

# CBO TESTIMONY

Statement of  
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before the  
Committee on the Budget  
United States Senate

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## NOTICE

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Mr. Chairman, I appreciate this opportunity to discuss the current economic outlook. This is my first appearance before a Committee of the 102d Congress, and I wish only that the message I am about to present were more positive.

## THE SHORT-TERM ECONOMIC FORECAST

CBO, like most other forecasters, believes that the U.S. economy is now in its ninth recession of the postwar period. This recession should be shorter and milder than the average postwar downturn. CBO expects the recession to end by midyear and to be followed by a period of solid economic growth and significantly reduced inflation. However, because this forecast is quite uncertain, especially given the situation in the Persian Gulf, I will also describe some alternative forecasts that illustrate other possible outcomes.

CBO's economic forecast calls for real GNP (gross national product) to grow about 1 1/2 percent between the fourth quarters of 1990 and 1991 (see Table 1). This forecast incorporates a decline in economic activity for the fourth quarter of 1990 and the first quarter of 1991. The recession will expand the gap between actual production and the economy's capacity to produce. Thus, there will be room for higher growth on average in the years after the recession as the economy catches up to its potential. For 1992, the growth rate is expected to rise to about 3 1/2 percent. This pattern of growth

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TABLE 1. CBO AND ALTERNATIVE FORECASTS

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	Estimated 1990	Forecast	
		1991	1992
Fourth Quarter to Fourth Quarter (Percentage <b>change</b> )			
<b>Real GNP</b>			
CBO forecast	0.2	1.3	3.4
High-growth alternative	0.2	2.2	4.1
Low-growth alternative	0.2	-0.9	4.6
Fixed-Weighted <b>GNP</b> Price Index			
CBO forecast	4.9	4.3	3.8
High-growth alternative	4.9	3.1	3.0
Low-growth alternative	4.9	3.8	2.4
Consumer Price Index			
CBO forecast	6.1	4.0	3.5
High-growth alternative	6.1	3.2	3.3
Low-growth alternative	6.1	4.2	2.0
<b>Calendar-Year</b> Averages (Percent)			
Civilian Unemployment Rate			
CBO forecast	5.5	6.8	6.4
High-growth <b>alternative</b>	5.5	6.5	5.9
Low-growth alternative	5.5	7.3	7.0
Three-Month Treasury Bill Rate			
CBO forecast	7.5	6.6	7.0
High-growth alternative	7.5	6.0	6.2
Low-growth alternative	7.5	5.9	6.0
Ten-Year <b>Treasury</b> Note Rate			
CBO forecast	8.6	7.9	7.7
High-growth alternative	8.6	7.4	7.4
Low-growth alternative	8.6	7.9	7.6

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SOURCE: **Congressional** Budget Office.

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in output is reflected in employment as well. The recession sharply increases the unemployment rate from 5.5 percent in 1990 to 6.8 percent in 1991, while the recovery causes it to drop below 6 1/2 percent in 1992.

After the recession, the inflation rate is apt to be significantly lower than it has been during most of the 1980s--down from between 4 percent and 5 percent to between 3 percent and 4 percent on a sustained basis. In other words, the pain of the recession will bring about the traditional benefit of reduced inflation.

The recession will cause a further reduction in interest rates. Long-term rates should fall in response to expectations of lower inflation, and short-term rates should ease slightly as the Federal Reserve continues to relax monetary policy to help moderate the recession. The rate on 10-year Treasury notes, which averaged 8.6 percent in 1990, is expected to fall to 7.9 percent in 1991. The three-month Treasury bill rate, which was 7.5 percent in 1990, is expected to average 6.6 percent in 1991. As the economy recovers, short-term interest rates are expected to rebound slightly in the second half of this year and early 1992. In contrast, long-term interest rates, responding to the permanent lowering of inflationary expectations, will remain low.

## Why the Economy Entered a Recession

Steering the economy between excessive inflation and inadequate growth is difficult. To its credit, the Federal Reserve navigated the economy relatively successfully between these two dangers during the late 1980s. In an attempt to prevent inflationary pressures from reemerging, it maintained a relatively tight monetary policy. But as the rate of economic growth slowed, and the July 1990 revisions to the national income and product accounts revealed that the economy was weaker in 1989 than originally recognized, the risk of a recession grew larger.

In the second half of 1990, the effects of Iraq's invasion of Kuwait rocked the economy. The invasion raised oil prices, consumer prices, and interest rates, which in turn reduced consumer confidence and spending. In addition, the decline in property values in some areas of the country together with the lingering effects of the savings and loan crisis pressured banks and bank regulators to tighten lending standards. This tightening led to reductions in the availability of credit to the private sector. CBO believes that the Iraqi invasion, coupled with a tightening of credit because of the problems in the banking and thrift industries, played an important role in precipitating the recession.

