7.3	7.0	6.9	6.7	6.5	6.4
Three-Month Treasury Bill Rate (percent, annual average)	9.5	7.9	7.4	7.3	7.2	7.2	7.2
Moody's AAA Corporate Bond Rate (percent, annual average)	12.7	11.9	10.8	10.3	10.2	10.2	10.2
Corporate Profits (percent of GNP)	7.8	7.7	8.2	8.1	8.2	8.1	7.9
Wage and Salary Disbursements (percent of GNP)	49.5	49.4	49.0	48.8	48.6	48.5	48.5
Other Taxable Income (percent of GNP)	19.6	20.0	19.9	19.9	19.8	19.6	19.5

SOURCE: Congressional Budget Office.

Aggregate Activity

During the first half of this year, the economy continued what many analysts believe is a temporary pause in its growth that began in mid-1984. Real GNP--that is, GNP adjusted for price-level changes--grew only 1.9 percent over the last four quarters and 1.0 percent over the first half of this year (at an annual rate). Economic activity has been uneven from quarter to quarter, partly reflecting sharp fluctuations in both imports and exports. Growth was barely positive in the first quarter of this year (0.3 percent), but somewhat stronger in the second (1.7 percent).

The slowdown was especially marked in the first quarter of this year for business fixed investment and government purchases, but both of these categories of spending rebounded in the second quarter (see Table I-4). On the other hand, residential investment, which had turned down in the second half of last year, responded to lower interest rates and showed significant growth in both the first and second quarters. The most important source of weakness remains the foreign trade sector. The volume of imports surged at a 27 percent rate in 1984 and rose again in the first half of this year. The volume of exports increased only 4.7 percent last year and fell at a 10.7 annual percent rate from the fourth quarter of 1984 to the second quarter of this year. Finally, businesses added to inventories at a much slower rate in the second quarter.

The sharp but uneven decline in this country's net export position has had major adverse implications for short-term growth in output, which has lagged behind domestic demands (see Figure I-1). Real sales to domestic purchasers have grown strongly in recent quarters. Because weak growth in output limits growth in labor and capital incomes, some economists fear that growth in final domestic demands cannot be sustained for long without an improvement in the net export position.

Industrial Production and Capacity Utilization. Industrial production, which accounts for about 46 percent of overall GNP, has borne the brunt of the sharp decline in net exports. Growth in industrial production slowed dramatically in mid-1984 (see Figure I-2). The most recent reading of the industrial production index (for June) was only 1.8 percent above the level of a year ago. As shown in the bottom part of Table I-4, production of both consumer and capital goods has slowed sharply, but rapid growth has continued in the index for defense and space production.

Capacity utilization in manufacturing, mining, and utilities rose sharply in the early part of the recovery until mid-1984. It then edged downward

TABLE I-4. REAL GNP AND INDUSTRIAL PRODUCTION (Percent change from previous period at annual rates, unless otherwise noted)

	1983	1984	1984 Q1	1984 Q2	1984 Q3	1984 Q4	1985 Q1	1985 Q2
Real GNP	3.7	6.8	10.1	7.1	1.6	4.3	0.3	1.7
Final sales	3.2	5.0	3.6	10.3	-1.0	7.9	-0.3	5.1
Personal consumption	4.8	5.3	4.6	7.9	0.7	3.6	5.2	5.2
Business fixed investment	2.5	19.8	20.6	21.3	13.7	8.5	-1.6	13.6
Residential investment	41.7	12.2	21.3	1.2	-4.6	-5.5	5.3	14.3
Government purchases	-0.3	3.5	1.0	18.6	5.4	5.9	0.3	3.9
Exports	-5.5	4.7	11.4	-0.5	7.5	-0.7	-9.0	-12.5
Imports	7.6	26.9	47.1	8.0	55.5	-28.3	32.3	1.4
Inventory Change (billions of 1972 dollars)	-3.6	24.8	31.6	20.3	30.6	16.8	19.1	5.8
Net Exports (billions of 1972 dollars)	12.6	-15.0	-8.3	-11.4	-27.0	-13.4	-28.4	-33.8
Real Final Sales to Domestic Purchasers a/	4.4	6.8	6.3	11.1	2.9	4.3	3.4	6.3
Industrial Production	5.9	11.5	16.1	7.5	6.4	-0.6	2.1	2.2
Consumer goods	7.8	8.1	10.7	4.8	1.5	2.3	-0.1	4.1
Business equipment	1.6	16.9	24.5	15.3	16.2	1.9	3.2	5.9
Defense and space	7.6	10.3	15.4	15.7	12.3	8.1	7.9	12.9

SOURCE: Bureau of Economic Analysis, U.S. Department of Commerce.

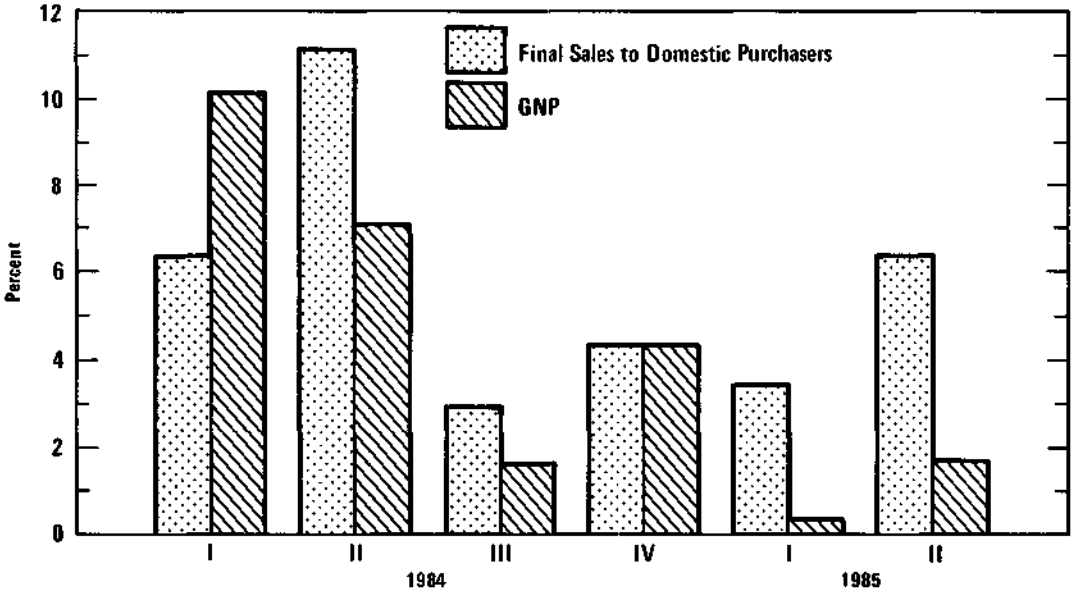
a. Real final sales minus net exports.

as capacity continued to grow at about a 3 percent rate, while output grew at about half that rate.

Inflation

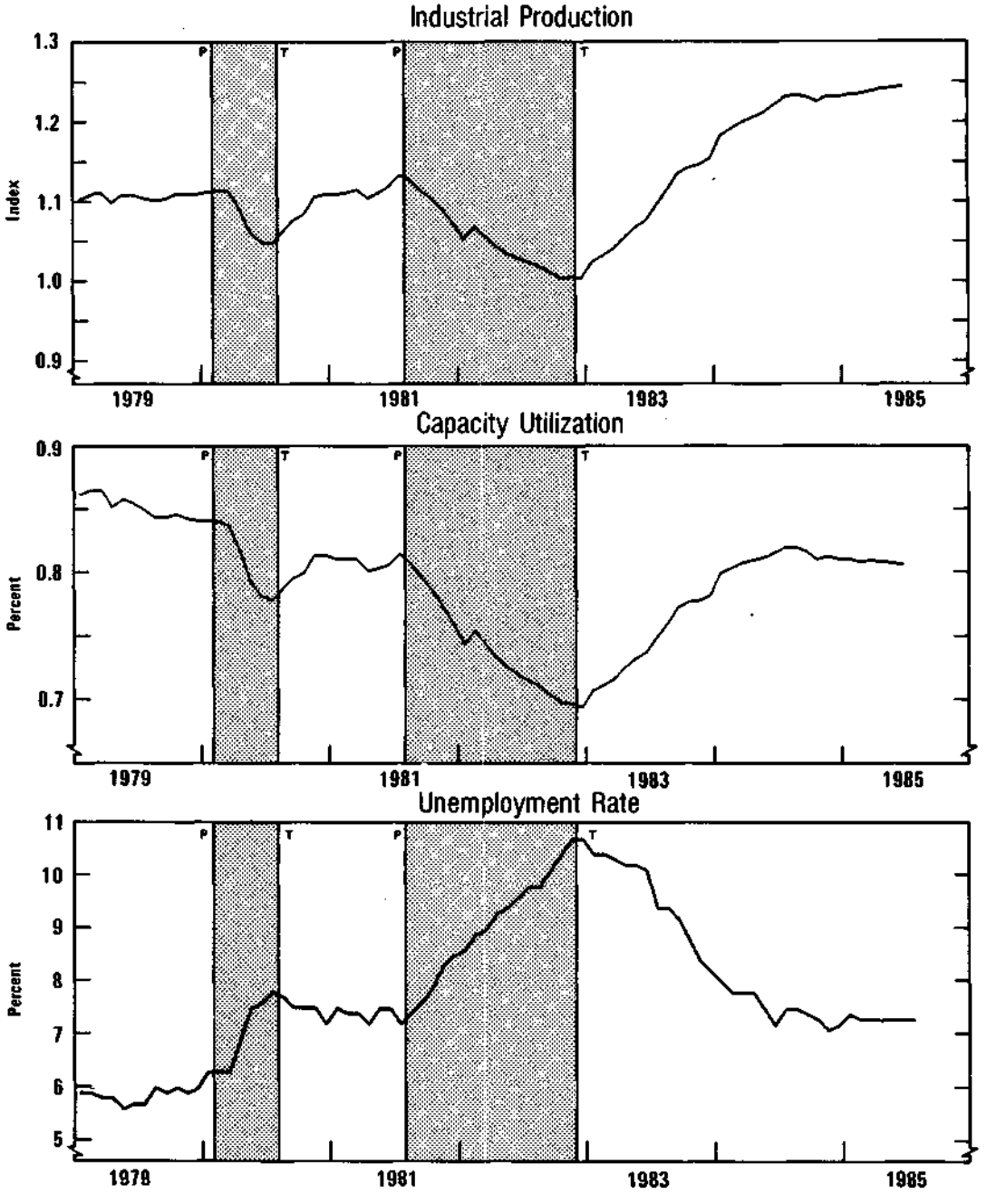
In the first half of 1985, prices rose at about the same rate as they had in 1984. The Consumer Price Index (CPI) excluding food and energy prices rose at a 4.4 percent rate in the first six months of 1985, while the index for all consumer prices rose at a 3.7 percent rate (see Table I-5 and Figure I-3). In both cases, the increase was about the same as over the preceding 12 months. The Producer Price Index for finished goods increased at around a 2 percent rate last year and even less in the first six months of 1985.

Figure I-1.
Domestic Demand Growth and GNP Growth



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.
NOTE: Final Sales to Domestic Purchasers is GNP less both inventory change and net exports.

Figure I-2.
Industrial Production and Resource Utilization



SOURCES: Federal Reserve Board; U.S. Department of Labor, Bureau of Labor Statistics.

Three related factors have contributed to the moderate inflation rate:

- The rising dollar, which cuts the cost of imports and forces price moderation on industries competing with imports. The value of the dollar in mid-1985, after a substantial depreciation since its peak in February, is close to its level in mid-1984 but is still about two-thirds above its level in the middle of 1980. 2/ According to common estimates, the appreciation of the dollar from mid-1980 through mid-1985 has subtracted about 7 percent from consumer prices, and thus, over five years, has held the annual inflation rate below what it would otherwise have been by an average of about

TABLE I-5. RECENT INFLATION RATES (Percent change over 12 months, unless otherwise indicated)

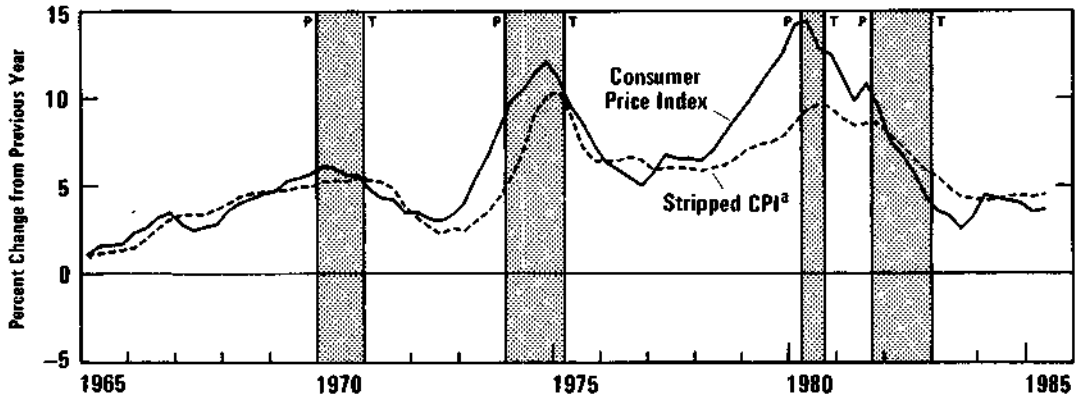
	1983	1984	1985 a/
Consumer Price Index	3.8	4.0	3.7
Food	2.6	3.8	0.8
Gasoline	-1.6	-2.5	7.2
CPI (excluding food and energy)	4.8	4.7	4.4
Stripped CPI (excluding food at home, energy, and used cars)	4.3	4.5	4.4
Producer Price Index			
Finished goods	0.6	1.7	1.4
Finished consumer goods	0.2	1.6	0.7
PPI crude materials	4.9	-1.5	-14.8
Average Hourly Earnings Index	3.8	3.5	2.4

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

a. Percent change, December through June, at annual rates.

2. According to the Federal Reserve Board exchange rate index.

Figure I-3.
Inflation



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.
[a]CPI less food, energy, and used cars; and homeownership before 1983.

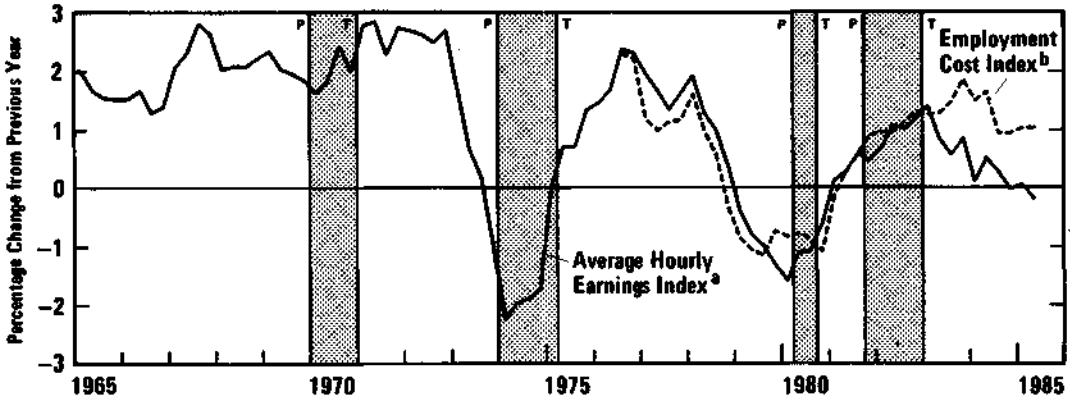
1½ percentage points. 3/ As the dollar has stabilized, its recent contribution to holding down inflation has probably been less.

- Low food prices, the result of excellent harvests both in the United States and abroad, as well as the high dollar. The Department of Agriculture expects that the food component of the CPI will increase 2 percent to 4 percent between 1984 and 1985: the low food price increases in the first half of the year suggest that the increase for the full year will be near the bottom of that range.

- Low average wage increases, with further wage cuts in important sectors. The average hourly earnings index shows a continuous decline in real wages since soon after the recovery from the recession began. The employment cost index (ECI), an alternative and superior measure, shows considerably more growth but its growth is still restrained (see Figure I-4). Real wage growth has

3. Estimates of the impact of changes in the exchange rate on consumer prices vary widely, probably in part because the impact is not always the same: it matters which currencies the dollar has moved against. The data are broadly consistent, however, with the assumption that the price effect is about 10 percent of the exchange rate movement within approximately one year.

Figure I-4.
Real Wages



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.

[a] Average hourly earnings index for nonfarm private industry, deflated by the personal consumption deflator.

[b] Employment cost index for wages in the nonfarm private economy, deflated by the personal consumption deflator.

been less than in similar cyclical periods in the past. 4/ The recent slowing in the real increase of the ECI has come from slow wage growth in the unionized part of nonmanufacturing, and reflects some very low settlements, particularly in the airline and communications industries. Overall growth in manufacturing wages appears to have leveled off. Again, however, this is the

4. The employment cost index is probably a more reliable measure of what has been happening to wages recently. A similar index for total compensation tells a similar story. Both the average hourly earnings index and the employment cost index adjust for the biases in measured wage growth that can arise from shifts in the composition of employment between high- and low-wage industries, and both also exclude the effect of changes in overtime in manufacturing. In addition, the employment cost index (ECI) allows for the effect of employment shifts within an industry between high-wage and low-wage occupations, as well as for overtime in industries other than manufacturing, and includes workers other than production workers (such as office workers). The lower growth rate of the average hourly earnings index compared with the ECI in the past few years could be the result of a reduced share of high-wage occupations within industries.

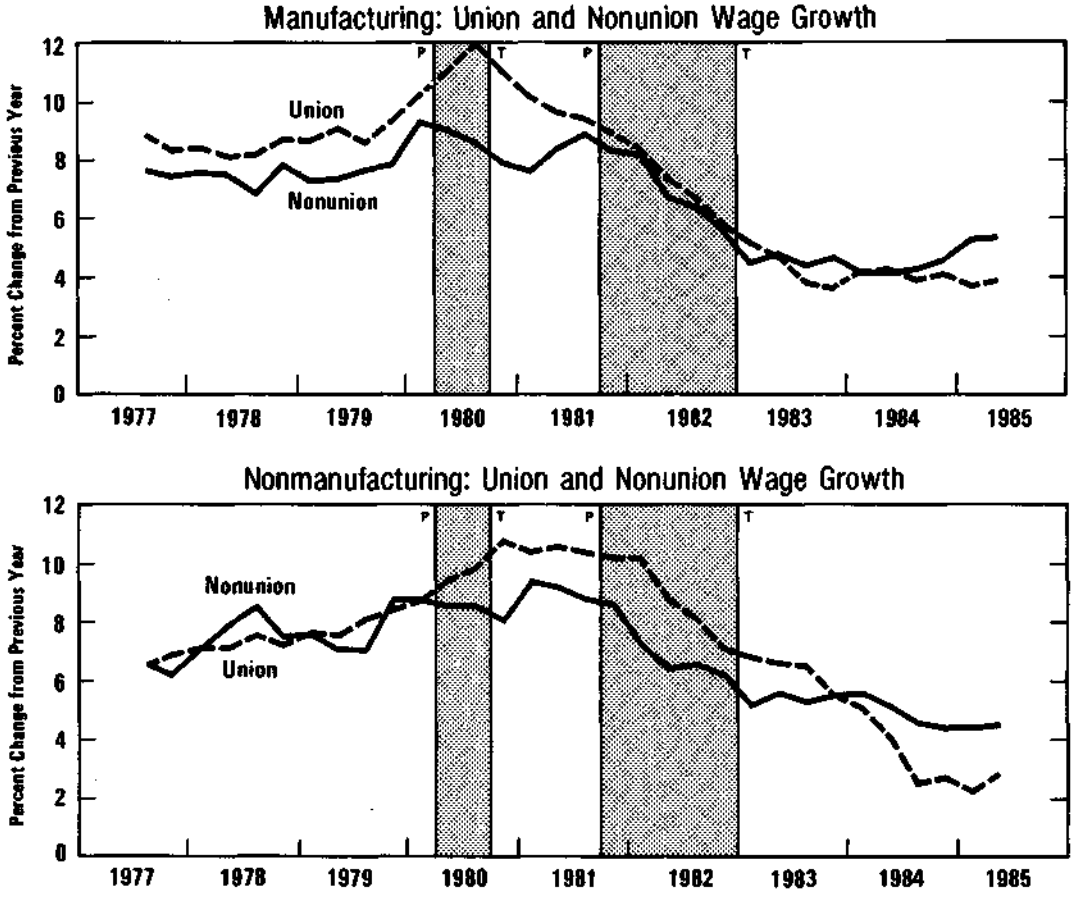
   Data for the employment cost index are available only since 1976, so it is difficult to be certain how the recent movements in this index differ from ordinary business cycle movements. Since the average hourly earnings index and the employment cost index moved quite closely together from 1976 to mid-1983, it may be reasonable to assume that the same cyclical pattern held before 1976. On this basis, the slow growth since 1980 has been quite unusual.

result of an increase in wage growth among nonunion workers, offset by a continued slowing of growth in the union sector (see Figure I-5).

