Statement to be Included in the Record by

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for the

Committee on the Budget
United States Senate

April 26, 1977

Mr. Chairman and Members of the Committee:

At the Committee's request, I am happy to share some brief observations on the economic outlook. I will address myself to three questions:

- o Has the economic news through early April provided reasons for altering the economic forecast that I presented to this committee on March 2, or the forecast contained in the Committee's report on the Third Concurrent Resolution for Fiscal Year 1977?
- o How will the outlook be affected by withdrawal of the $50 rebate assumed in the Third Concurrent Resolution for Fiscal Year 1977?
- o What is the effect of the shortfall in federal expenditures on the economic outlook?

Recent Economic News

The economic statistics of the last few weeks have contained bad news about prices, at least from the consumer's point of view, and good news about economic activity. Before a drastic change in fiscal policy is made, however, these statistics should be examined carefully. It seems to us at the Congressional Budget Office that the recent speedup in the rate of price increase reflects mainly the continued effects of cold weather on food and energy prices, and it does not necessarily presage a permanent increase in the underlying rate of inflation. Recent favorable statistics on economic activity, moreover, probably reflect inventory rebuilding and a rapid rebound from the cold weather. There are reasons to think that this upsurge may be temporary and that it does not justify increased optimism about the level of activity in the second half of the year.

The rate of increase in consumer prices rose from 4.2 percent during the last quarter of 1976 to 10 percent in the three months ending in March, with the biggest single factor being a 15 percent rate of rise in food prices. This sort of increase is not expected to continue, and in fact the food price rise was already beginning to slow down in March. The rise in energy prices continues fairly high, but it has little or no relation to the balance of aggregate demand and supply in the economy. We have also seen some recent increase in the rate of change in prices other than food and energy from their relatively good performance last year. But wage rate changes have remained in the 7 to 8 percent range, and we do not interpret recent developments as evidence that the underlying rate of inflation has moved out of the 4.5 to 6.5 percent range.

<u>Output Growth in the First Quarter</u>

According to the preliminary estimate, the rate of growth in national output in the quarter just ended was 5.2 percent--the highest it has been since the first quarter of last year and considerably better than most forecasters had expected. Furthermore, the quarter ended on a high note, with retail sales, industrial output, and employment expanding rapidly. These gains were not unexpected by CBO and other forecasters; the principal surprise since I last testified before you is that the cold-weather disruptions were smaller, and the rebound earlier, than we had anticipated in early March. Good news though this was,

we may want to look at it in a slightly longer perspective. Compared with a year earlier, real GNP was only 4 percent higher, and the unemployment rate only two-tenths of a percentage point lower.

While we may well see more good news in the immediate future, we have a number of reasons for expecting that growth rates in output will slow after midyear and that the unemployment rate at yearend will be little improved from the current quarter. Much of the present strength in the economy results from temporary factors and high rates of growth are therefore not likely to be maintained through the end of the year.

The first temporary factor is, of course, the rebound from output disruptions caused by the cold weather. For example, the high level of housing starts reported for March probably included starts postponed from January or February. For the quarter as a whole, starts were hardly changed from the final quarter of last year, and we continue to anticipate that the housing sector will contribute less to growth during 1977 than it did during 1976.

Second, the acceleration in growth in the first quarter was entirely due to inventories--final sales growth slowed down in real terms--and the same is likely to be true in the current quarter. After the marked slowing of inventory investment during 1976, businesses apparently found their stocks a little low by the end of the year, and stock rebuilding is currently giving an upward boost to output. By the middle of the year, the desired inventory-to-sales ratios are quite likely to be achieved, and output gains should then slow to the rate of growth of real final sales.

Consumer Behavior

Third, over the past two quarters we have seen a dramatic decline in the personal saving rate. This means that consumer spending increased faster than consumer incomes, providing stimulus to final sales. The rising rate of consumer spending was not associated with an increase in consumer confidence. Consumer confidence, as measured by the University of Michigan Survey Research Center in February, was a little better than in November but not quite as high as it had been in the late summer. Saving rate behavior is not perfectly understood, but our best judgment is that the decline in the saving rate has reflected special factors, namely the increased availability of autos this spring, after supply disruptions caused by the Ford Motor strike and the cold weather; and what I would call "involuntary consumption"--high heating requirements in those cold months last winter. In addition, there is the disquieting possibility that some consumers may have raised spending in anticipation of a rebate this spring.