## Why the Recession is Expected to be Mild

While the decline in economic activity is unmistakable, the current slowdown differs from previous postwar downturns, and these differences suggest that a short and shallow recession is likely. Several factors contribute to this view. They include changes in the structure of the economy, the likely strength of net exports, the nature of the current oil price shock, and the flexibility currently available to the monetary authorities.

**Structural Changes.** In the past, inventory stocks have increased sharply and unexpectedly following the onset of a recession, leading businesses to cutback orders of new goods. Manufacturing production and employment have fallen sharply in response, which has tended to exacerbate the initial effects of the downturn. Such effects, however, are unlikely to complicate the current downturn. The current ratio of inventory stocks to sales is comparatively low. Although sales slowed early in this recession, such slowing did not lead to a sharp accumulation of inventories, perhaps because the slowdown had been expected as a result of the tight monetary policies of earlier years and because of improved management of inventories.

In addition, the service-producing sector has provided an increasing share of total income and employment over the postwar period. Because the

service sector is less sensitive to the business cycle than is the goods-producing sector, a given decline in the goods sector will not have as prominent an effect on total income as was the case in previous downturns.

Net Exports. Real exports are currently strong and are expected to remain so over the two-year forecast period. Such strength will help to offset weakness in other sectors. The sources of this strength are the dollar's decline over the last year as well as the relatively healthy growth in foreign demand.

Since mid-1989, the dollar has depreciated about 17 percent in inflation-adjusted terms against the currencies of our major trading partners. Much of the stimulative effect of this depreciation remains to be felt. Because of the continued decline in U.S. interest rates relative to those abroad, CBO does not expect this depreciation to be reversed.

Although economic growth has slowed recently, it continues in much of the rest of the world, helping to sustain the growth in U.S. exports. The greatest economic strength is in western Germany, which is enjoying a boom as a result of unification. Economic strength is also pronounced in Japan, where growth continues despite marked reversals in financial markets.

Growth in these countries should offset the effects of the recessions that have apparently begun in Canada, the United Kingdom, and Australia.

These same developments are likely to continue to hold interest rates at high levels in 1991. For example, German unification has pushed world interest rates upward in the past year, both because of the demand for funds to finance new investment in what was East Germany and because of the large budget deficits that the German government has incurred in order to finance unemployment compensation and other benefits for east Germans. Upward pressures on interest rates also stem in part from Japan, where financial markets have declined and monetary policy has been tightened to prevent an upsurge in inflation in response to the continued high rate of economic growth.

Nature of the Current Oil Shock. The current crisis in the Persian Gulf is not likely to generate the economic repercussions that followed the earlier disruptions in oil supplies in 1973 and 1979. The Iraq-Kuwait supply disruption so far is much smaller than the earlier supply shocks, and the United States and other oil-importing countries are better prepared today for disruptions in oil supplies than was true earlier.



Adjusted for inflation, the increase in oil prices that was brought about by the Iraqi invasion of Kuwait amounts to roughly 65 percent of the increase that followed the embargo by the OPEC in 1973, and to about 50 percent of the increase that followed the price increase that OPEC imposed in 1979.

The current disruption in oil supply is smaller than in the past both because the initial loss of oil was smaller and because some of the initial price shock was mitigated by both demand- and supply-side factors. Oil-exporting nations have replaced all of the oil lost from Iraq and Kuwait and are adding to their surplus capacity. In addition, world and domestic inventories of oil are now relatively abundant because stocks of oil at the onset of the crisis were very high and because demand for world oil fell off sharply in the last quarter of 1990.

The United States, like other oil-importing countries, is also better prepared for high oil prices in the 1990s because it has come to use energy more efficiently. By 1988, the use of energy per dollar of gross domestic product (GDP) had fallen to 74 percent of its 1973 level.

Monetary Policy and the Outlook for Inflation. The Federal Reserve responded to the initial signs of weakness in the economy by a slight easing of its tight monetary policy in mid-1990 and a more dramatic easing late in

the year. The current state of the economy should permit further easing without a pickup of inflation. Most of the 1990 increase in overall consumer inflation was related to energy and has already dissipated. In fact, there is little evidence that the underlying rate of inflation has moved outside the 4 percent to 5 percent range that has persisted since 1983. Moreover, the rising unemployment rate will help to restrain future wage increases, while declining factory operating rates will help hold down other prices as well.

#### The State of Fiscal Policy

Passage of the Omnibus Budget Reconciliation Act (OBRA) of 1990 represents a major step forward in this nation's budgetary policy. CBO projects that the act will reduce federal borrowing over the next five years by nearly \$500 billion, and sharply reduce the annual deficit both in dollars and in relation to GNP. To be sure, the deficit is going to balloon to record levels this year and next because of the recession and spending for deposit insurance. The favorable longer-term trends, however, are clear.

Although OBRA reduces spending and raises taxes, overall fiscal policy in 1991 is unlikely to be significantly contractionary. The costs associated with the military operation in the Gulf could offset a substantial amount of the

OBRA deficit reductions in 1991. While the estimates are highly uncertain, the incremental costs associated with the deployment of forces in the Gulf region and the hostilities there could be well in excess of \$15 billion. While not all of these costs will result in outlays in 1991, a substantial share of the portion that is spent could stimulate the U.S. economy, since it is likely to be spent on goods and services produced in the United States. Such outlays should offset some of the reductions mandated by OBRA for the current fiscal year.