These inflation-reducing factors have been partly offset by the recent increase in the price of gasoline. OPEC is under pressure to reduce prices again, however, and the New York oil futures market is assuming a further substantial decline in crude oil prices between now and the beginning of next year. Non-OPEC producers have already cut their oil prices by about $2.00 since the beginning of the year. Two OPEC meetings in July reportedly failed to resolve the issue.

Real Wages. Since 1980, wage inflation has slowed more quickly than price inflation of domestically produced goods and services, and is now considerably less than would be expected on the basis of historical

Figure I-5.
Union and Nonunion Wage Growth (Employment Cost Index, Current Dollars)



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

relationships between wages and prices of domestically produced goods and services. 5/ Two factors may have been important:

- Unemployment, at 7.3 percent, remains higher than usual after several years of recovery, and is still well above most estimates of the level at which wage inflation might be expected to rise. 6/

- Deregulation and the strong dollar have increased competition in many industries. Companies that previously could hold prices high because they faced relatively little domestic competition have had to cut prices to meet the new competition. Where these companies were previously able to pay relatively high wages, these wages too have been cut. One illustration of this situation is the particularly weak growth since 1980 in the wages of unionized workers, who many analysts believe have in the past been able to take advantage of relatively uncompetitive situations to negotiate higher wages.

Employment and Unemployment

Growth in employment has slowed significantly in recent quarters, although not as much as the slowing in output growth. Nonfarm payrolls grew at more than a 4 percent rate in the first two quarters of 1984, but at roughly a 3 percent rate in the first two quarters of this year (see Table I-6). 7/ Growth in employment slowed much more in the goods-producing sector than in the service-producing sector. In the goods sector, employment fell in the second quarter; in the service sector, however, it showed strong momentum. (For a more detailed discussion of changes in the composition of employment, see the last part of this chapter.)

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5. Wages have fallen sharply relative to the prices of goods and services produced in the United States. This is not reflected in Figure I-4, which includes the positive contribution to real wages from falling prices of oil and other imports since 1980.

6. This level is often estimated at between 6 percent and 6.5 percent, which is higher than it was in the 1950s and 1960s in part because women and young workers, who now form a larger part of the labor force, tend to have to spend a larger proportion of their labor force time in job searches than adult males, more of whom have settled jobs. As the baby boom bulge of people entering the labor force slows down, the level of unemployment consistent with constant inflation is likely to be lower.

7. The slowdown in employment growth has been much more pronounced in the data drawn from the household surveys than in that drawn from payrolls. Total civilian employment grew 1.7 percent over the last four quarters. Nonfarm payroll employment rose 3.5 percent in the same period (see Table 1-7).

TABLE I-6. EMPLOYMENT AND UNEMPLOYMENT (Percent change from previous period at annual rates, unless otherwise noted)

	1983	1984	1984 I	1984 II	1984 III	1984 IV	1985 I	1985 II
Payroll Employment, Nonfarm	0.7	4.7	5.5	4.3	3.9	4.0	3.3	2.9
Goods-producing	-2.0	6.0	8.0	4.6	3.0	1.8	1.7	-0.4
Service-producing	1.7	4.3	4.6	4.1	4.2	4.8	3.9	4.0
Civilian Employment	1.3	4.1	4.7	4.8	1.2	2.5	3.0	0.1
Civilian Unemployment Rate (percent)	9.6	7.5	7.9	7.5	7.5	7.2	7.3	7.3
Adult males	8.9	6.6	7.0	6.6	6.4	6.2	6.3	6.3
Adult females	8.1	6.8	7.0	6.7	6.8	6.6	6.7	6.8
Teenagers	22.4	18.9	19.6	18.8	18.6	18.4	18.5	18.3
White	8.4	6.5	6.8	6.4	6.3	6.2	6.3	6.3
Black	19.5	15.9	16.7	16.0	15.8	15.1	15.5	15.0

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

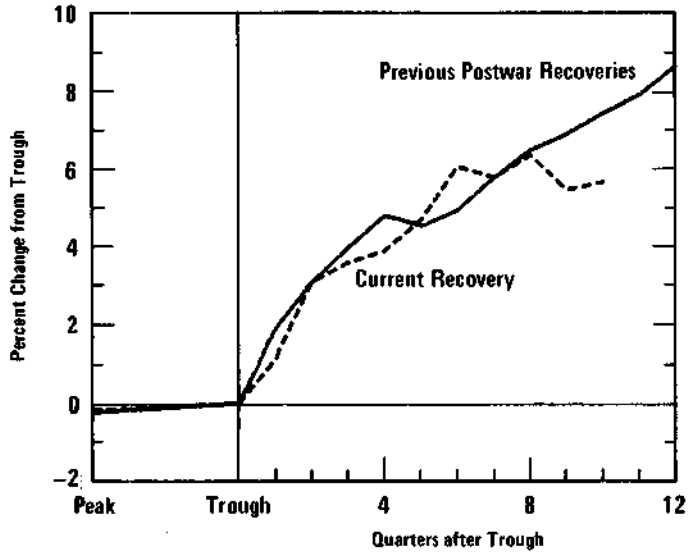
NOTE: Nonfarm payroll employment is measured by a survey of business establishments. The civilian employment and unemployment rates cited are based on a survey of households.

The unemployment situation has changed little in recent quarters. The civilian unemployment rate rose slightly from 7.2 percent in the fourth quarter of 1984 to 7.3 percent in the first two quarters of this year. Differences in unemployment rates among demographic groups have stayed about the same, with unemployment among blacks at about 15 percent and the rate for whites at about 6 percent. In recent quarters, the unemployment rate for adult men has been slightly below the rate for adult women--6.3 percent versus 6.8 percent in the second quarter of this year. (During most of the recession and first year of recovery, unemployment was higher among men than among women.) The teenage unemployment rate has averaged about 18½ percent in the first half of the year--15 percent for white teenagers but 40 percent for black teenagers.

Productivity

Recent productivity performance has been lackluster. Output per hour in the nonfarm business sector grew 2.4 percent over the four quarters of 1984 and appears to have declined at about a 1.3 percent annual rate in the first half of 1985 (see Figure I-6). It is not unusual for productivity to dip when economic growth slows sharply. Nevertheless, the accumulating record does not support the hope that growth in productivity will return to the high levels of the years before the mid-1970s. The slowdown in the growth of productivity is more pronounced in the nonfarm business sector as a whole than in manufacturing, where growth in productivity appears to be close to its long-run trend.

Figure I-6.
Labor Productivity, Nonfarm Business



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

Indicators of Future Demands

Based on recent indicators, the outlook for the next several quarters is mixed. Some indicators, such as the growth in the real money stock, point to robust growth; others, such as contracts and orders for plant and equipment and the indexes compiled by the National Association of Purchasing Management, point to lackluster growth. The Commerce Department's composite index of leading indicators has increased in four of the last six months, but it is only slightly above its peak in the first half of 1984 (see Figure I-7). For the latest month available (June), it rose 1.0 percent after rising 0.1 percent in May and decreasing 0.5 percent in April.

Business Fixed Investment. Although investment spending has been unusually strong in this expansion, several near-term indicators of business fixed investment suggest a slowing in the future. As shown in Table I-7, new orders for nondefense capital goods have been quite flat in recent quarters. The capacity utilization rate in manufacturing has been edging downward, and is now below its long-term average. (From 1960 to 1979, the capacity utilization rate averaged about 83 percent.) Corporate economic profits have leveled out. Yet, net cash flow, which includes depreciation allowances, has continued to rise. 8/ Office vacancy rates have risen to very high levels, suggesting future weakness in office construction. In addition, some analysts worry that the stimulative effects of the 1981-1982 business tax changes on investment are beginning to wear off. 9/ On the plus side, however, interest rates have fallen sharply in recent months and this drop should help to stimulate investment outlays.

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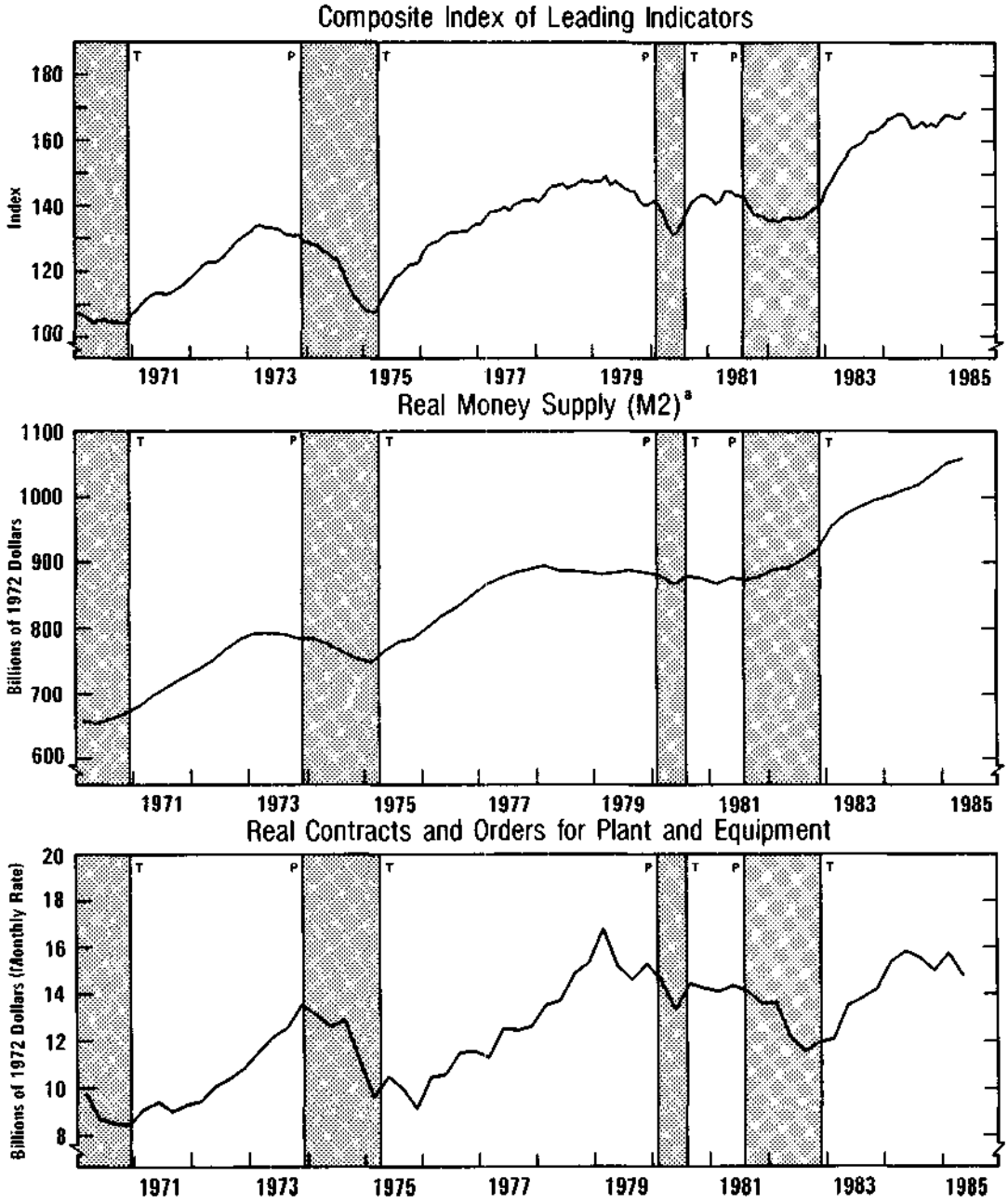
8. Book profits (before adjustments for inventory and depreciation valuation) declined from a peak of $246 billion in 1984 to $222 billion in the first quarter of 1985, the latest data available.

9. A reduction in business taxes is generally thought to raise the desired level of capital, causing growth in capital spending to accelerate temporarily until business has achieved the new preferred level. According to some estimates, the stimulus effect may begin to fade after approximately two to three years, and after five years could be virtually over, except for capital replacement which would be permanently higher. However, most estimates suggest that the impact may be considerably slower. In addition, the rise in interest rates in the early 1980s may have delayed the effects of lower taxes on the cost of capital. For a discussion of these issues, see Charles W. Bischoff, "The Effect of Alternate Lag Distributions," in Gary Fromm, ed., *Tax Incentives and Capital Spending* (Washington, D.C.: Brookings Institution, 1971), pp. 61-130. For more recent analyses, see Barry P. Bosworth, "Taxes and the Investment Recovery," *Brookings Papers on Economic Activity*, vol. 1, 1985, pp. 1-38; and John H. Makin, "The Effects of Government Deficits on Capital Formation," in Phillip Cagan, ed., *Essays in Contemporary Economic Problems: The Economy in Deficit* (Washington, D.C.: American Enterprise Institute, 1985), pp. 163-194.

Figure I-7.
Leading Indicators



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; McGraw-Hill Incorporated; Congressional Budget Office.

[a] M2 deflated by the GNP deflator.

TABLE I-7. CURRENT INDICATORS OF BUSINESS FIXED INVESTMENT AND SURVEYS OF CAPITAL SPENDING PLANS FOR 1985

	1984	1984 I	1984 II	1984 III	1984 IV	1985 I	1985 II
Current Indicators							
Nondefense Capital Goods Orders (billions of dollars per month)	26.9	26.5	27.5	27.4	26.3	26.8	27.0
Manufacturers' Capital Appropriations (billions of dollars per quarter)	30.2	26.8	37.2	27.6	29.2	30.5	N.A.
Manufacturing Capacity Utilization Rate (percent)	80.8	79.8	80.8	81.6	81.0	80.5	80.4
Corporate Economic Profits (billions of dollars, annual rate) a/	286	277	291	283	292	292	N.A.
Corporate Net Cash Flow (billions of dollars, annual rate) b/	362	347	359	367	374	380	N.A.
Corporate AAA Bond Rate (percent)	12.7	12.3	13.2	13.0	12.4	12.3	11.6

Surveys of Capital Spending Plans for 1985

	Nominal	Real
U.S. Department of Commerce c/	9.2	6.2
McGraw-Hill Survey d/	9.9	4.6

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; McGraw-Hill, Inc., Conference Board; Federal Reserve Board; Congressional Budget Office.

NOTE: N.A. = not available.

a. Economic profits are adjusted for inventory valuation and capital consumption allowances.

b. Net cash flow equals corporate retained earnings with inventory valuation adjustment, plus economic depreciation.

c. Conducted in April and May 1985.

d. Conducted in March and April 1985.

The most encouraging direct indicator of the near-term investment outlook is that of business capital spending plans. The latest Commerce Department survey, released in June and taken in April-May, indicates that businesses planned to increase nominal spending by 9.2 percent this year over 1984--half a percentage point more than shown in the January-March survey (8.7 percent). 10/ Another survey, one by McGraw-Hill, showed approximately the same intentions by businesses as the Commerce Department's survey, although they are down slightly from last winter. The Department of Commerce survey, which provides information on the quarterly pattern of intended capital spending, suggests continued moderate growth in the second half of 1985.

Current proposals to restructure business taxes may be adding significantly to the uncertainty associated with business investment planning. The Administration's package contains a number of changes that would affect the cost of capital, including repeal of the investment tax credit (which now applies to equipment), much longer depreciation lives for tax purposes, indexing depreciation for inflation, and a reduction in the top corporate income tax rate from 46 percent to 33 percent. In addition, several tax rules that pertain to real estate would be tightened. Together, the unveiled package of proposals implies only small changes in the overall cost of capital but much more significant shifts in the relative costs of different kinds of capital. Some parts of the package could have a pronounced effect on the timing of investment. For instance, the proposal to repeal the investment tax credit at the end of 1985 could stimulate equipment spending this year to beat the deadline, but retard spending after January 1, 1986.

Inventories. Last winter, CBO noted that inventory investment was a particular source of uncertainty for the forecast. The overall inventory-to-sales ratio was low compared with recent history (see Figure I-8). Inventory accumulation was very rapid in the first and third quarters of 1984 and continued at a lower rate in the fourth quarter. The decline in final sales in the first quarter of this year meant a modest increase in inventory accumulation, but the latest data available (for April and May) suggest that inventories have since been reduced: inventory-to-sales ratios in wholesale and retail trade declined in April and May. Thus, the inventory situation does not appear to be a negative factor in the outlook.

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10. After the Department of Commerce adjusts for inflation, the increase in planned real investment for 1985 over 1984 is 6.2 percent.

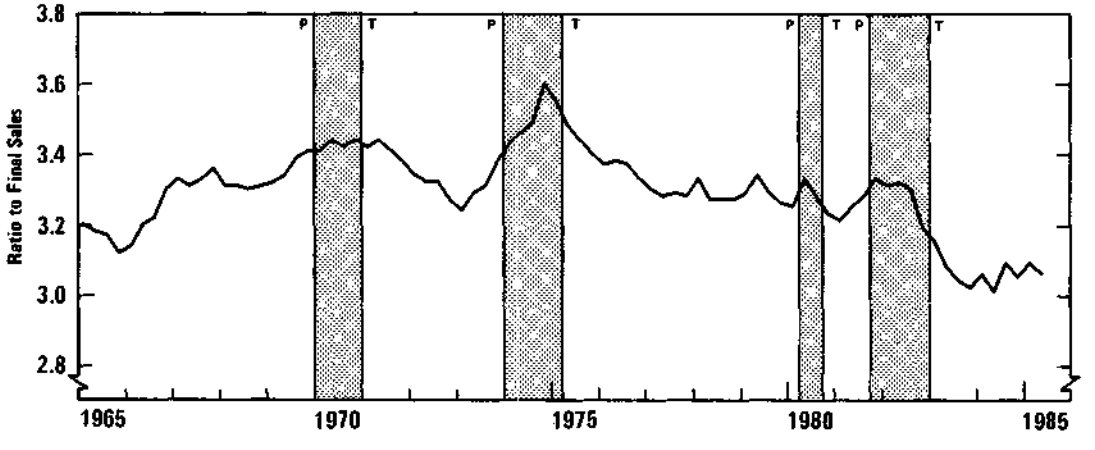
Consumer Spending. Recent data suggest that a continuation of moderate growth in consumer spending is likely in the near term (see Table I-8).

Personal income, adjusted for inflation, grew at a 2.9 percent rate in the first quarter and 2.3 percent in the second, reflecting continued but slowing growth in employment. The recent growth in real disposable personal income has been erratic, in part because tax refunds occurred later than usual and tended to shift household disposable income from the first to the second quarter (see Table I-8). The personal saving rate has been relatively low, with the rate in the first quarter extremely low because of the lateness in tax refunds. Household financial net worth in terms of purchasing power has been growing strongly. At the same time, consumer installment credit relative to disposable personal income has been very high by historical comparison (see Figure I-9), which suggests some cash flow difficulties. Indexes of consumer sentiment, however, generally remain at high levels, although below the peaks attained during 1984.

Residential Investment. Housing starts have been running at just under a 1.8 million-unit annual pace in the first six months of 1985, up from about a 1.6 million-unit annual pace at the end of last year (see Figure I-10). While single-family starts in 1985 have been relatively steady, multifamily starts have fluctuated widely--probably in part because varying interpretations of possible tax law changes have increased the uncertainty of this type of investment.

Despite the fact that housing starts during the first half of this year averaged higher than they did at the end of last year, their monthly

Figure I-8.
Real Business Inventories: Relative to Final Sales



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

variation has raised concern as to their growth over the remainder of 1985. In May and June, single-family starts were well below their pace earlier in the year, though this was more likely the result of short-term adjustments than a harbinger of a prolonged slowdown in this sector. After declining in April, sales of new homes rebounded in recent months. In addition, the affordability index of new homes improved as the previous drop in interest rates was more fully reflected in mortgage rates.

Table I-8. CURRENT INDICATORS OF FUTURE CONSUMER SPENDING

	1984	1984 I	1984 II	1984 III	1984 IV	1985 I	1985 II
			Percent Change, Annual Rates				
Real Personal Income	6.4	8.3	6.8	4.2	4.1	2.9	2.3
Real Disposable Income	6.7	8.6	6.3	3.9	3.5	-1.6	9.3
Real Household Financial Net Worth	4.6	-1.3	4.3	15.7	5.2	15.2	N.A.
			Levels				
Installment Credit (percent of disposable income)	16.5	15.7	16.3	16.6	17.1	18.0	17.8 a/
Consumer Sentiment Index	97.5	99.5	96.6	98.9	95.0	94.5	94.3
Personal Saving Rate (saving as a percent of disposable income)	6.1	6.1	5.8	6.3	6.2	4.5	5.3

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board, Flow of Funds Section; Institute for Social Research, University of Michigan; Congressional Budget Office.