What all this means is that if consumers paid their extra heating bills entirely out of savings, the saving rate is likely to rise from its first-quarter level. If they attempt to rebuild their net money balances by cutting back on other consumption, it will rise even more. And this rise in the saving rate will mean that consumption will now grow more slowly than disposable income.

If consumer confidence is significantly reduced by dropping the rebate or by the prospective energy program, this may depress consumer spending still further. Sindlinger's telephone survey

has reported a sharp decline in confidence following the announcement of the energy program, but it remains to be seen whether the decline will last. The energy program has introduced new uncertainties, not only about business conditions in general, but about markets for particular goods and services, and spending is likely to be somewhat unsettled until the uncertainties are resolved. We might expect, for instance, that sales of gas-guzzling cars would be strong but that sales of small cars, and perhaps other energy-saving products as well, might languish until the proposed taxes and subsidies are either put into effect or voted down.

Forecasting aggregate consumer behavior is subject to as much uncertainty as forecasting the rest of the economy--or more--but the latest information we have suggests that in the absence of the rebate consumer spending will be slowing down economic growth rather than leading it over the rest of 1977. What early indications we have on the second quarter go along with this, although they are extremely tentative. New auto sales appear to have slipped a little in the first 20 days of April, though the decline may reflect distortions caused by sales contests. Retail sales excluding autos dropped in the third week of April, following gains earlier in the month.

Business Investment

Will the ending of the rebates have offsetting beneficial effects on interest rates, business confidence, and investment? We believe the answer is yes, but that these effects are relatively

small. One reason they are small is that the Federal Reserve was expected, as Chairman Burns testified before this Committee, to allow a temporary bulge in the money supply during the rebate period, which would keep interest rates from rising as much as they would without such an accommodative policy. With the rebates withdrawn, we now presume that there will be no bulge in the money supply either, hence a relatively small and temporary difference in forecast interest rates.

A second reason that the positive effects on investment are relatively small is that the reduced business sales to consumers in the absence of the rebate may offset some of the positive effect of easier credit on the demand for capital goods. Our latest information on demand for capital goods does not cover the period since the withdrawal of the rebate. As of March, new orders for nondefense capital equipment were down for the second month in a row, after a very strong January. On a quarterly average basis, orders were still well above the fourth quarter, and appeared consistent with the spending plans businesses reported to the Commerce Department, which we incorporate in our forecast.

As for business confidence, we have now been told by the Conference Board that assessments of economic conditions by businesses improved between October and February. We have no information later than February, and the rebate looked like a pretty sure thing in February. Right now, judging by the behavior of the stock market, any bolstering of business confidence that followed withdrawal of the rebate may well have been offset by the uncertainties inevitably introduced by the President's announced energy program.

Revised Forecast

These judgments by the Congressional Budget Office are summarized in Table 1. Compared with the forecast I presented to you in my testimony of March 2, we have not changed the level of real GNP or unemployment at the end of 1978, but we are forecasting higher rates of unemployment and inflation during 1977. The forecast just released by the Administration is very similar to ours on inflation but near the optimistic end of our range for unemployment.

The withdrawal of the rebate adds 0.2 percent to the unemployment rate at the end of this year, representing the loss of 280,000 jobs. Since the rebate was to be a one-shot rather than a continuing stimulus, we estimated that it would have no effect on employment by the end of 1978.

Withdrawal of the rebate should not have a measurable effect on inflation either. The speedup in inflation that we are projecting during 1977 results from further effects of the cold weather on food and energy prices. This forecast does not include any effects of the President's energy program, which we are now in the process of evaluating. We are now estimating that the cold weather has added more than a point to the rate of change in the Consumer Price Index in 1977, but this has not been enough to raise the underlying inflation rate permanently; inflation reverts to an estimated 4.5 to 6.5 percent during 1978.