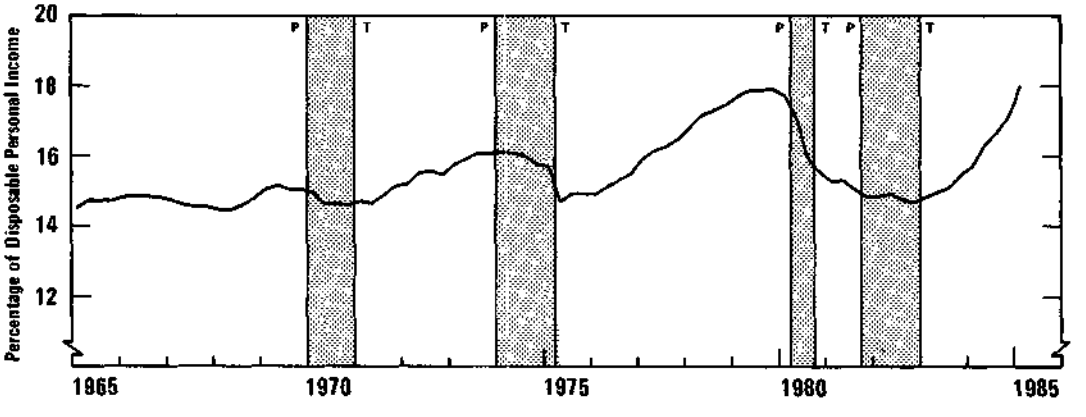
a. April only.

The Federal Sector. Real federal purchases of goods and services--excluding the activities of the Commodity Credit Corporation (CCC)--increased 3.3 percent (annual rate) in the first half of 1985, compared with 6.4 percent during 1984 (see Table I-9). Defense purchases slowed from 7.4 percent growth in 1984 to 4.6 percent in the first half of 1985. Nondefense purchases (excluding CCC) showed no growth in the first half of 1985, compared with a 3.5 percent growth rate last year.

The delay in the payment of federal tax refunds swelled federal revenues in the first quarter and reduced them in the second quarter. The primary result appears to have been a swing in the saving rate rather than a shift in the growth of consumer spending.

Under the Budget Resolution for 1986, there is likely to be little real growth in total federal purchases on a national income accounts basis during the forecast period. Real defense purchases would increase, but most of this growth would be offset by a decline in real nondefense purchases. The budget resolution would keep real budget authority for defense during fiscal year 1986 at the current level. But because of long lags between the provision of budget authority and actual outlays, the procurement component of real defense spending would increase in 1986, accounting for virtually all of the real growth in federal purchases during the forecast

Figure I-9.
Consumer Installment Credit



SOURCES: Federal Reserve Board; U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

period. In contrast, the federal civilian pay freeze contained in the budget resolution would immediately slow the growth of compensation.

The State and Local Sector. Purchases of goods and services by state and local governments increased at a 2.5 percent rate in real terms during the first half of 1985, compared with 2.9 percent over the four quarters of 1984. All of this growth was in the second quarter. The slowdown this year primarily reflected a decline in highway construction that may have resulted in part from unusually bad weather in some areas, and from a temporary delay in federal highway funding. In the second quarter, state and local construction activity rebounded strongly and is expected to grow throughout this year. A general slowdown in the growth of state and local purchases, however, seems probable next year, when the pace of construction activity is expected to subside.

The overall surpluses of state and local governments are expected to remain close to current levels during the forecast period, as an upward trend in trust fund surpluses offsets a downward trend in operating balances. The outlook for smaller state and local operating balances mainly reflects an expected slowdown in the growth of revenues resulting from some net tax reductions and reduced growth in federal aid.

The Dollar and Foreign Trade

The first half of 1985 saw the longest and largest reversal in the upward trend of the dollar since 1981. The international value of the dollar rose

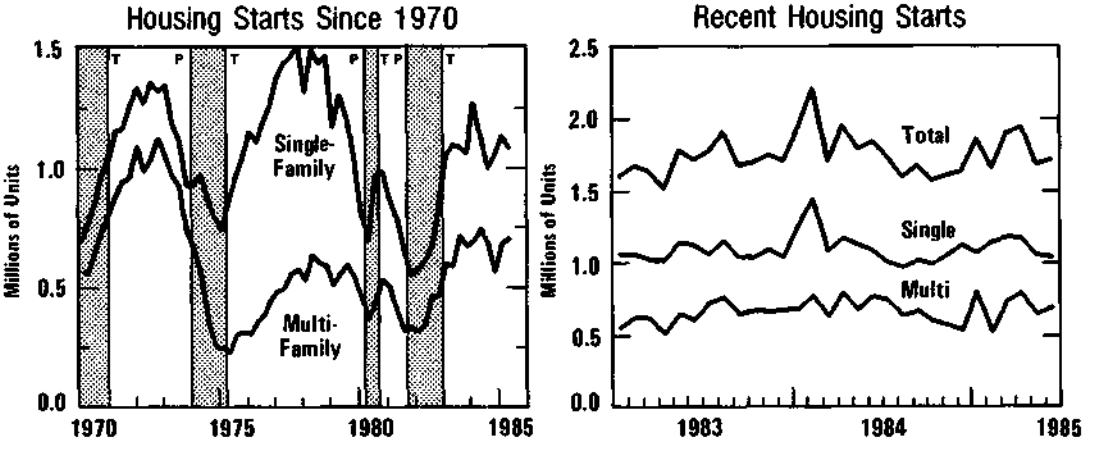
TABLE I-9. GOVERNMENT PURCHASES OF GOODS AND SERVICES
(National income basis, billions of 1972 dollars)

	1983	1984				1985	
		I	II	III	IV	I	II
Federal a/	118.6	121.2	123.4	123.3	128.2	127.7	130.3
Defense	84.7	87.1	89.6	89.1	92.7	92.7	94.8
State and Local	175.7	177.3	178.9	181.1	180.9	180.9	183.1

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

a. Excludes purchases by the Commodity Credit Corporation.

Figure I-10.
Selected Housing Statistics



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

from mid-November 1984 through most of February, and subsequently fell quite sharply.

Figure I-11 shows the trade-weighted exchange value of the dollar in both nominal and real terms. 11/ On an average monthly basis, the peak value of the nominal exchange index for the dollar stood last February about 6 percent higher than its December 1984 level and 87 percent higher than its July 1980 low. By the end of July 1985, however, the exchange rate was about 12 percent below its February peak and about 7 percent below its December 1984 average, indicating some improvement this year in the competitive position of U.S. producers.

Determinants of the Exchange Rate. International capital flows have been the main determinant of movements in dollar exchange rates in recent years. 12/ Relative movements in interest rates and expected changes in

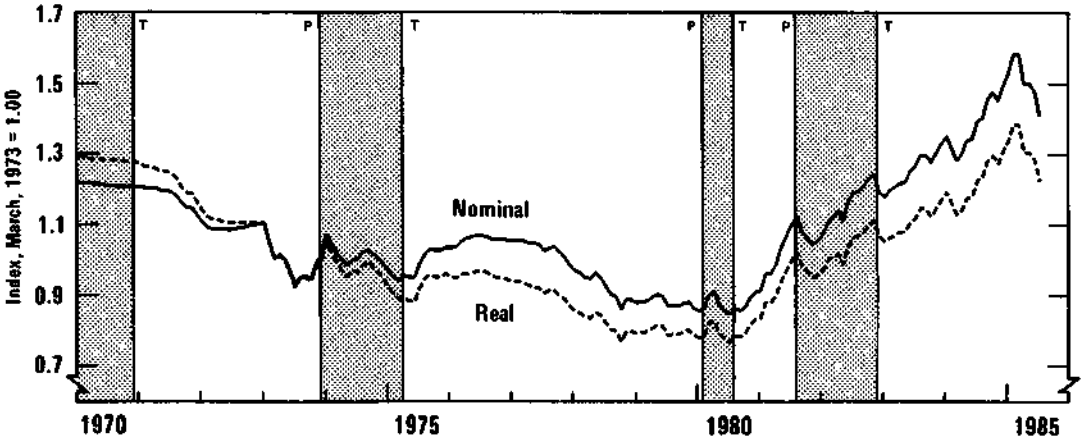
11. The nominal index is simply a trade-weighted average of bilateral dollar exchange rates. The real index adjusts the nominal index for movements in national price levels, and is a measure of the dollar's purchasing power in foreign countries. Because the average inflation rate for other industrial countries was not much higher than that for the United States after 1983, movements in the real exchange-rate index have broadly paralleled those in the nominal one.

12. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1986-1990* (February 1985).

exchange rates provide an important motivation for international movements of capital. Other determinants include changes in the perceived risk associated with international investment opportunities. Although all of these factors are significant in influencing capital movements, there is little agreement on their relative importance.

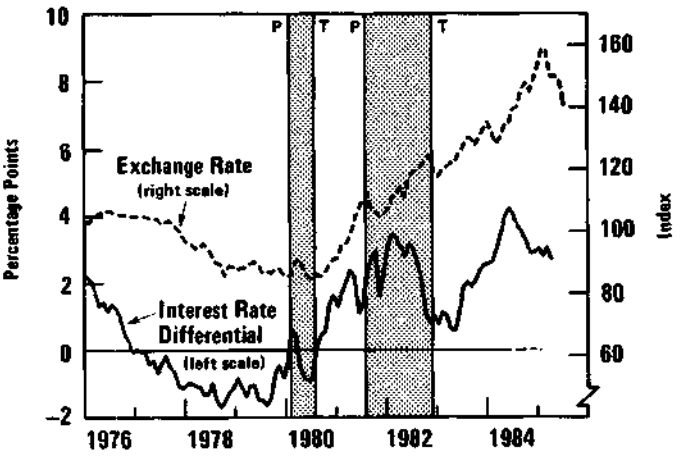
The decline in the value of the dollar after last February seemed to reflect events in the United States that tended to reduce confidence in the dollar and to make U.S. investment less attractive. These events included the weak first-quarter growth of the economy and the difficulties experienced by some commercial banks and S&Ls. Another important factor was the decline in U.S. interest rates relative to foreign rates. Although international capital flows often do not respond immediately to movements in real long-term interest differentials, there is a significant long-run relationship between them (see Figure I-12). Because U.S. interest rates are expected to remain low over the forecast horizon relative to what they were in the 1981-1984 period, the strength of international demand for dollar assets is expected to diminish somewhat. This reduced demand, together with the accumulation of dollars by foreigners implied by current account deficits, should help to hold down the international value of the dollar.

Figure I-11.
Exchange Rate



SOURCES: Federal Reserve Board; International Monetary Fund; Congressional Budget Office.
NOTE: The nominal index is a trade-weighted average of bilateral dollar exchange rates. The real index adjusts the nominal index for relative movements in CPIs, and is a measure of the relative prices of domestic and foreign goods and services.

Figure I-12.
The Exchange Rate and Relative Interest Rates



SOURCES: Federal Reserve Board; International Monetary Fund; Congressional Budget Office.

NOTE: The exchange rate is a trade-weighted average of bilateral dollar exchange rates. The real interest-rate differential is the difference between long-term real interest rates for the United States and a GDP-weighted average for other industrial countries. Long-term real interest rates are long-term nominal interest rates (on government bonds), adjusted for expected inflation rates. Expected inflation is proxied by a two-year centered moving average of actual and projected CPI inflation rates.

International Capital Flows. Reported net capital flows into the United States more than doubled in 1984 to $77 billion from the previous year (see Table I-10). At the same time, the statistical discrepancy in the balance of payments accounts rose to $25 billion in 1984 from only $9 billion in the previous year. If the statistical discrepancy represents unreported capital flows for the most part, as many experts believe it does (rather than unreported current account transactions), both reported and unreported net capital inflows for 1984 may have exceeded $100 billion.

Measured net capital inflows are likely to continue to grow for some time, even as the dollar continues to depreciate. The reason that the underlying demand for dollar assets and measured net capital inflows move in opposite directions for a while is that such inflows are the mirror image of the current account balance. 13/ The current account, however, is rela-

13. In the absence of measurement errors, net capital flows must equal the current account balance, which is exactly equal to the rate at which net assets are exchanged between residents of different nations. Without current earnings from international trade, the only way U.S. residents can acquire foreign assets is by selling off previously acquired foreign assets, by borrowing from foreigners, or by paying foreigners with U.S. dollars that are official liabilities of the United States. The only way the United States can run continuing current account deficits is by borrowing from abroad.

TABLE I-10. INTERNATIONAL CAPITAL FLOWS (In billions of dollars, seasonally adjusted) a/

	1983	1984	1984 I	1984 II	1984 III	1984 IV	1985 I b/
Change in Foreign-Owned U.S. Assets (a)	81.7	97.3	19.3	41.6	3.1	33.3	16.5
Official Foreign Assets (b)	5.3	3.4	-2.8	-0.2	-0.7	7.1	-11.4
Private Assets	76.4	93.9	22.1	41.8	3.8	26.2	27.9
Direct investment	11.3	22.5	3.3	9.3	5.2	4.7	2.7
Treasury securities	8.7	22.4	1.4	6.5	5.1	9.5	2.7
Other securities	8.6	13.0	1.5	0.5	1.6	9.4	9.5
Other reported by nonbanks	-1.3	4.3	4.5	4.6	-2.9	-1.9	N.A.
Other reported by banks	49.1	31.7	11.3	21.0	-5.1	4.5	13.0
Change in U.S.-Owned Foreign Assets (c)	49.5	20.4	5.0	19.0	-18.4	14.8	3.2
U.S. Government Assets (d)	6.2	8.6	2.7	1.9	2.2	1.8	1.0
Private Assets	43.3	11.8	2.3	17.1	-20.5	13.0	2.2
Direct investment	4.9	4.5	3.1	-2.0	-2.0	5.4	-0.6
Securities	7.7	5.1	-0.7	0.8	1.3	3.7	2.5
Other reported by nonbanks	5.3	-6.3	-1.3	-1.9	-2.1	-1.0	N.A.
Other reported by banks	25.4	8.5	1.1	20.2	-17.7	4.9	0.3
Net Capital Inflows on a Reported Basis (e = a-c)	32.2	76.9	14.3	22.6	21.5	18.5	13.3
Net Official Capital Inflows (f = b-d)	-0.9	-5.2	-5.5	-2.1	-2.9	5.3	-12.4
Net Private Capital Inflows (e-f)	33.1	82.1	19.8	24.7	24.4	13.2	25.8
Statistical Discrepancy (g)	9.3	24.7	4.8	1.9	11.0	7.0	16.7
Net Capital Inflows Including Statistical Discrepancy (h = e + g)	41.6	101.5	19.1	24.5	32.5	25.5	30.0
Net Official Capital Inflows (f)	-0.9	-5.2	-5.5	-2.1	-2.9	5.3	-12.4
Net Private Capital Inflows (h-f)	42.4	106.8	24.6	26.6	35.4	20.2	42.4

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: N.A. = not available.

a. Quarterly figures are shown at quarterly rates.
b. Preliminary data.

tively sluggish because it responds to exchange-rate developments with a considerable time lag. In short, the external accounts of the United States are rather like an ocean liner--difficult to turn around quickly.

U.S. Net International Assets. The counterpart to large net capital inflows is an erosion of the U.S. international asset position. 14/ U.S. net foreign assets declined to $106.2 billion by the end of 1983, and to only $28.2 billion at the end of 1984 (see Table I-11). Although complete data for the period are not yet in, it is quite possible that the United States became a net debtor nation during the first half of 1985.

The growth of net capital inflows and the deterioration of U.S. net foreign assets have financed a surge in imports since 1982. As a result, domestic spending has increasingly exceeded output and income generated domestically. The now emerging U.S. external debt will rise as long as the current account deficit is not completely eliminated. Moreover, the day may soon come when the balance between the United States and the rest of the world on labor and capital income turns negative. When it does, the income that Americans earn from domestic production will fall short of the total value of output because of the need to make net payments to foreign holders of U.S. capital.

The Slow Turnaround in Trade. Despite the recent decline in the dollar, the foreign sector is expected to be a drag on the economy for several more quarters. Prices and volumes of internationally traded goods and services respond to exchange-rate movements with a lag. Hence, even though the CBO forecast reflects the recent dollar depreciation, real net exports are not expected to stabilize until late this year or early next year. For 1986 as a whole, the change in real net exports should have little effect on the real GNP growth rate. This is in sharp contrast to 1984, when the change in real net exports pulled the real growth rate down by about 1.8 percentage points.

The Outlook for Foreign Growth. The prospect for U.S. exports depends critically on rates of economic growth abroad, which are expected to be slightly lower than in the United States over the forecast horizon. Lower real interest rates in the United States should lead to some reduction of real

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14/ The U.S. net international asset position is the difference between the value of U.S.-owned foreign assets and the value of foreign-owned U.S. assets. It is measured, however, with considerable error. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1985-1990* (February 1985).

interest rates worldwide, eventually stimulating private investment spending abroad.

The outlook remains uncertain, however. Growth of real GNP seemed to falter in a number of foreign industrial countries during the first quarter of this year:

- Japan's real output rose at only a 0.4 percent annualized rate;
- France showed no growth at all; and
- Output in West Germany fell at a 3.9 percent annualized rate.

Preliminary data suggest that the average growth rate in the first quarter for foreign industrial countries was only about 1 percent at an annualized rate. But this slowdown may be only temporary; most forecasters call for growth in the 2.5 to 3.0 percent range for 1985, and slightly lower for 1986.

TABLE I-11. NET INTERNATIONAL ASSETS OF THE UNITED STATES (In billions of dollars, seasonally adjusted)

	1981	1982	1983	1984	1984 IV	1985 I
Net Capital Inflows on a Reported Basis	-29.7	-23.7	32.2	76.9	18.5	13.3
Net Foreign Assets (end of period) a/	143.1	149.5	106.2	28.2	28.2	14.9

SOURCE: U.S. Department of Commerce.

a. The estimate for the first quarter of 1985 is based only on reported net capital inflows, excluding valuation adjustments that would account for capital gains and translation gains on outstanding asset positions. Valuation adjustments, which are officially prepared only with annual data, can be quite large. These account for the discrepancy between net inflows and the change in net assets.

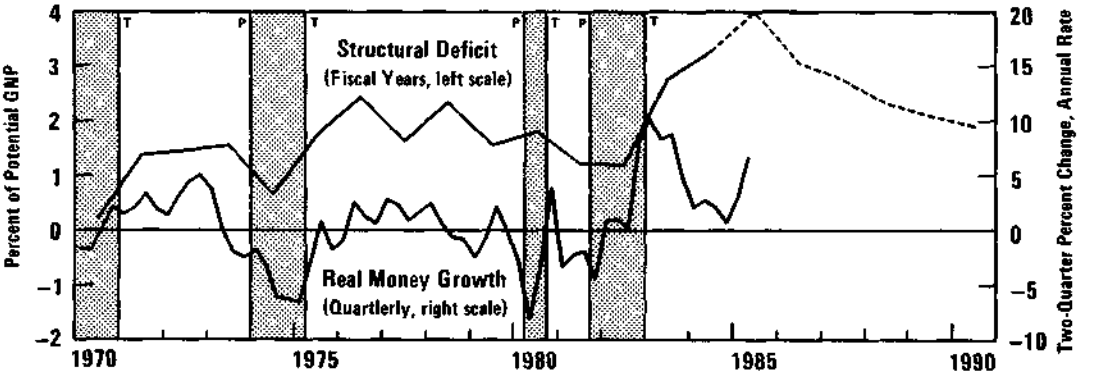
CHANGES IN MONETARY AND FISCAL POLICY

Monetary and fiscal policies have gone through several phases since 1980. Late in the 1981-1982 recession, the growth rate of the real money supply and the increase in the standardized budget deficit--crude measures of the impact of monetary and fiscal policy on aggregate demand--both became very expansive. Later during the recovery, fiscal policy remained expansive, while monetary conditions became more stringent (see Figure I-13). Late in 1984 and continuing to the present, monetary policy again became expansive. In the last few quarters, the structural budget deficit relative to GNP appears to have been leveling off and it is projected to decline if policies contained in the Congressional Budget Resolution for Fiscal Year 1986 are implemented.

These policy developments and assumptions, which are described below, have important implications for the economic outlook. Interest rates have already eased. Moreover, interest-sensitive sectors, such as residential construction, may soon begin showing signs of renewed vitality. After a sharp runup in the first quarter of the year, the dollar exchange rate has weakened considerably as U.S. interest rates declined, and many observers expect the exchange rate to decline further as federal budget deficits are being reduced.

The revised CBO projections incorporate lower real interest rates than shown in last February's forecast. This change in the projections reflects, among others, the assumption that deficit reduction policies embodied in the

Figure I-13.
Fiscal and Monetary Indicators



SOURCES: Federal Reserve Board; Congressional Budget Office.

Congressional Budget Resolution will be enacted. If such policies are not fully implemented, the outlook for interest rates and possibly exchange rates will not be so favorable.

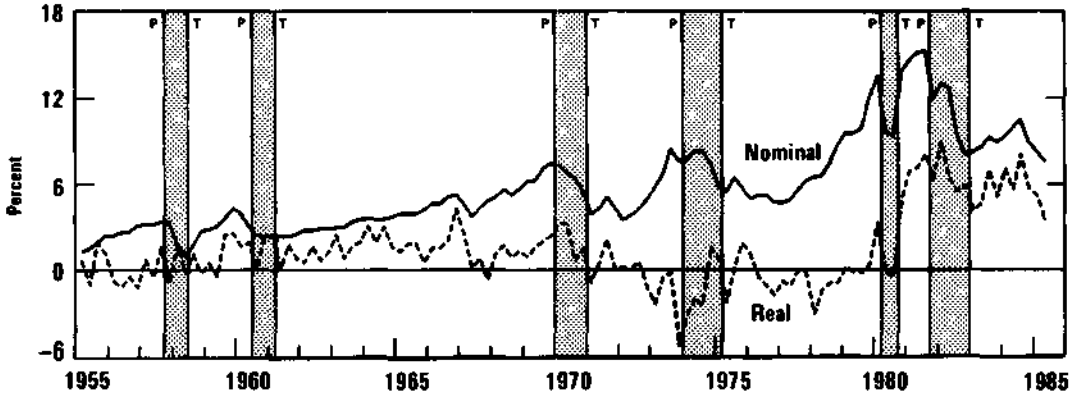
Financial Markets and Monetary Policy

After a brief upturn in February and March of this year, interest rates declined rapidly until they reached levels not seen since mid-1980. The drop in rates appears to reflect an easing of credit demands as a result of flagging economic growth, and an expansive monetary policy. Inflation-adjusted (real) rates have also fallen (see Figure I-14). Recent monthly data show that real interest rates are at their lowest levels since the beginning of the recovery.

The decline in interest rates has occurred among all maturities but has been somewhat greater among the middle-term securities. As a result, the overall yield curve has remained relatively steep (see Figure I-15). The short-term end of the curve, however, has flattened slightly. Thus, the shape of the yield curve suggests market expectations of modest increases in short-term rates over the remainder of this year and into early 1986. These expectations are corroborated by prices in the futures market.

Credit Demands. As Table I-12 shows, the growth rate of domestic nonfinancial sector debt slowed markedly in the first quarter of this year,

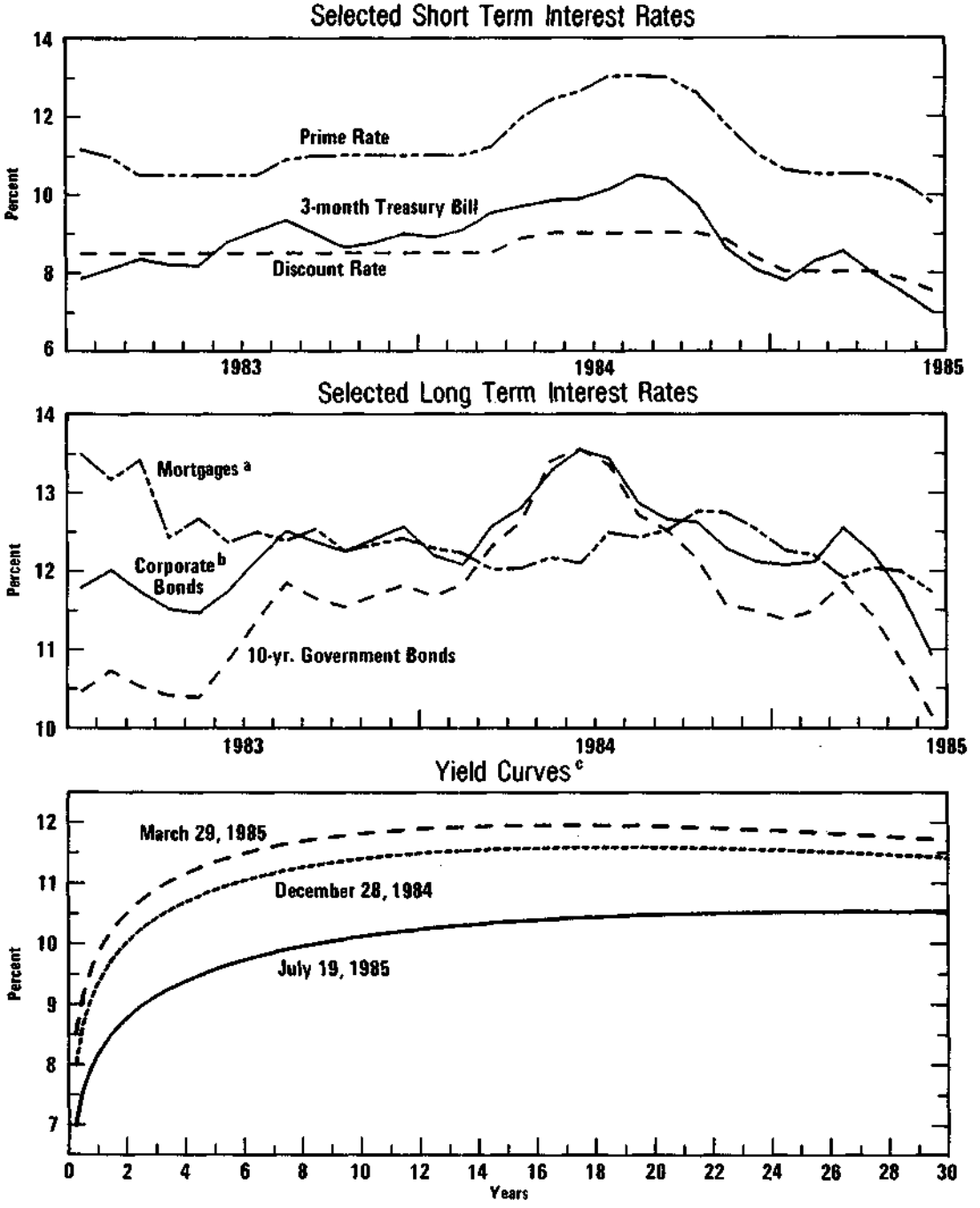
Figure I-14.
Three-Month Treasury Bill Rates



SOURCES: Federal Reserve Board; U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

NOTE: Real interest rates are calculated by subtracting from the nominal interest rate the rate of inflation in the succeeding quarter. This value, the "ex post real rate," is the proxy for the unobserved real rate, which is the nominal rate less expected inflation over the life of the instrument. The inflation rate used is that of the consumption deflator and is assumed to be 4.0 percent in the third quarter of 1985.

Figure I-15.
Interest Rates



SOURCES: Federal Reserve Board; Federal Home Loan Bank Board; Congressional Budget Office.

[a] Effective interest rate on new mortgage closings.

[b] Moody's AAA corporate bond rate.

[c] These curves were fitted to weekly average yields on Treasury instruments using a logrithmic function described by Bradley and Crane in the Journal of Bank Research, Spring 1973. The curves were then smoothed by hand.

though it remained above the growth rate in nominal GNP. The slowdown was evident in both the public and private sectors. Among the domestic private-sector components, the corporate sector had the sharpest slowdown despite continued merger-related financing. The slowing of growth in the household sector reflected primarily the reduced pace of mortgage financing, since consumer credit continued to expand at a brisk pace. Growth in state and local debt also declined substantially from its fourth-quarter pace, although remaining very strong by historical standards.

The projected improvement in economic growth over the remainder of 1985 should lead to a modest increase in private-sector credit demand, and public-sector demands are also likely to remain relatively strong over this period. These increases in demand for credit, however, are not expected to be large enough to lead to sharply higher interest rates over the remainder of the year.

Monetary Policy. Monetary policy, as measured by growth in M1, has been very expansive over the first half of this year (see Figure I-16). M1 has grown at a 10.8 percent pace since the fourth quarter of 1984, which is well above the upper target of 7 percent that was set by the Federal Reserve in February. Moreover, this growth has recently pushed M1 above the

TABLE I-12. GROWTH RATES OF CREDIT MARKET DEBT, NONFINANCIAL SECTORS (Seasonally adjusted, annual rates of change)

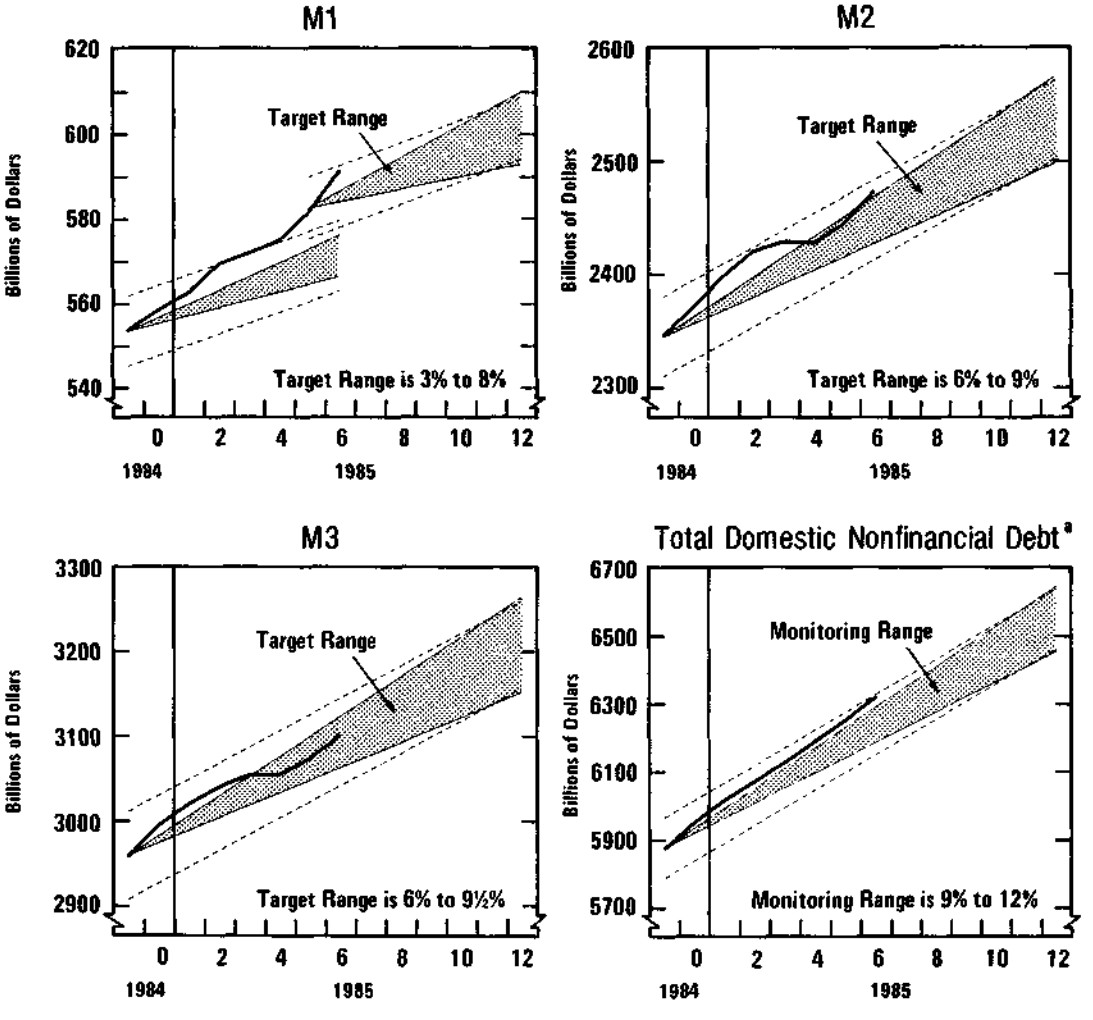
	1984				1985
	I	II	III	IV	I
Total Debt	11.8	13.6	10.7	14.9	10.6
Private	10.6	13.7	9.7	13.7	10.1
Corporations	15.8	15.8	10.2	16.5	10.8
Households	11.0	14.2	10.8	13.1	11.9
Foreign	-4.3	20.1	-14.4	0.4	-7.6
Other	10.7	14.0	11.2	10.4	6.8
Public	13.0	10.0	14.8	20.0	13.0
Federal government	16.2	13.3	14.7	19.3	12.2
State and local governments	2.6	-1.0	15.0	22.1	15.9

SOURCES: Federal Reserve Board; Congressional Budget Office.

more lenient "growth bands" described by the Federal Reserve at that time. Growth in M2 and M3 has been somewhat more subdued than that of M1 in recent months. Nevertheless, M2 is just above its upper target and M3 is in the upper half of its range. Total domestic nonfinancial debt has been consistently above the upper bound of its monitoring range.

One explanation for the difference between the behavior of M1 and that of the broader aggregates during the second quarter is a possible

Figure I-16.
Money Growth and Targets in 1985



SOURCES: Federal Reserve Board; Congressional Budget Office.

NOTE: Widened target bands are presented in accordance with current Federal Reserve practice. See Chairman Volcker's testimony to the Senate Banking Committee, February 20, 1985.

[a] Preliminary Federal Reserve estimate for June.

TABLE I-13. SELECTED RESERVE AGGREGATES AND INTEREST-RATE SPREADS

Quarter	Monetary Base Growth a/	Borrowed Reserves b/	Federal Funds-Discount Rate Spread c/
1984:I	9.8	727	1.19
1984:II	6.9	1858	1.60
1984:III	7.3	908	2.39
1984:IV	4.8	753	0.53
1985:I	8.4	460	0.48
April	3.7	476	0.27
May	11.1	773	0.16
June	14.3	529	0.03

SOURCES: Federal Reserve Board; Congressional Budget Office.

a. Percent, annual rate. The monetary base consists of currency plus total reserves. For a more detailed discussion, see Federal Reserve Statistical Release H.3 (502).

b. Adjustment plus seasonal credit, in millions of dollars.

c. Difference in percentage points between the federal funds rate and the Federal Reserve discount rate.

shifting of assets into M1 from the remaining components of M2. 15/ Since M1 is included in M2, such a shift would boost M1 growth while leaving M2 and M3 unchanged. The decline in interest rates during the second quarter reduced the interest-rate spread between "other checkable deposits" (primarily NOW accounts) included in M1 and nontransactions deposits, such as savings and small time deposits and money market mutual funds, included in M2. As the spread decreased, the relative cost of holding the more liquid M1 deposit was lessened and may have induced some shifting.

As Table I-13 indicates, the reserve aggregates also show signs of monetary accommodation. The monetary base has grown at approximately a

15. M1 consists of currency, travelers' checks, demand deposits, and other checkable deposits. M2 consists of M1, plus overnight repurchase agreements, Eurodollars, money market mutual fund balances, money market demand accounts, and savings and small time deposits.

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9 percent pace so far this year, well above the pace during the second half of last year. In addition, borrowed reserves are running well below their levels in the second half of 1984. 16/ Finally, the spread between the federal funds rate and the discount rate has narrowed appreciably since the end of last year, despite a discount rate cut in May. 17/

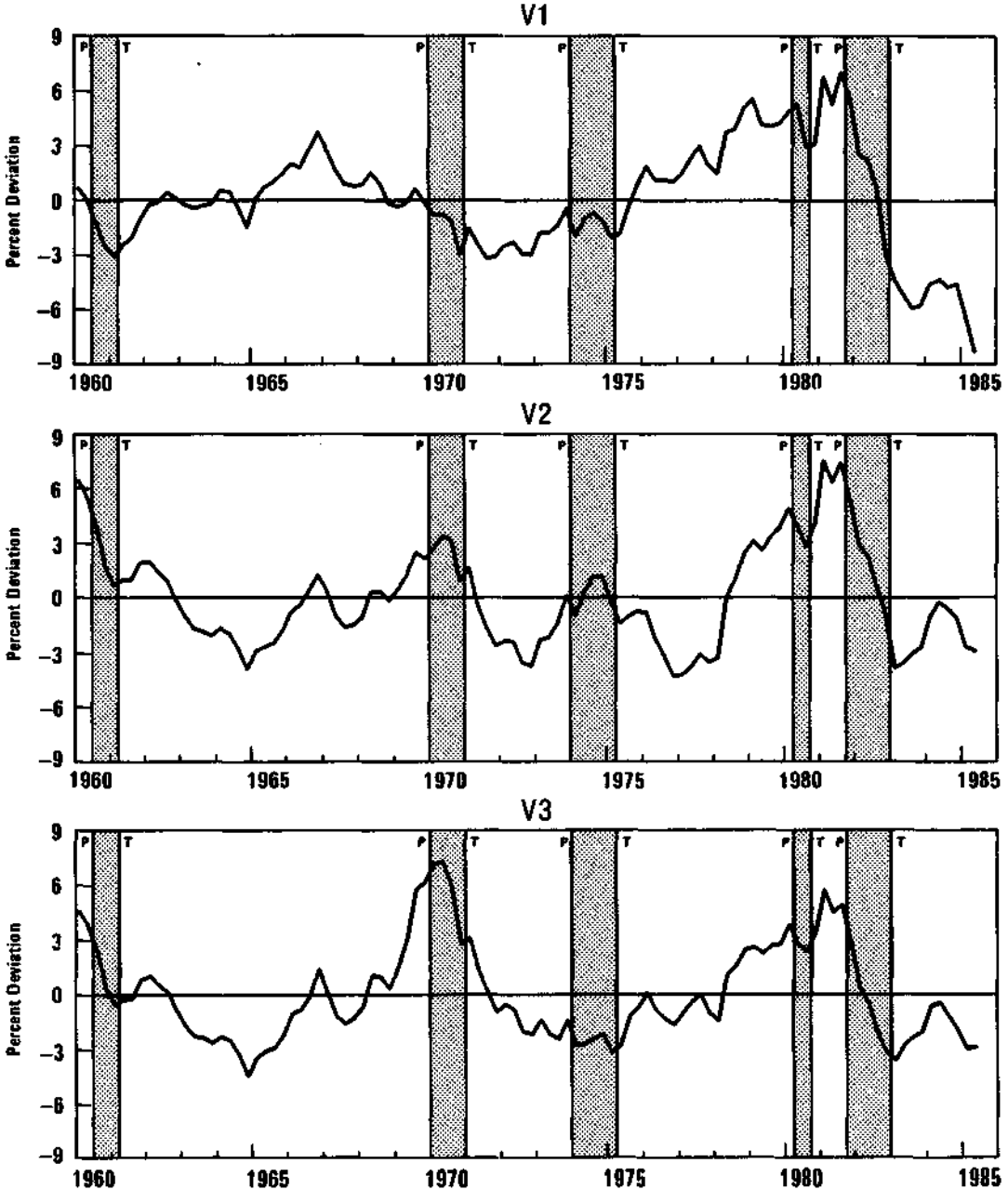
To a large degree, a decline in the velocity of money--the ratio of GNP to the money supply--has so far offset the expansionary effects of the bulge in money growth. As shown in the upper panel of Figure I-17, M1 velocity, V1, has recently declined and is well below its long-run trend. After a sharp downward shift during the 1981 to 1983 period, V1 growth returned to more normal behavior last year but again declined sharply during the first two quarters of this year. Studies conducted in the wake of the 1981-1983 fall attributed the decline in V1 to factors such as the sharp drop in inflation, an increase in precautionary money balances owing to the severity of the recession, and growth in the interest-sensitive component of M1 resulting from deposit deregulation. Many of these studies implied that velocity should begin to behave more normally once these changes were assimilated. When velocity growth in 1984 proved to be somewhat faster than average for the second year of a recovery, it was felt that the behavior of velocity had returned to a more normal pattern. Thus, the recent decline was unexpected and is somewhat perplexing.

Preliminary studies suggest that part of the explanation for the decline may be related to deposit shifts in the wake of the decline in interest rates over the last year and to the increase in the share of imports in domestic spending. As mentioned earlier, the decline in interest rates decreases the opportunity costs of holding liquid balances that are included in M1. As a result, funds that might normally be invested in higher-yielding assets outside of M1 are placed in deposits included in M1. Since these transferred deposits are not primarily used for making transactions, they do not contribute to as high a level of GNP as do traditional M1 deposits. Thus, V1--the ratio of GNP to M1--declines. The increase in imports also contributes to weakness in velocity. As more M1 transactions balances are

16. Borrowed reserves reflect the shortfall in desired reserves that must be made up by borrowing from the Federal Reserve. Thus, a smaller number generally is indicative of a more accommodative policy stance.

17. The spread between the federal funds rate and the discount rate is viewed by many money market participants as a measure of monetary policy stringency, with larger spreads implying tighter policy and vice versa.

Figure I-17.
Velocity: Deviations from Trend Level



SOURCES: Federal Reserve Board; U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

NOTE: Velocity is the ratio of GNP to money. The trend is log-linear, estimated from 1960 through 1985.

used to purchase imports rather than domestic output, V1 falls. 18/ Moreover, these studies suggest that lags in the effects of interest rates and trade flows may cause V1 growth to be relatively weak throughout 1985 and early 1986.

In order to address the problem with V1 and to provide a clearer understanding of monetary policy, the Federal Reserve announced certain policy changes in its midyear report to the Congress. The M1 target was rebased to its average second-quarter level and the target growth range for the remainder of 1985 was expanded to between 3 percent and 8 percent. The central bank also set a tentative M1 range for 1986 of 4 percent to 7 percent. In rebasing the M1 target, the Federal Reserve noted that M1 is currently above even its rebased target and may not reenter its target range for some time.