TABLE 1. ECONOMIC PROJECTIONS BASED ON THE THIRD CONCURRENT RESOLUTION WITHOUT REBATES

Economic Variables	Levels			Rates of Change (percent)	
	1976:4 (actual)	1977:4	1978:4	1976:4 to 1977:4	1977:4 to 1978:4
GNP (billions of current dollars)	1745	1910 to 1970	2100 to 2230	10.0 to 13.0	8.5 to 13.0
GNP (billions of 1972 dollars)	1280	1335 to 1355	1390 to 1440	4.3 to 5.8	4.0 to 6.0
General Price Index (GNP deflator, 1972 = 100)	136	143 to 146	150 to 156	5.5 to 7.0	4.5 to 6.5
Consumer Price Index (1967 = 100)	174	185 to 188	193 to 199	6.5 to 7.5	4.5 to 6.5
Unemployment Rate (percentage points)	7.9	6.8 to 7.5	5.8 to 6.8	--	--

NOTE: Projections include business tax cuts, which have some stimulative effect in 1978.

Federal Spending

Still another potential problem for the economy arises from the continuing shortfall in federal spending. When I testified before this Committee in early March, we anticipated a 1977 spending shortfall of at least $5 billion from the third concurrent resolution outlay level. This shortfall was incorporated in our March economic projections. OMB's recent spending estimates include a net downward revision of outlays of $6.1 billion for 1977 due to the shortfall and other factors. Other observers of federal spending have estimated that the shortfall could be as much as $10 billion or more. We are now reviewing the recent OMB estimates and will adjust our scorekeeping tabulations where this appears to be appropriate.

About one-third of OMB's downward revision in estimated 1977 spending levels is in financial transactions, such as foreign military sales and HUD mortgage market activities, which do not have a significant effect on the "National Income and Product Accounts." The remaining downward adjustment falls mainly in grants to state and local governments (e.g., public service jobs, EPA construction, local public works, highway construction, education programs) and in federal purchases (e.g., defense spending, federal construction activities, and energy R & D and strategic petroleum reserves). Spending for farm price supports and social security benefits have been revised upward.

If OMB's estimate of a $6.1 billion shortfall holds, then federal spending trends do not imply any revision of the

projections in Table 1. However, if the spending shortfall rises to $10 billion or more and is in federal purchases, grants, or transfers which are counted in the national income and product accounts, we would expect slightly less GNP and more unemployment in 1977 than is shown in the forecast in Table 1.

Changing Fiscal Policy

The Budget Committees and the Congress as a whole assessed the economic situation in March. At that time, they were aware that inventory-building and the recovery from cold weather would lead to some strong economic statistics in the spring. Weighing the economic forecast and the difficult choices involving unemployment and inflation, the Congress decided on an expansionary modification of the budget for fiscal year 1977. The possibility that this modification would lead to an overheated economy and an acceleration of inflation was judged by the Congressional Budget Office and others to be quite small.

In our judgment, recent economic news does not provide any reason for changing this assessment. Favorable statistics on economic growth were expected and do not justify feeling that stimulus would overheat the economy. Nor do the weather-related increases in prices indicate that a rebate would be more inflationary than was thought previously.

Suppose that the economy is clearly heading toward the pessimistic end of our forecast range by summer. Are there fiscal policy alternatives available to the Congress that could return

the economy toward the levels of real GNP, employment, and unemployment in the March 2 forecast? Clearly one possibility is a revival of the rebate later in the fiscal year. This alternative would raise no conflict with the third concurrent resolution, as long as the margin created by withdrawal of the rebate is not used up for other tax or spending measures.

Most other tax and spending measures are not likely to have any noticeable effect this year. Permanent cuts in personal and business taxes have effects that build up rather slowly. Similarly, additional spending on countercyclical revenue sharing, public works or public service employment probably could not have a sizable effect by the end of 1977--indeed, we may be having trouble getting existing authorizations for public service employment spent.

While we do not think it likely, we cannot rule out a more optimistic prospect in which the strong growth apparent in the March statistics will be sustained through the second half of the year. But I would remind you, Mr. Chairman, that we have been beguiled by month-to-month irregularities in economic news before. Last year many forecasters, including those at CBO, were misled by an inventory swing in late winter and spring, and failed to anticipate a return to a slower rate of recovery late in the year. I hope that we guard against the possibility of making a similar error in the direction of overoptimism this year.