While generally similar to those of V1, deviations in V2 and V3 from their trends are much less severe. Moreover, since M2 and M3 are either near or within their respective target ranges, they pose less of a problem for monetary policy. For these aggregates, the Federal Reserve announced no changes in 1985 target ranges. For 1986, it tentatively decided to lower the upper bound of the M3 target range by one-half percentage point, and both the upper and lower bounds of the debt monitoring range by one percentage point.

The Fiscal Policy Outlook

The Congressional Budget Resolution for Fiscal Year 1986 would significantly reduce federal budget deficits in coming years. Based on the tax and spending policies of the resolution and on the economic assumptions described in this report, CBO estimates that the total federal deficit (including off-budget outlays) will drop from $210 billion in 1985 to $143 billion in 1988. Extrapolating these policies past 1988 yields further reductions in the estimated deficit to $120 billion by 1990. Without the policy changes adopted in the budget resolution, CBO estimates that the baseline deficit would rise to $285 billion by 1990. 19/

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18. This occurs because imports reduce GNP, but the transactions balances used to purchase imports are included in the domestic money supply.

19. Chapter II presents the budget outlook in detail, including the baseline budget estimates and projections based on alternative high-growth and low-growth economic assumptions.

Of course, deficit projections based on the policies contained in the budget resolution would differ significantly if the economy were assumed to perform differently than is now projected. For example, assuming much stronger economic growth--approximating the growth of the 1960s--CBO estimates that the budget would show a $72 billion surplus by 1990. Such rapid growth would be accompanied, however, by much higher inflation and interest rates. 20/ On the other hand, CBO estimates that if a deep recession began in the second half of 1986, the absolute size of the deficit would not fall continuously as it does under the baseline economic assumptions. Instead, it would rise to $272 billion in 1988 as revenues grew very slowly and outlays rose rapidly in response to depressed levels of income and employment. Even by 1990, it would remain large at $252 billion. Most economists, however, would not regard such a cyclical bulge in the deficit as a worsening of the long-run deficit problem requiring offsetting deficit-reducing measures.

To gauge the degree of long-term budget imbalance, it is customary to eliminate the effects of the business cycle on deficits. For this purpose, a number of cyclically-adjusted or structural budget measures have been developed. 21/ One such measure of the structural deficit is the standardized-employment deficit--that is, the total budget deficit standardized at 6 percent unemployment. Extrapolating the policies adopted in the 1986 budget resolution, CBO projects standardized-employment deficits of $157 billion in 1985, falling to $104 billion by 1990 (see Table I-14). These deficits amount to 4.0 percent and 1.8 percent of standardized GNP--a measure of GNP consistent with 6 percent unemployment. In contrast, under the pre-resolution policies the standardized-employment deficit would rise to $268 billion by 1990, or to 4.8 percent of standardized GNP. Thus, although the budget resolution does not eliminate the structural deficit problem, it does bring about a significant improvement.

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20. In 1990, for example, the rate of inflation, as measured by the GNP fixed-weight deflator, is 9.1 perent under the high growth alternative but only 4.3 percent under CBO's baseline economic assumptions. Similarly, the three-month Treasury bill rate in 1990 is 12.7 percent under the high-growth alternative and 7.2 percent under baseline economic assumptions. For a full description of CBO's alternative economic assumptions, see Chapter II.

21. For a discussion of such measures, see Congressional Budget Office, *The Economic Outlook* (February 1984), Appendix B, pp. 103-118.

TABLE I-14. STANDARDIZED-EMPLOYMENT DEFICIT (Fiscal years, unified budget basis) a/

	1984	1985	1986	1987	1988	1989	1990
In Billions of Dollars							
Standardized-Employment Deficit							
Baseline b/	121	157	166	189	210	239	268
Budget resolution		157	129	123	111	107	104
As a Percent of Standardized GNP							
Standardized-Employment Deficit							
Baseline b/	3.2	4.0	3.9	4.1	4.3	4.6	4.8
Budget resolution		4.0	3.0	2.7	2.3	2.0	1.8

SOURCE: Congressional Budget Office.

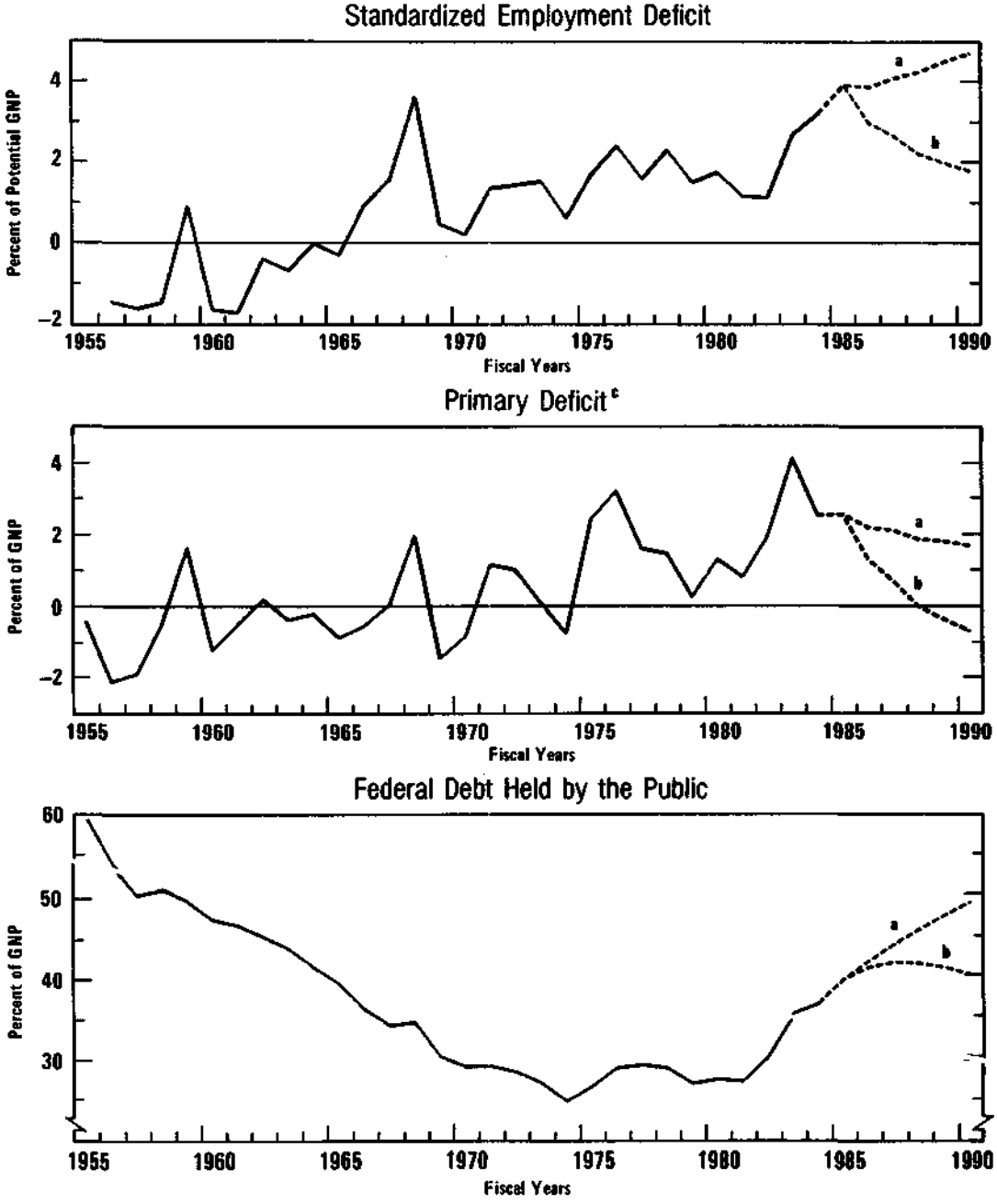
a. All numbers include off-budget outlays.

b. Revised CBO February baseline (see Chapter II).

Perhaps a more significant measure of how the budget resolution has altered the stance of fiscal policy is provided by the outlook for the federal debt-to-GNP ratio. By 1988, the new policies embodied in the resolution would reduce this ratio which has risen substantially with few interruptions since 1974 (see Figure I-18). 22/ Based on the CBO economic assumptions and on an extrapolation of the policies contained in the budget resolution, the decline in the federal debt-to-GNP ratio is expected to continue after 1988.

22. The main reason that the debt-to-GNP ratio begins to decline is that the budget resolution eliminates a large primary budget deficit--the total deficit minus net interest payments plus Federal Reserve payments to the Treasury. When the primary budget is in balance, the growth rate of the debt equals the interest rate on the debt. In 1985, the primary deficit is estimated to be nearly $100 billion. By 1988, the resolution balances the primary budget. By 1990, it produces a primary budget surplus of $39 billion. During this period, with the interest rate on the federal debt roughly equal to the rate of growth of nominal GNP, federal debt would grow about as fast as GNP if the primary budget were in balance. Because of primary budget surpluses, however, the federal debt-GNP ratio declines.

Figure I-18.
Measures of Fiscal Policy



SOURCE: Congressional Budget Office.

NOTE: [a] CBO Baseline.
[b] Congressional resolution reestimated by CBO.
[c] The Primary deficit is the total deficit less interest payments adjusted for Federal Reserve payments to the Treasury Department.

Overall, these changes in the fiscal policy outlook will help to keep interest rates from rising, with favorable effects on those sectors of the economy that are sensitive to interest rates. They also are likely to have a favorable impact on the trade sector by helping to reduce capital imports and their mirror image--current account deficits.

THE IMPACT OF BUDGET DEFICITS AND THE DOLLAR ON THE COMPOSITION OF THE ECONOMY

In earlier reports, CBO has argued that budget deficits have contributed to the rise in the dollar. In turn, the high dollar has seriously hampered industries that sell abroad or that must compete with low-priced imports. 23/ These effects on the composition of the economy have occurred slowly, and they have often been obscured by other important developments, such as the strong cyclical recovery and changes in federal spending, tax, and regulatory policies. Only recently has it become possible to examine the effects of the appreciation of the dollar on many sectors of the economy.

The rise in the value of the dollar should logically cause industries that produce tradeables--in large part goods--to fall as a share of GNP, and also to reduce their share of total employment. 24/ Important suppliers to these industries should also lose. Among the most vulnerable are industries--such as steel, textiles, apparel, and footwear--that were already undergoing a secular decline as a result of the growth of similar industries in foreign countries. The effects of the high dollar have also been particularly adverse for some basic industries that are suffering from high real interest rates.

On the other hand, the increase in the value of the dollar also tends to help some sectors of the economy. Consumers benefit from lower costs of imported goods, while industries producing nontradeables--services, structures, and goods with high transport costs--or industries shielded from foreign competition by quotas, benefit from lower input costs without losing

23. Congressional Budget Office, *The Economic and Budget Outlook, Fiscal Years 1986-1990* (February 1985), pp. 81-84.

24. Production or purchases can be divided into goods, services, and structures components: the goods component is sometimes used as a proxy for industries that engage in international trade, though some services are also traded.

sales to increased foreign competition. 25/ Further, the reduction in import prices is not always completely passed on to consumers, leaving the opportunity for increases in profits for importers, distributors, and retailers of imported goods.

In addition to their effects on the dollar and on trade, the spending and tax policies underlying the deficit have a direct effect on the composition of the economy. Federal spending has encouraged a particularly large increase in production of defense-related industries, and tax policy has encouraged investment spending. Similarly, the anti-inflationary course followed by the Federal Reserve since 1979 has had dramatic effects on interest-sensitive sectors of the economy. These effects can be seen in the relative share of structures spending, which declined sharply in the recession periods. The rapid recovery in private housing construction and the continued strength of office building appear, however, to have brought the structures share roughly back to its trend level.

Net Exports

The most dramatic change in the composition of final demands in the U.S. economy since 1980 has been the unprecedented deterioration of net exports. Real net exports--exports less imports, both valued in constant 1972 prices--have gone from a surplus equal to 3.4 percent of GNP in 1980 to a deficit equal to 1.9 percent of GNP in the first half of 1985. Valued in current prices, the share of net exports has moved somewhat less, from 0.9 percent of GNP in 1980 to -2.2 percent in early 1985 (see Figure I-19). 26/ While not all of the worsened net export position can be directly attributed to the rise in the dollar, the high dollar has clearly played an important role.

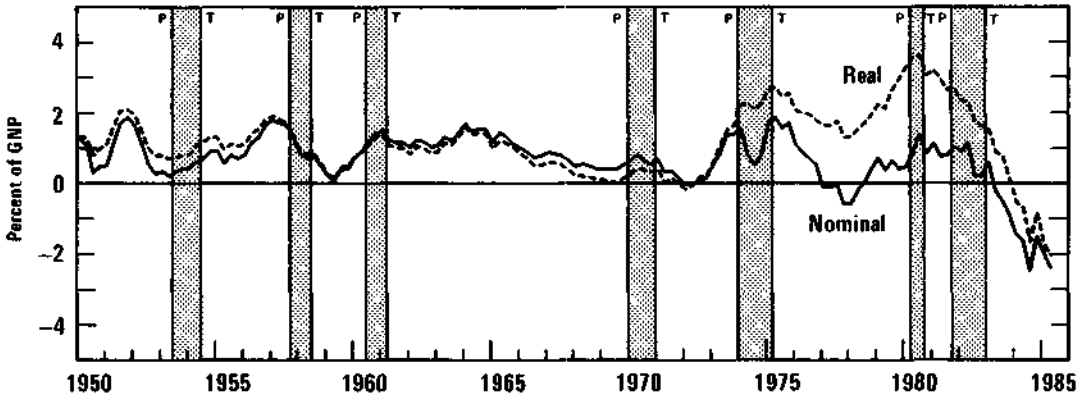
Sensitivity of Net Exports to the Exchange Rate. The $83 billion increase in the merchandise trade deficit between 1980 and 1984 was the result of a number of factors, including:

- Relative movements in real GNP levels among major trading nations;

25. Protective measures such as quotas benefit the industries protected, but they also prevent consumers from receiving the benefits of lower import costs for the protected industries. In almost all cases, the benefits forgone by consumers exceed the value of the protection afforded to industry.

26. The difference between these estimates is the result of the changes in relative prices that have occurred in this period, particularly the decline in the price of oil between 1980 and 1985.

Figure I-19.
Net Exports



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

- o Austerity measures adopted by Third World countries with debt problems;
- o Weakness in the markets for many primary commodities; and
- o Appreciation of the dollar in real terms.

Some of these factors tended to reinforce the effect of the high dollar on the trade deficit, but others worked to offset it. Despite the complexity of underlying forces, it is clear that the most important reason behind the deterioration of the U.S. trade deficit over recent years was the cumulative appreciation of the dollar in real terms.

Estimates of the long-run price elasticities of demand for U.S. merchandise exports and imports are shown in Table I-15. These price elasticities are indicators of the sensitivity of demand to a change in the real exchange rate. 27/ The average price elasticities shown in the table suggest that each percentage point rise in the real exchange rate eventually leads to a 1.1 percent fall in export volume and to a 1.1 percent rise in import volume. 28/

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27. The real exchange rate is a measure of relative prices between the United States and the rest of the world.

28. The long-run price elasticity of export demand is the total percentage change in export volume in response to a sustained 1 percent change in the relative price of U.S. exports to foreigners, after it has had time to adjust fully. The long-run price elasticity of import demand is the total percentage change in import volume in response to a sustained 1 percent change in the relative price of imports to domestic residents. The short-run price elasticity of export or import demand measures the percentage change in volume during the first quarter in which the relevant price changes by 1 percent.

TABLE I-15. LONG-RUN PRICE ELASTICITIES OF DEMAND FOR U.S. MERCHANDISE EXPORTS AND IMPORTS

Exports			Imports		
Study or Model	Year of Estimate	Elasticity	Study or Model	Year of Estimate	Elasticity
Adams et al.	1969	-0.60	Adams et al.	1969	-1.16
Houthakker-Magee	1969	-1.51	Houthakker-Magee	1969	-1.03
Basevi	1973	-1.44	Armington	1970	-1.73
Hickman-Lau	1973	-1.38	Taplin	1973	-1.05
Samuelson	1973	-1.13	Beenstock-Minford	1976	-1.04
Stern et al.	1976	-1.41	Stern et al.	1976	-1.66
Goldstein-Khan	1978	-2.32	Gylfason	1978	-1.12
Gylfason	1978	-0.62	Geraci-Prewo	1980	-1.23
Amano et al.	1981	-0.32	Goldstein-Khan	1980	-1.12
DRI Model	1982	-0.83	DRI Model	1982	-0.56
Helkie	1983	-0.90	Helkie	1983	-0.85
Wharton Model	1984	-0.98	Wharton Model	1984	-0.64
Average		-1.12	Average		-1.10

SOURCES: Morris Goldstein and Mohsin S. Khan, "Income and Price Effects in Foreign Trade," in *Handbook of International Economics*, vol. 2, edited by R.W. Jones and P.B. Kenen (Amsterdam: Elsevier Science Publishers B.V., 1985); Data Resources, Inc., *Quarterly Model of the U.S. Economy* (version US83A); William L. Helkie, "A Forecasting Model for the U.S. Merchandise Trade Balance," Board of Governors of the Federal Reserve System, 1985; Wharton Econometric Forecasting Associates, Inc., Quarterly Model of the U.S. Economy.

Such estimates can be used in conjunction with other behavioral relationships to evaluate the contribution of dollar appreciation to change in the merchandise trade deficit. One recent study allocates the total deterioration of $77 billion (annual rate) in the nominal trade balance between the fourth quarter of 1980 and the fourth quarter of 1984 among contributing factors as follows: 29/

- o $67 billion to dollar appreciation;
- o $21 billion to cyclical differences in rates of growth;
- o Minus $23 billion to the decline in the value of oil imports; and
- o $12 billion to the decline in exports to financially constrained developing countries.

The study thus estimates dollar appreciation as explaining roughly 87 percent of the total deterioration in the nominal trade deficit over this period. The analysis underlying the study also indicates that, in terms of volume, roughly 80 percent of the deterioration in the real National Income and Product Account trade balance was attributable to the high dollar.

Use of other long-run price elasticities shown in Table I-15 would lead to somewhat different quantitative estimates. The smallest price elasticities from the table would indicate that roughly 40 percent of the total deterioration in the real trade balance was the result of the high dollar, while the largest would suggest that more than twice the total increase in the real trade deficit was attributable to dollar appreciation, thus implying that other factors worked to improve the trade balance. 30/

The Composition of Merchandise Trade. The effects of the high dollar have not been evenly distributed among the various components of merchandise trade because individual items exhibit varying sensitivities to relative price changes (and to real GNP movements as well). Nonetheless, the substantial increase in merchandise imports in 1984 on a year-over-year basis was

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29. See William L. Helkie, "A Forecasting Model for the U.S. Merchandise Trade Balance," paper presented at the Fifth International Symposium on Forecasting, June 9-12, 1985, Montreal, Canada (Washington, D.C.: Board of Governors of the Federal Reserve System, International Finance Division, processed).

30. These calculations assume that overall U.S. inflation would have been higher and overall foreign inflation would have been lower in the absence of an appreciating dollar. It is also assumed that the prices of internationally traded goods are directly affected by exchange rate movements.

reflected in significant increases in all major end-use categories shown in Table I-16, with the value of imports of capital goods and consumer goods rising most rapidly. Performance on the export side was much more uneven; in value terms, exports of both consumer goods and foods, feeds, and beverages registered declines, while exports in the remaining categories rose.

The trade deficit continued to widen in the first half of 1985, with both agricultural exports and petroleum imports declining substantially (despite a significant increase of petroleum imports in the second quarter from the first). Performance among categories of nonagricultural exports was very mixed. Exports of automotive products and capital goods rose on average; at the same time, there were declines in exports of foods, feeds, and beverages; industrial supplies and materials; and consumer goods.

The value of total imports rose at a 3.1 percent annualized rate during the first half of 1985, with nonpetroleum imports rising at a nearly 10 percent rate. Imports of automotive products rose most rapidly, followed by imports of foods, feeds, and beverages, and consumer goods. Imports of capital goods and industrial supplies and materials grew more slowly, probably reflecting the weakness of domestic industrial production.

Trade Penetration at the Aggregate Level. The share of real merchandise exports in total real goods GNP (see Figure I-20) fell from above 14 percent in mid-1980 (substantially above trend) to below 11 percent in 1984 (substantially below trend). The share of real services exports in purchases-based real services GNP has been significantly smaller; it averaged around 9 percent last year. Real merchandise imports have grown significantly above trend since mid-1983. Measured at 1972 prices, merchandise imports reached nearly 15 percent of total real domestic demand for goods in 1984 on average (as shown in the lower panel of Figure I-20). 31/ Recently, this import penetration ratio rose to nearly 16 percent. The corresponding import penetration for the services sector was only about 6 percent for 1984 on average. This difference suggests that rising import penetration may have had a substantially greater restraining effect on output of domestic goods than on output of domestic services.

Domestic Purchases

Theory suggests that a rising dollar should have strong adverse effects on domestic production of tradeable goods. Its effect on purchases of domestic

31. Domestic demand for goods equals total sales of domestic goods to domestic residents plus total imports of goods.

TABLE I-16. MERCHANDISE TRADE BY END-USE CATEGORY

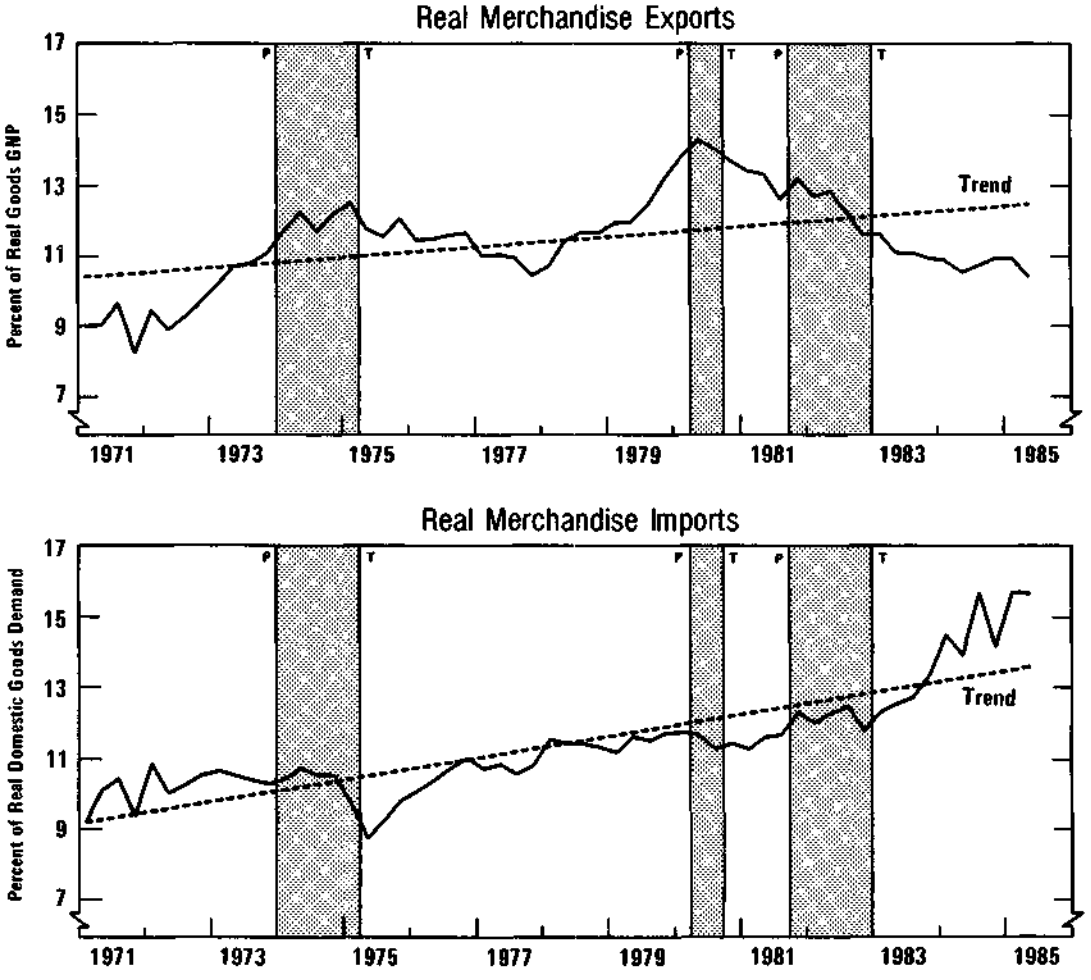
	Share in Total 1984 Exports or Imports (Percent)	Percent Change (Annualized rate)		
		Average Annual 1980-1983	Year 1984	First Half 1985 Over Second Half 1984
Total Exports	100.0	-3.6	9.7	-5.8
Agricultural	17.4	-4.5	4.5	-32.1
Nonagricultural	82.6	-3.4	10.9	0.0
Capital goods (nonauto)	33.2	-2.6	6.8	N.A.
Industrial supplies and materials	25.4	-7.2	7.9	N.A.
Automotive vehicles, parts, and engines	10.1	2.0	19.8	N.A.
Consumer goods (nonfood and nonauto)	6.3	-5.6	-1.1	N.A.
Foods, feeds, and beverages	0.4	-0.9	-11.9	N.A.
All other	7.2	7.3	56.9	N.A.
Total Imports	100.0	1.7	25.1	3.1
Petroleum	17.5	-12.0	6.3	-26.8
Nonpetroleum	82.5	7.0	29.9	9.9
Industrial supplies and materials	20.2	-0.1	23.1	N.A.
Capital goods (nonauto)	18.3	9.5	47.1	N.A.
Consumer goods (nonfood and nonauto)	18.1	9.6	31.5	N.A.
Automotive vehicles, parts, and engines	16.9	15.2	30.0	N.A.
Foods, feeds, and beverages	6.4	0.2	15.5	N.A.
All other	2.5	15.9	10.4	N.A.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Bureau of the Census; Congressional Budget Office.

NOTE: N.A. = not available.

goods is more ambiguous. If imported goods prices are lower, consumers may increase their purchases of goods. On the other hand, if growth in income weakens because of low output and employment, purchases may decline. 32/

Figure I-20.
Merchandise Trade Shares



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.
NOTE: The trend is a linear trend for the period 1971-1985.

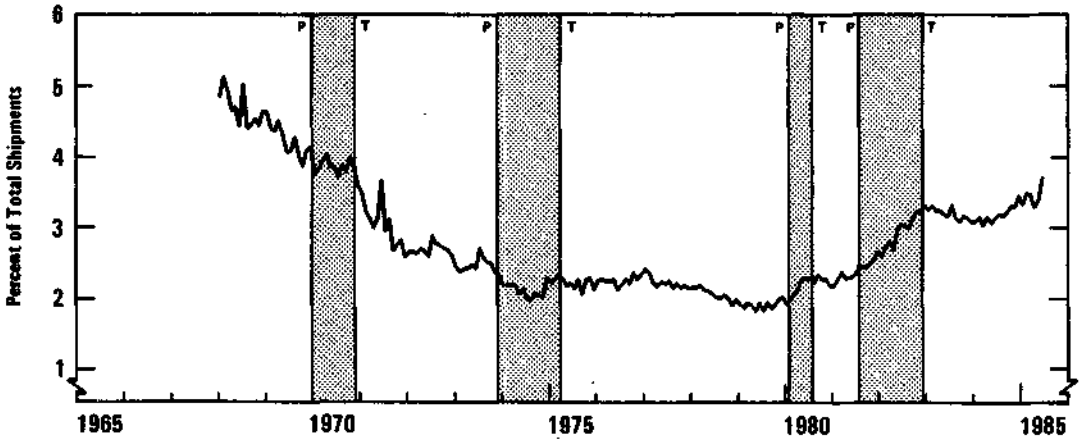
32. As noted earlier in the report, growth of domestic output has recently lagged purchases.

Purchases of producers' and consumer durable goods have grown strongly recently for a number of reasons:

- Some of the same factors that held down structures spending--high real interest rates and the two recessions of the early 1980s--also tended to hold down investment in producers' durable equipment (PDE). But in this case tax policy changes, specifically the increased depreciation allowances made available under the Accelerated Cost Recovery System (ACRS), completely offset the effects of high interest rates. 33/ Thus, PDE spending has been unusually strong in the recent recovery, and is a relatively high proportion of GNP.
- Goods purchases are very cyclical and have benefited from the exceptionally sharp cyclical recovery. Moreover, the personal tax cuts of the early 1980s also tended to increase the share of consumption spending in the economy. This increase, together with the strong recovery, has tended to stimulate durable goods consumption in the short run.

Increased defense procurement since 1980 has added substantially to the domestic demand for goods. Because of the general preference for buying defense goods from domestic sources, however, it has not directly increased imports. Thus, much of the increased defense procurement has

Figure I-21.
Defense Capital Goods Shipments



SOURCES: U.S. Department of Commerce, Bureau of the Census; Congressional Budget Office.

33. See Congressional Budget Office, *The Economic and Budget Outlook: An Update* (August 1984), p. 19.

benefited U.S. producers. Defense capital goods shipments--only a part of total defense purchases, which include in addition progress payments on capital goods under construction, and purchases of materials for operations and maintenance--rose from about 1.9 percent of all manufacturing shipments in 1979 to 3.4 percent in the first 5 months of 1985 (see Figure I-21).

The high dollar has thus tended to increase imports of goods, while several domestic factors have tended to increase purchases of goods. As a result, the purchases-based goods share of real GNP was until recently at its highest level since the 1950s (see Figure I-22). 34/ As the structures share of GNP has increased in the recovery, the services share has dropped precipitously. Net inflows of interest and dividends on U.S. capital owned abroad have fallen by 40 percent since 1980, as a result of both lower interest rates and a deterioration of the net capital position of the United States. 35/ This decline has contributed substantially to holding down the services share of GNP.

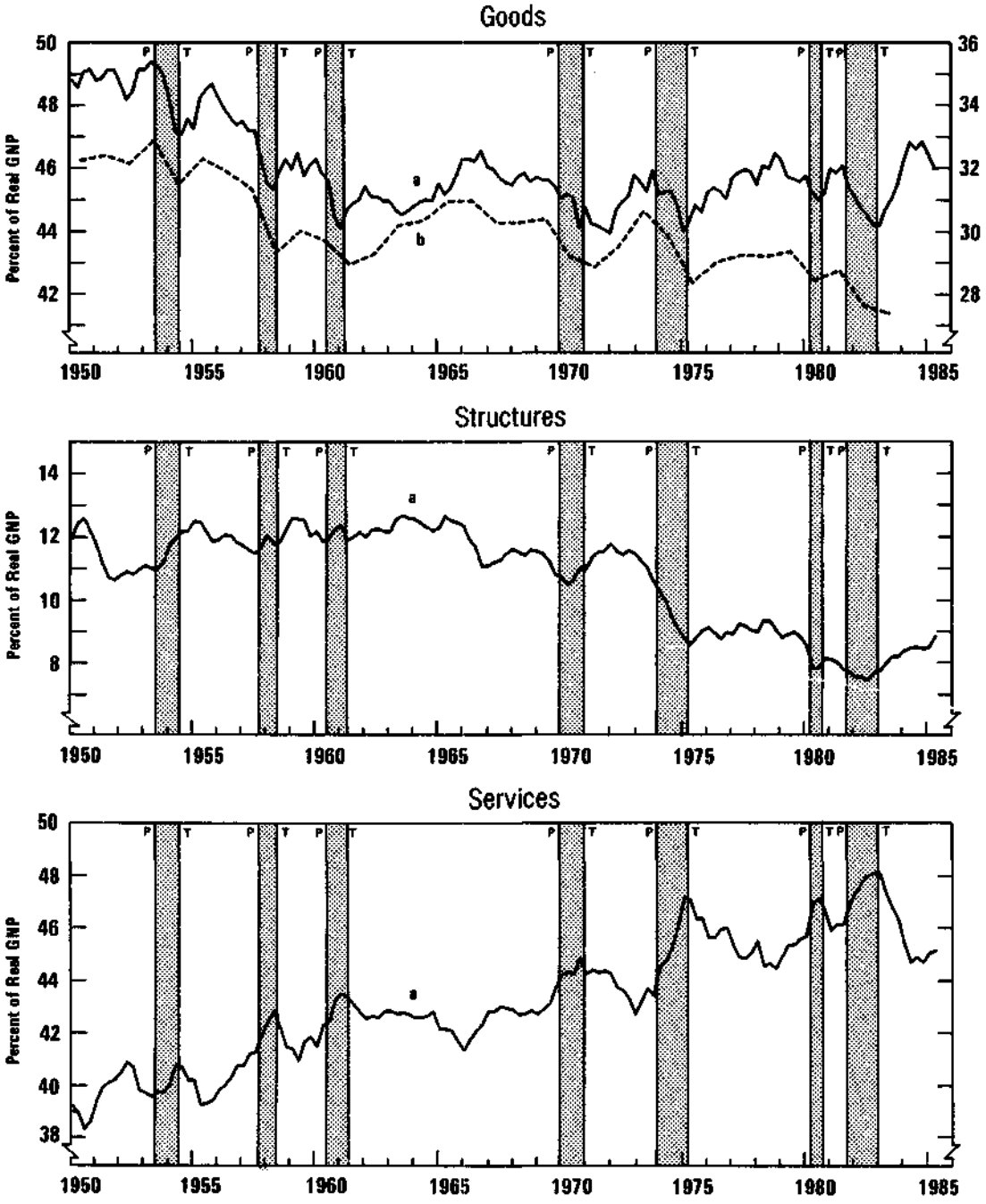
Aggregate Output and Employment. The trend growth in goods output (excluding distribution margins) as a share of GNP was lower than that of the purchases-based goods share of GNP through the recession trough (see Figure I-22). 36/ It probably rose as the goods purchases share increased in the recovery from recession, though in view of the rapid recent growth in wholesale and retail trade it may not have reached the same high as the purchases series did. During the last year, however, purchases of goods

34. The purchases-based goods share of GNP--the sum of total goods purchases in the United States plus net exports of goods, as a share of GNP--is not necessarily a good indicator of what is happening to goods output. The purchases-based division of GNP into goods, services, and structures differs from other and apparently similar classifications, in particular in its treatment of wholesale and retail trade. Most of the distribution industry is included in the goods sector of GNP, while with respect to employment data distribution is conventionally included among service-producing industries. Changes in the relative shares of real GNP attributed to different sectors of the economy depend sensitively on the relative prices that are used to calculate real goods, services, and structures aggregates. The prices used in these calculations are currently those of 1972, when oil prices were very low and the relative price of computers was very high. When the GNP accounts are revised in December 1985, a 1982 price base, with much lower computer prices and much higher oil prices, will be introduced. In addition, the real rate of growth of computer production will be revised up sharply. It is not possible at present to predict the net outcome of these revisions: in the meantime, analyses based on small changes in calculated shares should be treated with caution.

35. Excluding foreign owned assets in the United States.

36. The goods output share of GNP is based on value added in manufacturing, mining, and agriculture. The data are annual, and are currently available only through 1983.

Figure I-22.
Major Production Groups



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

[a] Purchase-based share of GNP (quarterly) — left scale.

[b] Value-added (production) share of GDP (annual) — right scale.

slowed dramatically, and fell in the first half of 1985, leading to an overall slowdown of GNP growth. This reduction in the purchases-based share of goods is most likely evidence of an underlying sharp reduction in the goods production share of GNP.

Employment data clearly show less strength in the goods sector than in the service sector of the economy (see Table I-17). Until recently, however, this may have reflected relatively strong productivity growth in goods production rather than the impact of the strong dollar. The decline in the share of employment in manufacturing and mining in the face of a high share of goods in total purchases is in part the result of higher productivity growth in the goods sector than in the economy as a whole. In fact, while manufacturing productivity is currently approximately on its postwar trend,

TABLE I-17. RECENT CHANGES IN GROSS INDUSTRIAL COMPOSITION

	1982:IV	1983:IV	1984:IV	1985:II
Percent of Real GNP (Purchases-based)				
Goods	44.2	45.5	46.8	46.0
Structures	7.7	8.2	8.4	8.8
Services	48.1	46.3	44.7	45.2
Percent of Payroll Employment				
Manufacturing and Mining	21.6	21.6	21.4	21.0
Construction	4.3	4.5	4.6	4.8
Service Producing Industries	74.1	73.9	73.9	74.3

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics.

NOTE: See also footnote in text.

productivity in the nonfarm business sector as a whole is well below trend, and has been so since about 1979. 37/

Employment in nonfarm goods industries is still below the peak reached in 1979, though total employment has increased 8.4 percent since then. Moreover, since the beginning of 1985, there has been no growth at all in employment in the goods sector, while employment in manufacturing has fallen by 211,000. 38/ Slow growth of employment in the goods sector, and a reduction of its share in total employment, are typical of recessions and other periods of slow overall economic growth. The recent slowing appears, however, to go beyond this, as trend-adjusted manufacturing and mining employment is below its normal share of total employment for the middle of a business cycle expansion (see Figure I-23). The relative weakness of manufacturing and mining employment first appeared during the last recession; early in the recovery, this category of employment appeared to grow slightly faster than usual. As a result of the losses of the past year, however, it is now close to the level reached at the bottom of the recession.

Domestic Output of Selected Industries. The effects of the high dollar are clearer in the data for individual industries than in the aggregate data discussed up to now, though even here the relationship is far from simple. In some industries, the share of domestic output in total GNP rose considerably despite significant losses in the export share of domestic output. Such industries include aerospace goods; X-ray, medical, and dental equipment; and scientific, measuring, and optical equipment. And in some industries, such as the auto industry, the share of domestic output in total GNP was up despite high import penetration since 1979 (which, in this case, was probably significantly lowered by protectionist barriers).

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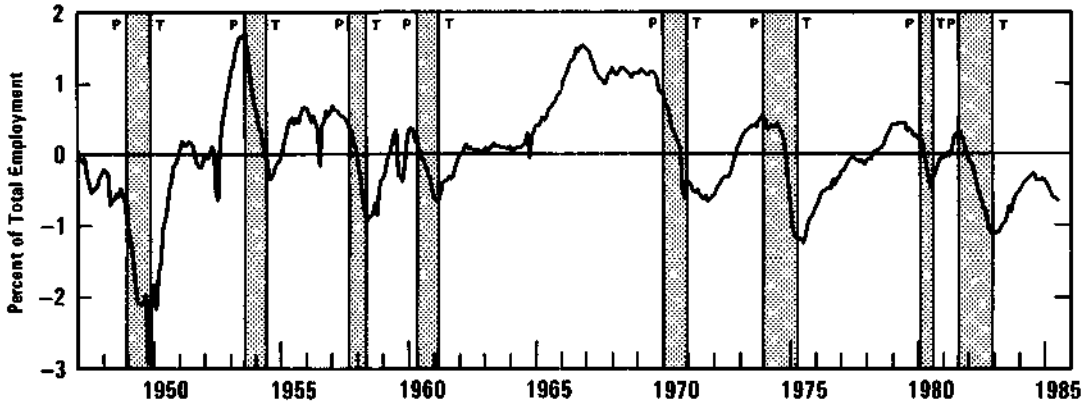
37. Published estimates of manufacturing productivity for 1984 and 1985 are based on relatively poor information. However, the largest discrepancy between overall and manufacturing productivity growth dates from 1979-1982, a period for which reasonable measures exist. Reasons for changes in productivity growth are not well understood, but many analysts would point to the two recessions of the 1980s, and the oil price increases of 1974-1979, as major factors in the sluggish performance of overall productivity since the late 1970s. Manufacturing does not seem to have shared in the overall weakness of productivity growth. Some analysts think this may be in part because foreign competition in the manufacturing sector has forced more stringent cost-cutting measures than in the rest of the economy. Recorded changes in productivity are also heavily affected by shifts of output between industries that use labor intensively and those that do not, and do not necessarily reflect any change in productivity in particular plants.

38. Some industries--steel, textiles, chemicals, petroleum and coal products, and leather products--have lower employment levels in mid-1985 than they had at the recession trough.

On the other hand, for a number of industries domestic output declined significantly as a percent of GNP. In some cases, the declining output share was the result of longer-run structural problems or longer-run losses in comparative advantage that were accentuated by the strong dollar, as in radio and television manufacturing and in the steel, footwear, and apparel industries. In others, a declining share of domestic output in total GNP appeared to be largely the result of the high dollar (see Table I-18). Rising import penetration was accompanied by substantial relative declines in domestic production for power-driven hand tools, and telephone and telegraph equipment. The latter industry also saw its export sales decline relative to domestic sales in the last few years. Other domestic producers experiencing falling export sales relative to domestic sales, as well as significant declines in total domestic output relative to total GNP, include producers of valves and pipe fittings; food products machinery; turbines and turbine-generator sets; and construction machinery in general. In some of these and in similar cases, the high value of the dollar may have been a decisive factor in causing poor performance that might otherwise have been good (see Table I-19).

The capital goods industries have been hit quite hard by the rising dollar. By and large, they are not well protected by tariffs or quotas (with the exception of the auto industry), though they have highly differentiated products. At the same time, demand for their products has generally been stimulated by the rapid growth of investment in producers' durable equipment, particularly for high-technology products. These industries have lost a considerable part of their market share in the past few years: domestic nondefense capital goods shipments, which in 1980 comprised

Figure I-23.
Manufacturing and Mining Employment (Deviation from Trend)



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.
NOTE: The trend is linear, estimated from 1947 through 1985.

about 90 percent of the total supply of nondefense capital goods (domestic shipments plus goods imports), had only about 84 percent of the market in mid-1984. Output in some specific industries--for example, construction and allied equipment, metalworking machinery, and, in the last six months, electrical machinery--has fallen significantly compared with total industrial production. The growth of domestic demand, combined with some apparent

TABLE I-18. IMPORTS AND DOMESTIC SHIPMENTS SHARES FOR SELECTED INDUSTRIES

Industry	Imports as a Percent of New Supply [a]		Domestic Shipments As a Percent of Total GNP	
	1979 to 1980	1983 to 1984	1979 to 1980	1983 to 1984
Electrical Manufacturing				
Telephone and telegraph apparatus	3.4	10.7	0.41	0.35
Nonelectrical Machinery				
Machine tools, metal-cutting	19.7	28.7	0.18	0.07
Power driven hand tools	13.8	20.5	0.08	0.05
Transport Equipment				
Motor vehicles	16.9	16.5	2.82	2.95
Industrial Supplies				
Tires	12.1	14.3	0.34	0.29
Steel mill products	10.6	15.2	2.30	1.20
Consumer Goods				
Apparel	12.8	17.5	1.76	1.62
Footwear, except rubber	33.5	46.5	0.18	0.13
Rubber footwear	47.4	39.2	0.02	0.02
Household furniture	5.5	10.5	0.48	0.43
Radio and television sets	42.1	54.8	0.22	0.18

SOURCE: Data used for this table are from U.S. Department of Commerce, *1985 Industrial Outlook, Prospects for over 350 Manufacturing and Service Industries* (January 1985). The 1983 and 1984 ratios are estimates.

a. New supply is domestic shipments (including exports) plus imports for the industry in question.

TABLE I-19. EXPORTS AND DOMESTIC SHIPMENTS SHARES FOR SELECTED INDUSTRIES

Industry	Exports as a Percent of Domestic Shipments a/		Domestic Shipments as a Percent of Total GNP	
	1979 to 1980	1983 to 1984	1979 to 1980	1983 to 1984
Electrical Machinery				
Electronic components	18.6	16.7	0.94	1.17
Nonelectrical Machinery				
Computers	28.3	26.5	0.91	1.31
Construction machinery	36.8	22.7	0.60	0.29
Farm machinery	17.8	21.3	0.47	0.29
Oilfield machinery	49.4	43.2	0.22	0.20
Food products machinery	31.5	20.7	0.08	0.07
Turbines, turbine generator sets	30.1	25.6	0.13	0.12
Scientific and Controlling Instruments				
X-ray, medical and dental equipment	17.7	13.1	0.36	0.50
Scientific, measuring, optical equipment	27.1	22.4	0.62	0.66
Transport Equipment				
Aerospace	27.7	21.4	1.92	2.08
Fabricated Metals				
Valves and pipe fittings	13.5	11.7	0.30	0.23
Chemicals				
Organic fibers; non-cellulosic	13.2	9.1	0.27	0.23
Industrial organic chemicals	17.5	14.6	1.33	1.26
Agricultural chemicals	19.9	23.7	0.52	0.36
Plastics materials, resins	14.0	12.5	0.69	0.58
Textiles				
Broadwoven fabric mills	9.8	3.9	0.55	0.49
Processed Foods				
Vegetable and animal oils	20.0	17.8	0.71	0.51

SOURCE: Data used for this table are from U.S. Department of Commerce, *1985 Industrial Outlook, Prospects for over 350 Manufacturing and Service Industries* (January 1985). The 1983 and 1984 ratios are estimates.

a. Ratios of exports to shipments can increase despite declines in exports, if domestic output values decline by greater percentages. For example, the average contribution of farm machinery exports to demand for domestic output increased from 17.8 percent to 21.3 percent between 1979-1980 and 1983-1984, even though average export values declined from 2.4 billion dollars in 1979-82 to 2.2 billion in 1983-1984.

tendency to hold down price increases, has worked to prevent severe impacts on production in broad capital goods industry aggregates.

In the agricultural sector, the strong dollar has combined with good world harvests and low world income growth to depress agricultural prices. This drop in prices has had three severe effects:

- Federal support programs for farmers have grown explosively;
- Farm land prices, which rose rapidly in the 1970s, have fallen sharply; and
- Farmers who took out high-interest loans in the late 1970s and early 1980s have had to pay them off with lower crop revenues than expected, and because of the decline in land values have less collateral for new loans. The result has been the farm credit problems discussed earlier.

Farm land, the major farm asset, cannot quickly be moved to other uses. For this reason, farm output has generally stayed close to trend in the face of reduced prices, except during the PIK program when farmers were offered particularly large incentives to reduce plantings and the harvest was reduced by drought.

Conclusion

In the last year, growth in domestic demand has significantly exceeded growth in output. Most of the slowdown in output growth has been in the goods-producing sector. Many analysts have attributed this slowdown to the high dollar, which has heightened foreign competition. Because of the many other factors involved, such as rising defense spending, examination of changes in the composition of domestic output does not show unequivocally which ones are attributable to the high value of the dollar. The examples given serve to suggest the extent of the short-run dislocations to domestic industries that are in direct competition with foreign firms.

The high dollar may impose long-run costs on the economy. An excessively high exchange rate could move resources out of industries that, at a lower exchange rate, would be able to compete in the international market. When the dollar returns to a more sustainable range, as most analysts believe it eventually will, the cost of rebuilding these industries could be high. In addition, the dislocations suffered by some industries could lead to calls for increased protection, which would impose a burden on consumers that, in almost all cases, would exceed the benefit felt by the trade-affected industries.

CHAPTER II

THE BUDGET OUTLOOK

The Congressional Budget Office (CBO) projects that, under the policies of the new Congressional budget resolution, the federal government deficit will decline from $210 billion this year to $175 billion in fiscal year 1986 and $143 billion in 1988. Extrapolating the budget resolution policies, CBO projects that the deficit will drop to $120 billion by 1990 (see Table II-1). The decline in the deficit appears even sharper in relation to the size of the economy. If the Congress follows the policies of the budget resolution, the deficit will shrink from 5.5 percent of the gross national product (GNP) in 1985 to 4.2 percent in 1986, 3.7 percent in 1987, 3.0 percent in 1988, and 2.1 percent by 1990.

Figure II-1 shows that the reduction in the deficit is to be achieved mostly by cutting federal government spending. Federal revenues are projected to rise from 19.2 percent of GNP in 1985 to 19.5 percent in 1988 through 1990. On the other hand, spending is projected to drop from 24.6 percent of GNP in 1985 to 22.5 percent in 1988 and 21.7 percent by 1990. In comparison, federal spending amounted to 20.3 percent of GNP in the 1966-1975 period and 23.2 percent of GNP in 1976-1985.

The budget resolution policies will halt and then reverse the increase in the ratio of federal debt to GNP that has been under way with little interruption since 1975. According to CBO's estimates, the budget resolution will stabilize the debt-to-GNP ratio at 41.6 percent of GNP in 1988. Extrapolating the budget resolution policies beyond 1988, the debt-to-GNP ratio will drop to 41.1 percent in 1989 and 40.2 percent in 1990.

The improvement in the deficit and debt picture does not mean, however, that all fiscal problems will disappear. The remaining deficits are still high by historical standards.

THE CONGRESSIONAL BUDGET RESOLUTION

On August 1, the House and Senate adopted the conference report on the First Concurrent Resolution on the Budget for Fiscal Year 1986 (S. Con. Res. 32). While the budget resolution covers only fiscal years 1985-1988, CBO has extrapolated its policies through 1990. Unless otherwise men-

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TABLE II-1. THE BUDGET OUTLOOK WITH POLICIES OF THE 1986 BUDGET RESOLUTION (By fiscal year)

	1984 Actual	1985 Estimate	CBO Projection 1986	1987	1988	CBO Extrapolation 1989	1990
In Billions of Dollars							
Revenues	666	737	790	858	939	1013	1094
Outlays	852	946	965	1021	1082	1145	1214
Deficit	185	210	175	163	143	132	120
Debt Held by the Public	1313	1522	1701	1861	2002	2133	2252
As a Percent of GNP							
Revenues	18.6	19.2	19.1	19.2	19.5	19.5	19.5
Outlays	23.8	24.6	23.3	22.9	22.5	22.1	21.7
Deficit	5.2	5.5	4.2	3.7	3.0	2.5	2.1
Debt Held by the Public	36.7	39.6	41.1	41.7	41.6	41.1	40.2

SOURCE: Congressional Budget Office.

tioned, the estimates of budget resolution policies cited here are based on CBO economic and technical assumptions. 1/

Compared with the policies in effect at the beginning of the current session of the Congress, the budget resolution would reduce the federal deficit by $37 billion in 1986, $100 billion in 1988, and $164 billion in 1990.

1. As passed, the budget resolution targets are as follows (by fiscal year, in billions of dollars):

	1986	1987	1988
Revenues	796	869	960
Outlays	968	1024	1073
Deficit	172	155	113
Deficit Reduction	55	90	131

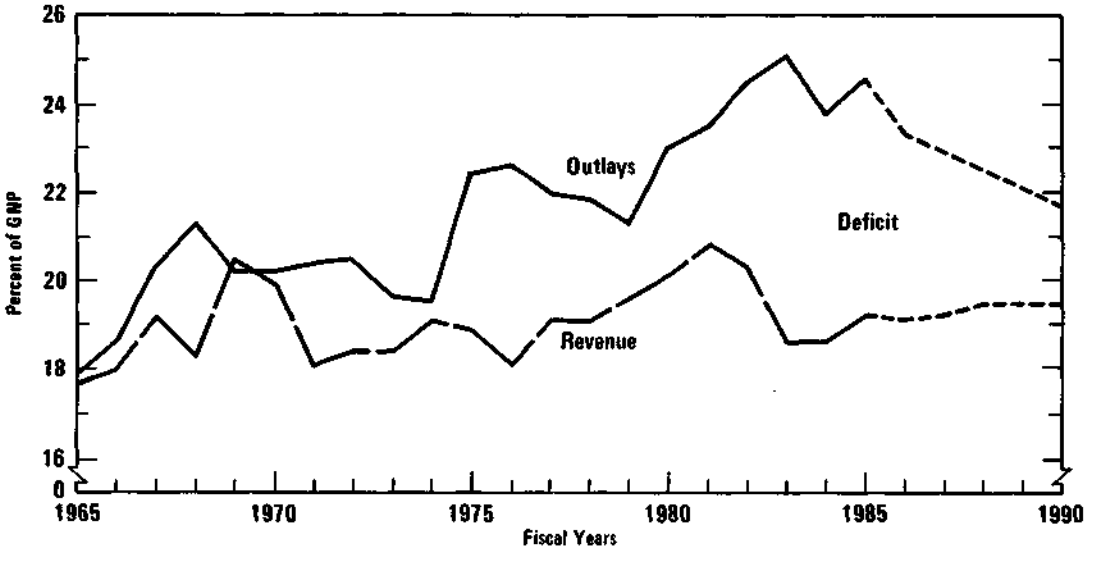
The budget resolution relies almost entirely on spending reductions to achieve the lower deficits. Only very small revenue increases from projected baseline levels are contemplated. Table II-2 summarizes the deficit reductions in the budget resolution in terms of changes from CBO's updated baseline (described at the end of this chapter).

Reconciliation instructions contained in the budget resolution require particular House and Senate committees to prepare legislation achieving specified amounts of deficit reduction in fiscal years 1986, 1987, and 1988. This legislation is to be submitted by September 27 to the Senate and House Budget Committees, which will package it in one or more reconciliation bills for consideration by the Congress.

Policy Changes

The budget resolution assumes revenue increases of $3 billion in 1986, $5 billion in 1987, and $8 billion in 1988, but does not specify how these revenues are to be raised. Reconciliation instructions cover about half of these increases. (The Senate Finance Committee has separate reconciliation instructions for revenue increases and spending cuts. The House Committee on Ways and Means is given a single deficit reduction instruction.)

Figure II-1.
Revenues and Total Outlays



SOURCE: Congressional Budget Office.

The largest spending reductions compared with prior policy are for national defense. The budget resolution allows defense budget authority to keep pace with inflation in 1986 and provides for real increases of about 2 percent per year thereafter under CBO economic assumptions (3 percent per year under the economic assumptions of the resolution). By comparison, the baseline, which assumes the defense budget authority figures from last year's budget resolution, provides for roughly 5½ percent annual real growth in defense appropriations. The resulting reductions in outlays amount to $11 billion in 1986, $41 billion in 1988, and $74 billion extrapolated to 1990. With the exception of a one-year freeze on the pay of federal civilian employees, which is the subject of reconciliation instructions, these savings are to be achieved through the normal defense authorization and appropriations process.

The budget resolution would reduce spending for entitlements and other mandatory programs by $7 billion in 1986, $13 billion in 1987, and $18 billion in 1988--a total of $38 billion over the 1986-1988 period. The resolu-

TABLE II-2. POLICY CHANGES IN THE 1986 BUDGET RESOLUTION AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

	CBO Projection			CBO Extrapolation	
	1986	1987	1988	1989	1990
CBO Baseline Deficit	212	229	243	264	285
Deficit Reductions as Estimated by CBO					
Revenue increases a/	-3	-5	-8	-11	-11
National defense	-11	-25	-41	-57	-74
Entitlements	-7	-13	-18	-19	-20
Nondefense discretionary	-11	-20	-24	-25	-26
Offsetting receipts	-4	b/	b/	-1	-1
Net interest	-1	-3	-10	-20	-33
Total reductions	-37	-66	-100	-132	-164
Deficit in Budget Resolution as Estimated by CBO	175	163	143	132	120

a. Revenue increases appear as negative numbers because they reduce the deficit.
b. Less than $500 million.

tion contains reconciliation instructions to the appropriate authorizing committees to achieve virtually all these savings. The largest reductions include savings in Medicare (a three-year savings of $11 billion), the elimination of general revenue sharing in 1987 ($8 billion), reform of farm programs ($8 billion), debt-service forgiveness for certain public housing projects ($5 billion before interest offsets), increased Pension Benefit Guarantee Corporation premiums ($900 million), and reform of guaranteed student loans ($800 million) and military retirement ($600 million).

Proposed reductions in nondefense discretionary spending amount to $11 billion in 1986, $20 billion in 1987, and $24 billion in 1988--a three-year total of $54 billion. Of these amounts, reconciliation instructions direct authorizing committees to save $23 billion over three years through changes in laws in their jurisdiction. The reconciled reductions include $6 billion from a one-year freeze on civilian agency pay, $5 billion from Farmers Home Administration rural housing programs, $4 billion from the strategic petroleum reserve, $2 billion from Small Business Administration programs, $2 billion from federal-aid highways, and $1 billion from veterans programs. About $9 billion in three-year savings can be attributed to freezing 1986 appropriations for programs not aimed at low-income people. The remaining $22 billion in assumed reductions over the 1986-1988 period consists of cuts in Export-Import Bank direct loans, foreign aid, agricultural credit, community and regional development, civilian agency employment, administrative overhead costs, and other appropriations. Achieving these savings will depend on actions by the appropriations committees over the next three years.

The budget resolution also reduces net interest outlays because of the reductions in the projected budget deficits that must be financed through borrowing from the public. The reductions in net interest amount to $1 billion in 1986, $10 billion in 1988, and $33 billion by 1990.

Outlay Targets

Table II-3 summarizes the budget resolution outlay targets by major category. Under budget resolution policies, total outlays would rise from an estimated $946 billion in 1985 to $965 billion in 1986, $1,082 billion in 1988, and $1,214 billion in 1990. Over the next five years, outlays would grow by $268 billion, or 28 percent. This amount represents an average growth in outlays of 5.1 percent each year, considerably lower than the rate of growth that has occurred recently. For example, during the last five years, outlays have grown by $356 billion--from $591 billion in 1980 to an estimated $946 billion in 1985, for an average growth rate of nearly 10 percent per year.

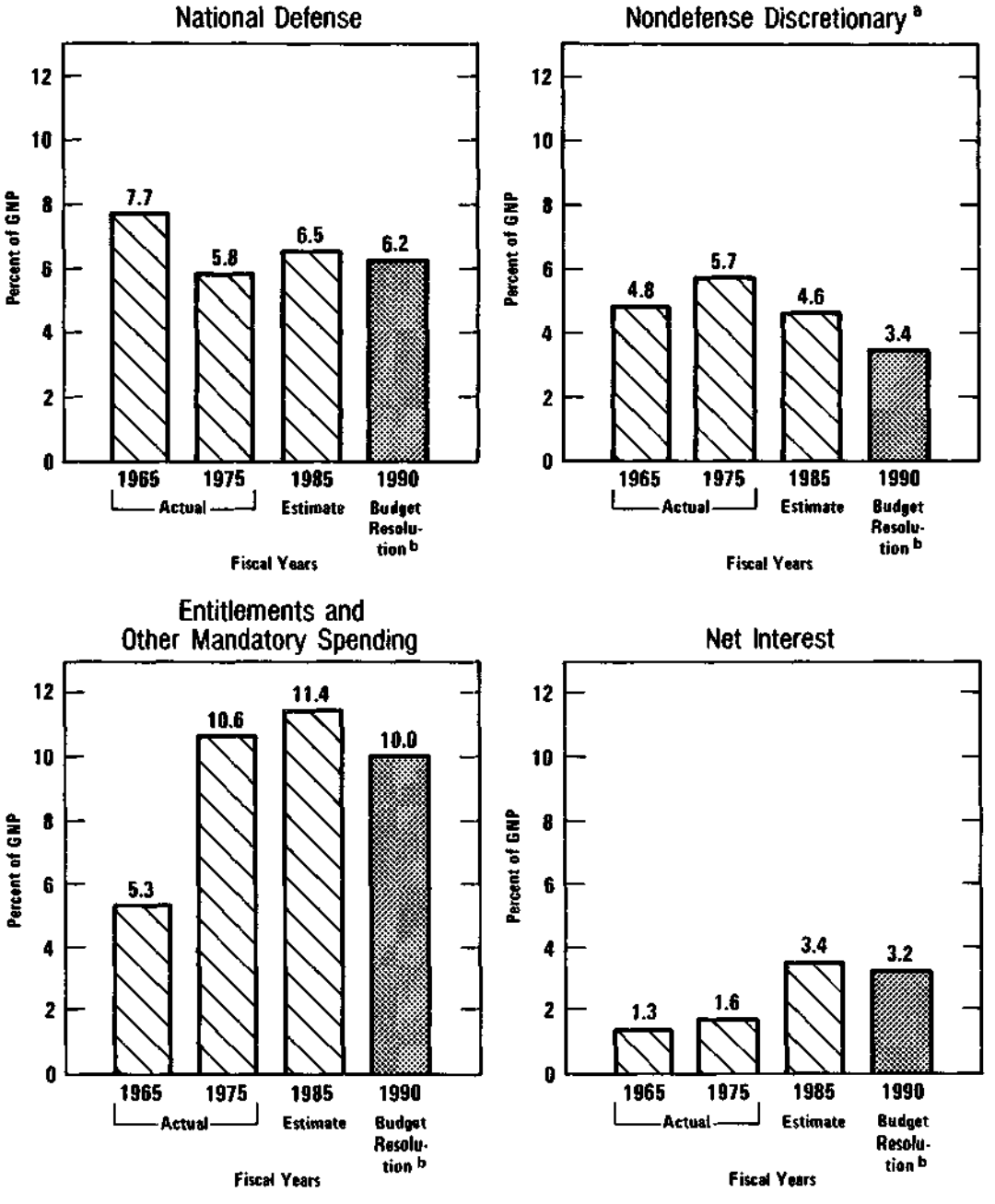
The projected outlay growth under the budget resolution also is slower than the projected growth of the economy. Consequently, outlays as a percent of GNP would decline from 24.6 percent in 1985 to 22.5 percent in 1988. Extrapolating the budget resolution policies to 1990, outlays would fall to 21.7 percent of GNP--about the average of the 1970s.

While all categories of spending would fall in relation to gross national product, defense would decline only slightly. Nondefense discretionary spending, however, as illustrated in Figure II-2, would decline from 4.6 percent of GNP in 1985 to 3.4 percent of GNP in 1990--below the levels of the 1960s. Spending for entitlement and other mandatory programs would decline from 11.4 percent in 1985 to 10.3 percent in 1988 and 10.0 percent in 1990--the lowest level recorded since 1979. Net interest outlays as a share of GNP would decline for the first time since 1971.

TABLE II-3. BUDGET RESOLUTION OUTLAY TARGETS AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

Major Category	1985 Estimate	CBO Projection 1986	1987	1988	CBO Extrapolation 1989	1990
		In Billions of Dollars				
National Defense	249	267	285	304	326	349
Entitlements	439	442	467	496	528	562
Nondefense Discretionary	176	173	173	179	184	191
Net Interest	129	137	149	161	169	178
Offsetting Receipts	-49	-54	-54	-58	-62	-66
Total	946	965	1021	1082	1145	1214
		As a Percent of GNP				
National Defense	6.5	6.5	6.4	6.3	6.3	6.2
Entitlements	11.4	10.7	10.5	10.3	10.2	10.0
Nondefense Discretionary	4.6	4.2	3.9	3.7	3.6	3.4
Net Interest	3.4	3.3	3.3	3.3	3.2	3.2
Offsetting Receipts	-1.2	-1.3	-1.2	-1.2	-1.2	-1.2
Total	24.6	23.3	22.9	22.5	22.1	21.7

Figure II-2.
The Composition of Federal Spending



SOURCE: Congressional Budget Office.

[a] Including programs that are off-budget under current law.

[b] Extrapolated by CBO.

CBO Reestimates of the Budget Resolution

Under CBO economic and technical assumptions, the deficits that would result under the policies in the budget resolution are higher than the targets specified in the resolution itself. Most of the increases in the deficit estimates are the result of using different economic assumptions. The resolution uses the economic assumptions of the Administration's February budget. CBO's latest economic forecast and longer-run assumptions project lower levels of nominal gross national product and taxable incomes than assumed for the budget resolution. This difference results in somewhat lower revenues than estimated in the resolution, by a total of $35 billion over the 1986-1988 period (see Table II-4). CBO has reestimated outlays for various benefit programs, primarily because of differences in assumed rates of inflation. Finally, CBO estimates lower net interest outlays in 1986 and 1987 and higher outlays in 1988 as the result of different interest rate assumptions.

CBO's technical reestimates of the resolution are relatively small. Assumed policy changes that are specified as dollar targets rather than specific legislative proposals have not been reestimated. For example, unspecified reductions in agriculture programs, Medicare, and a number of other areas have not been reestimated for this report. Similarly, CBO has not reestimated defense outlays, which appear to represent a target to be achieved through appropriations action. Although defense outlays will vary with the mix of programs funded, the outlays in the budget resolution are compatible with the assumed budget authority because of the recent slowdown in defense spending. On the other hand, CBO has reestimated the effect of the budget resolution policies in a few instances. For example, the resolution assumes that $3 billion will be gained from petroleum price overcharge recoveries during 1986-1988, whereas CBO estimates that only $0.5 billion will be available.

Most of the technical reestimates of the budget resolution reflect changes in baseline spending or tax collection trends that have become evident during the past six months. These recent developments are not reflected in the resolution, which is generally based on CBO's February technical estimating assumptions. On the spending side, the biggest change is an increase in farm price supports. CBO's February projections of revenues have been reduced by $3 billion in 1986 and $1 billion in 1987 for technical reasons. These changes in CBO's baseline budget projections are discussed in more detail in the final section of this chapter.

BUDGET PROJECTIONS UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS

The budget is highly sensitive to changes in the economy, and forecasting economic conditions is subject to great uncertainty. For example, a one-percentage-point change in interest rates would affect the deficit estimates by roughly $4 billion in 1986, $16 billion in 1988, and $23 billion in 1990. Of course, changes in economic variables rarely occur in isolation. To show how changes in the economic conditions can affect the budget, CBO has prepared two consistent alternative sets of economic assumptions. These high-growth and low-growth paths, however, are only illustrative. The CBO economic assumptions represent, in CBO's judgment, a more reasonable basis for budget projections than either of the alternatives.

Table II-5 compares the high-growth and low-growth alternatives with CBO's economic assumptions, which were described in the first chapter.

TABLE II-4. CBO REESTIMATES OF THE BUDGET RESOLUTION
(By fiscal year, in billions of dollars)

	1986	1987	1988
Deficit in Budget Resolution	172	155	113
CBO Economic Reestimates:			
Revenues	2	11	23
Benefit programs	-2	-1	a/
Net interest (rates)	-4	-5	3
Subtotal	-4	5	25
CBO Technical Reestimates	6	3	3
Debt Service Effect of Reestimates	a/	1	2
Total reestimates	3	9	30
Deficit in Budget Resolution as Estimated by CBO	175	163	143

a. Less than $500 million.

TABLE II-5. ALTERNATIVE ECONOMIC ASSUMPTIONS
(By calendar year)

	1985	1986	1987	1988	1989	1990
GNP (billions of current dollars)						
High-growth alternative	3920	4296	4731	5260	5922	6766
CBO economic assumptions	3906	4217	4548	4905	5289	5704
Low-growth alternative	3902	4135	4144	4409	4691	4975
Real GNP (percent change, year over year)						
High-growth alternative	2.9	4.8	4.8	4.8	4.8	4.8
CBO economic assumptions	2.6	3.6	3.4	3.5	3.5	3.5
Low-growth alternative	2.5	1.8	-3.0	3.6	3.9	3.7
Fixed-Weight GNP Deflator (percent change, year over year)						
High-growth alternative	4.3	4.4	5.2	6.1	7.5	9.1
CBO economic assumptions	4.2	4.2	4.3	4.2	4.3	4.3
Low-growth alternative	4.2	4.0	3.4	2.7	2.4	2.4
CPI-U (percent change, year over year)						
High-growth alternative	3.7	4.4	5.1	6.1	7.4	9.0
CBO economic assumptions	3.7	4.5	4.4	4.2	4.2	4.2
Low-growth alternative	3.7	4.3	3.4	2.7	2.4	2.3
Civilian Unemployment Rate (percent, annual average)						
High-growth alternative	7.2	6.7	6.2	5.7	5.3	4.9
CBO economic assumptions	7.2	7.0	6.8	6.6	6.5	6.3
Low-growth alternative	7.3	7.6	10.0	9.6	9.1	8.7
Three-Month Treasury Bill Rate (percent, annual average)						
High-growth alternative	7.2	6.7	8.1	9.6	10.9	12.7
CBO economic assumptions	7.6	7.4	7.2	7.2	7.2	7.2
Low-growth alternative	7.9	7.8	6.5	6.1	6.3	6.5

SOURCE: Congressional Budget Office.

The high path assumes growth equal to that of the strongest eight-year recovery in the postwar period--that experienced in the 1960s. This very rapid growth means that inflation and interest rates rise steadily beginning in 1986. Inflation doubles, and short-term interest rates approach 13 percent by 1990. The low path assumes growth from the recession trough at the end of 1982 to the end of 1990 averaging one percentage point less than in the baseline projection. This low path incorporates a recession beginning in mid-1986, equal in length and depth to the 1974-1975 recession. The weaker growth results in somewhat lower inflation and lower interest rates than in the baseline.

Table II-6 shows how the high-growth and low-growth assumptions would affect the budget outlook. In the high-growth case, the deficit drops swiftly. The budget is roughly in balance in 1989 and shows a surplus of about 1 percent of GNP in 1990. Under the low-growth assumptions, however, the deficit grows sharply in 1987 and 1988. By 1990, the deficit represents about 5 percent of GNP--little different from what it is expected to be this year (see Figure II-3). Even in this low-growth case, however, the policies of the budget resolution would substantially reduce the structural deficit--the portion of the deficit not resulting from cyclical economic factors (see Chapter I).

In preparing these alternative budget projections, the Congessional Budget Office has assumed that discretionary defense and nondefense appropriations are adjusted for differences in inflation. Revenues and entitlement spending respond automatically to changes in economic conditions. Net interest outlays are estimated consistently with the assumed interest rates and resulting deficits.

As a percent of GNP, revenues are higher with the high-growth assumptions and lower in the low-growth case. In the high-growth case, considerably higher personal income drives up individual income taxes and social insurance contributions by increasing amounts each year; the reverse is true in the low-growth alternative. Because corporate profits vary more than proportionately with GNP, corporate income tax collections are higher in relation to GNP in the high-growth case and lower in the low-growth case.

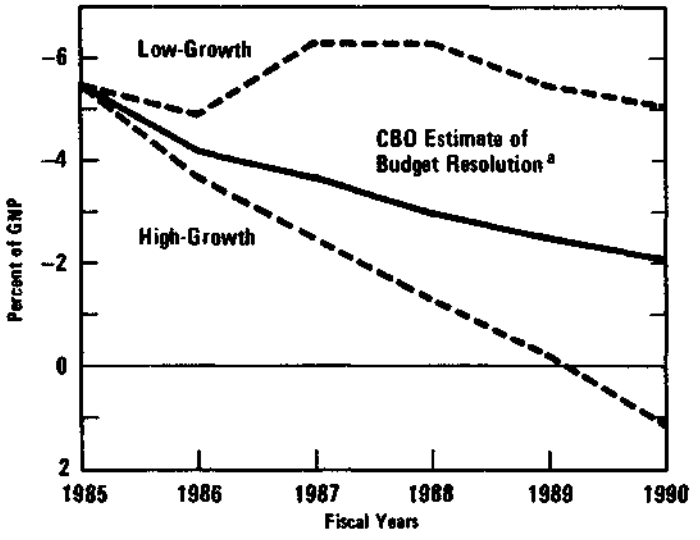
Outlays as a fraction of GNP tend to drop with higher real growth and to rise with lower growth. There are three basic reasons for this. First, the number of people eligible for benefit programs such as unemployment compensation, Medicaid, Food Stamps, and assistance payments varies directly with the rate of unemployment. Second, lower deficits in the high-growth case tend to reduce net interest outlays, while higher deficits in the low-growth alternative increase interest spending. Third, while most spending is assumed to be indexed for inflation, higher or lower real GNP growth causes spending to fall or increase in relative terms.

TABLE II-6. THE BUDGET OUTLOOK UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS (By fiscal year)

	CBO Projection			CBO Extrapolation	
	1986	1987	1988	1989	1990
In Billions of Dollars					
Revenues					
High-growth alternative	805	900	1024	1167	1356
CBO estimate of budget resolution	790	858	939	1013	1094
Low-growth alternative	773	777	819	882	949
Outlays					
High-growth alternative	959	1016	1090	1177	1283
CBO estimate of budget resolution	965	1021	1082	1145	1214
Low-growth alternative	972	1035	1092	1137	1201
Deficit (-) or Surplus					
High-growth alternative	-155	-117	-67	-10	72
CBO estimate of budget resolution	-175	-163	-143	-132	-120
Low-growth alternative	-200	-259	-272	-256	-252
As a Percent of GNP					
Revenues					
High-growth alternative	19.2	19.5	20.0	20.3	20.7
CBO estimate of budget resolution	19.1	19.2	19.5	19.5	19.5
Low-growth alternative	18.8	18.8	18.9	19.1	19.4
Outlays					
High-growth alternative	22.9	22.0	21.3	20.5	19.6
CBO estimate of budget resolution	23.3	22.9	22.5	22.1	21.7
Low-growth alternative	23.7	25.1	25.2	24.6	24.5
Deficit (-) or Surplus					
High-growth alternative	-3.7	-2.5	-1.3	-0.2	1.1
CBO estimate of budget resolution	-4.2	-3.7	-3.0	-2.5	-2.1
Low-growth alternative	-4.9	-6.3	-6.3	-5.5	-5.1

SOURCE: Congressional Budget Office.

Figure II-3.
Federal Deficit Under Alternative Economic Assumptions



SOURCE: Congressional Budget Office.

[a] Extrapolated by CBO in 1989 and 1990.

THE UPDATED CBO BASELINE

CBO's baseline budget projections, against which the policy changes of the resolution are measured, generally assume no changes in current laws governing taxes or entitlement spending. The projections for nondefense discretionary spending assume that the 1985 appropriations level will be maintained and that future increases will keep pace with inflation. The projections for defense spending are based on last year's Congressional budget resolution, the resolution for fiscal year 1985 adopted by the Congress in September 1984. Under CBO economic assumptions, the assumed average rate of growth for defense appropriations is 5½ percent a year after adjustments for projected inflation. 2/

Table II-7 presents updated baseline projections for 1986-1990, which incorporate legislation enacted since the beginning of the year as well as revised economic and technical estimating assumptions. The changes made in CBO's February baseline projections are summarized in Table II-8. Over the six-year period from 1985 through 1990, projected deficits under baseline assumptions are cumulatively $70 billion lower than CBO projected in February. Revised economic assumptions--largely lower interest rates--account for nearly all of this reduction. Under CBO's latest assumptions,

2. For a detailed discussion of baseline concepts, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years, 1986-1990* (February 1985).

baseline deficits would rise from $210 billion in 1985 to $212 billion in 1986, $243 billion in 1988, and $285 billion in 1990. The deficit as a percent of GNP under baseline assumptions would remain relatively constant at 5.1 percent from 1986 to 1990. Debt held by the public, however, would grow as a percent of GNP, from 39.6 percent at the end of 1985 to 49.1 percent at the end of 1990.

Revenues

CBO projects baseline revenues to grow from $737 billion in 1985 to $787 billion in 1986, $931 billion in 1988, and $1,083 billion in 1990. Receipts are projected to grow faster than GNP during this period. Consequently, revenues as a percent of GNP rise from 19.0 percent in 1986 to 19.4 percent in 1990.

Baseline revenues are revenues generated under existing tax law, with four exceptions. Taxes for the Hazardous Substance Response (Superfund), Airport and Airway, and Highway Trust Funds are extended at current rates beyond their expiration dates in 1985, 1987, and 1988, respectively. The adjustment in the federal civil service retirement contribution for new employees is also extended beyond its scheduled expiration date at the end of 1985. By 1990, the trust fund extensions add $14 billion to annual baseline revenues. The civil service adjustment extension reduces baseline revenues by amounts ranging from $0.4 billion in 1986 to $1.4 billion in 1990. All other provisions of existing tax law, including the extension of the telephone excise tax and other temporary provisions of the Deficit Reduction Act of 1984 that are scheduled to expire during the next five years, are assumed to do so.

As shown in Table II-8, CBO's updated baseline revenue projections differ very little from those made in February. The projections are now somewhat lower because of the poorer than anticipated economic performance so far in 1985. Nominal incomes, and therefore tax bases, are lower throughout the forecast period in all cases except that of wages and salaries. On balance, the generally lower income assumptions reduce revenues in all years except 1986. Revenues have been revised downward by $1 billion in 1985, $4 billion in 1988, and $10 billion in 1990 because of changes in the economic assumptions.

The largest change is in corporate income taxes, which are $2 billion lower in 1987, and $13 billion lower by 1990 because of the new economic

TABLE II-7. UPDATED CBO BASELINE PROJECTIONS (By fiscal year)

	1985	1986	1987	1988	1989	1990
	In Billions of Dollars					
Revenues						
Individual income	338	361	393	432	472	517
Corporate income	61	73	86	93	98	97
Social insurance	265	285	304	336	362	395
Other	72	69	70	70	71	75
Total	737	787	853	931	1002	1083
Outlays						
Defense	249	279	310	345	382	423
Entitlements	439	449	480	514	546	582
Nondefense discretionary	176	184	193	202	209	218
Net interest	129	138	152	171	189	210
Offsetting receipts	-47	-50	-54	-58	-61	-65
Total	946	1000	1082	1174	1266	1368
Deficit	210	212	229	243	264	285
Debt Held by the Public	1522	1733	1961	2203	2466	2750
	As a Percent of GNP					
Revenues						
Individual income	8.8	8.7	8.8	9.0	9.1	9.2
Corporate income	1.6	1.8	1.9	1.9	1.9	1.7
Social insurance	6.9	6.9	6.8	7.0	7.0	7.1
Other	1.9	1.7	1.6	1.4	1.4	1.3
Total	19.2	19.0	19.1	19.3	19.3	19.4
Outlays						
Defense	6.5	6.7	6.9	7.2	7.4	7.6
Entitlements	11.4	10.9	10.8	10.7	10.5	10.4
Nondefense discretionary	4.6	4.4	4.3	4.2	4.0	3.9
Net interest	3.4	3.3	3.4	3.5	3.6	3.8
Offsetting receipts	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2
Total	24.6	24.2	24.2	24.4	24.4	24.4
Deficit	5.5	5.1	5.1	5.1	5.1	5.1
Debt Held by the Public	39.6	41.9	43.9	45.8	47.5	49.1

TABLE II-8. CHANGES FROM CBO FEBRUARY BASELINE BUDGET PROJECTIONS (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Revenues						
CBO February Baseline a/	735	788	855	934	1005	1088
Enacted legislation	b/	b/	b/	b/	b/	b/
Revised economic assumptions	-1	2	-2	-4	-6	-10
Technical reestimates	3	-3	-1	1	4	6
Updated Baseline	737	787	853	931	1002	1083
Outlays						
CBO February Baseline a/	950	1008	1095	1191	1284	1390
Enacted legislation	1	2	b/	b/	b/	b/
Revised economic assumptions	-1	-8	-12	-16	-19	-23
Technical reestimates	-3	-2	-2	-1	1	1
Updated Baseline	946	1000	1082	1174	1266	1368
Deficit						
CBO February Baseline a/	215	220	240	257	280	302
Enacted legislation	2	2	b/	b/	b/	b/
Revised economic assumptions	b/	-10	-10	-12	-13	-13
Technical reestimates	-7	1	-1	-3	-3	-5
Updated Baseline	210	212	229	243	264	285

SOURCE: Congressional Budget Office.

a. The CBO February baseline figures shown here were published in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1986* (February 1985).

b. Less than $500 million.

projections. Taxable profits are lower each year because of lower domestic economic profits in 1986 and beyond. The projected corporate profits share of GNP is significantly lower in each year after 1986. An upward revision in corporate taxes in 1986 primarily reflects lower projected investment in equipment, which diminishes the revenue reduction from the investment tax credit and shifts depreciation deductions from 1986 to future years. Lower taxable personal income resulting from lower nonwage income reduces individual income taxes by $1 billion or less in each year from 1986 through 1990. Wages and salaries are now projected at higher levels for each year of the projection period, and yield higher Social Security taxes by amounts ranging from $1 billion in 1986 to $6 billion in 1990.

Windfall profit taxes have been reduced by about $1 billion each year in response to lower oil price assumptions, and estimated Federal Reserve System payments to the Treasury are lower by $1 billion to $2 billion annually as a result of lower projected interest rates. Other changes attributable to revised economic assumptions are small and offsetting.

Technical reestimates raise revenues by $3 billion in 1985, reduce revenues in 1986 and 1987, and raise them each year from 1988 through 1990. The net effect on receipts in the 1986-1990 period is a $6 billion increase. In 1985, technical changes primarily reflect recent tax collections. Despite lower-than-projected personal income, individual income tax receipts have remained strong. This partly reflects unusually small growth in tax refunds, and may also reflect higher withheld taxes relative to taxes owed by wage earners and salaried workers resulting from changes in withholding schedules made in January to index for inflation. This increase has been partially offset by lower-than-expected corporate income and excise taxes. For 1986 through 1990, technical changes are dominated by updated information that shifts forward revenue reductions from accelerated depreciation on equipment, resulting in larger revenue reductions in early years and smaller reductions in later years compared with CBO's February estimates. Because most business equipment is owned by corporations, this change affects mainly the corporate income tax estimates. Excise taxes have been revised downward to reflect lower per capita consumption of both alcohol and cigarettes, and customs duties have been revised upward based on updated data about the composition of imports and tariff rates. These two effects are largely offsetting.

Recent legislation has had a very small effect on revenues. Public Law 99-44 repealed contemporaneous car log recordkeeping requirements and reduced the investment tax credit and depreciation deductions for automobiles; on balance, this reduces income taxes by $150 million in 1985 and increases them by small amounts each year after that. The United

States-Israel Free Trade Area Implementation Act of 1985 (Public Law 99-47) and the settlement of Iranian claims in the Foreign Relations Authorization Act reduce revenues slightly each year. The net effect of recent legislation is a revenue increase of less than $100 million over the 1985-1990 period.

Outlays

Baseline outlays are projected to rise from an estimated $946 billion in 1985 to $1,000 billion in 1986, $1,174 billion in 1988, and $1,368 billion in 1990. The average growth rate each year would be 7.6 percent, as compared with 5.1 percent under budget resolution policies. Relative to GNP, baseline outlays would remain relatively constant at slightly more than 24 percent throughout the next five years.

As shown in Table II-8, CBO's updated baseline outlay projections are slightly lower than those made in February, largely as a result of revised economic assumptions. Almost all of the economic reestimates result from lower interest rate assumptions, and from the indirect effect of these lower rates on debt service costs. On average, the interest rates in CBO's August economic assumptions are about four-fifths of a percentage point below CBO's February assumptions. This drop in rates lowers outlays for net interest and other interest-sensitive programs by $8 billion in 1986, $12 billion in 1987, and $24 billion in 1990. These reductions are offset by about $1 billion per year in the 1988-1990 period on account of higher projected cost-of-living adjustments for indexed benefit programs.

Technical reestimates of baseline outlays are small and largely offsetting. Defense spending estimates have been reduced by $3 billion per year in 1985-1987, $2 billion in 1988-1989, and $1 billion in 1990 to reflect a slowdown in the rate at which appropriations for procurement and operations and maintenance are resulting in cash outlays. On the other hand, projected spending for farm price supports has been increased by $2 billion to $3 billion in each year from 1985 through 1990; the estimated costs of both the corn and cotton programs have risen substantially on account of favorable weather conditions, higher-than-expected program participation, and declines in exports. Projected outlays in the international affairs function have been reduced by $2 billion in 1985 and $1 billion in 1986 because of lower levels of lending by the Export-Import Bank and reduced foreign military credit sales. Finally, estimated energy spending is $1 billion lower in 1985 and 1986 because of accelerated repayments of loans to the Rural Electrification Administration.

Legislation enacted since February has had a very small effect on outlays. Outlays are up by about $1 billion in 1985 and 1986 as a result of supplemental appropriations for African famine relief and for assistance to Israel, Egypt, and Jordan.

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