In any case, as with earlier recessions, the current recession will cause the budget deficit to increase in 1991, which will help to ease the severity of the economic downturn. Taxes will automatically be less than, and transfer payments automatically greater than, what they would have been without an economic slowdown. As a result of these "automatic stabilizers," the reductions in consumption and other components of GNP will be dampened.

#### Risks to the Forecast

CBO's forecast has been made at a time when there is extraordinary uncertainty about the economy. Military developments in the Gulf, which impinge on the economic outlook, are a major source of uncertainty. In

addition, there is a good deal of uncertainty about whether banks and other financial institutions are in a position to extend sufficient credit to the rest of the U.S. economy.

With respect to the Middle East, the CBO forecast assumes that the unpredictable situation in this region keeps oil prices at about \$25 a barrel, and that U.S. military spending is relatively modest. The forecast also assumes that the credit crunch will remain relatively mild.

These assumptions, however, could easily turn out to be wrong. On the one hand, a speedy resolution of the Gulf conflict could lead to lower oil prices that could improve the short-term economic outlook. On the other hand, adverse events could significantly increase oil prices, putting a damper on economic activity in the United States and elsewhere.

With respect to the financial problems of banks, a further deterioration in credit conditions is possible if real estate prices continue to decline, and if banks with loan portfolios sensitive to the real estate market weaken further. In any case, regulatory and self-imposed pressures on banks to increase the overall quality of their assets and reduce bank size could work to slow the recovery by **restricting** the supply of credit.

## Alternative Forecasts

To account for these risks, CBO developed two alternative forecasts, one entailing a more severe recession, and the other a slightly shallower one. These alternatives give a flavor of other possible outcomes, but by no means do they encompass the range of possible economic scenarios.

The *high-growth alternative* makes relatively optimistic assumptions about oil prices, inflation, and the credit crunch. Oil prices are assumed to fall quite quickly to around \$15 a barrel, followed by an increase to around \$20 by the end of 1991. This oil price scenario obviously entails some sort of quick resolution of the Gulf conflict that allows at least some additional oil onto the markets, either from extra production or from existing stocks. The excess of new supplies would push prices at least temporarily below \$20. In addition, this alternative assumes that the economic weakness we are experiencing reduces inflation by more than the CBO forecast assumes. The high-growth alternative forecast also assumes that the credit crunch turns out to be minor.

The more favorable outlook for inflation in this forecast allows interest rates to be lower than in the CBO forecast, despite stronger growth. These lower interest rates come about both because expectations of inflation are

lower--a major factor in long rates--and because the more optimistic outlook for inflation means that the Federal Reserve has less to do to bring inflation within acceptable bounds.

In contrast, the *low-growth alternative* assumes that oil prices are temporarily higher than in the CBO forecast, and that the outlook for real GNP is substantially worse. Instead of a mild recession, this alternative calls for a recession of about average depth and duration. It is not simply a mirror image of the high-growth alternative, and does not make opposite assumptions in every respect. Nevertheless, the assumptions are generally more pessimistic.

Oil prices in this alternative are assumed to rise to the \$35 to \$40 range for about six months, before falling by the end of 1992 to levels close to those in the optimistic alternative. Such a scenario implies a resolution of the Gulf conflict, but a much more painful one than that assumed in the high-growth alternative.

The main reason for weak growth in this alternative forecast is, however, not the higher path of oil prices: it is that the credit crunch is assumed to become substantially worse than it currently seems. This turn of events would weaken private domestic spending. Indeed, although military

spending in this alternative could be substantially higher than in the baseline, it is assumed nevertheless that the private spending would be even weaker.

Inflation in the low-growth alternative forecast is slightly higher in 1991 than in the CBO forecast because of the temporarily higher oil prices. But by 1992, falling oil prices together with lower growth in non-oil prices because of the recession, sharply reduce the growth of the consumer price index (CPI).

Finally, in the low-growth scenario, short-term rates are lower than in the base forecast, because they reflect the effects of lower credit demands in a recession as well as efforts by the Federal Reserve to offset the assumed credit crunch.

#### Comparison with Other Forecasts

The CBO forecast for real GNP is considerably lower than what CBO predicted last June (see Table 2). That forecast was prepared before the Iraqi invasion, before the major downward revisions to estimates of economic growth in 1989 and early 1990, and before evidence of the seriousness of the credit crunch had emerged. The new forecast differs from the old primarily because of these changes.

TABLE 2. FORECASTS FOR 1991 AND 1992

	Estimated 1990	Forecast	
		1991	1992
Fourth Quarter to Fourth Quarter (Percentage change)			
<b>Real GNP</b>			
CBO current forecast	0.2	1.3	3.4
<i>Blue Chip</i>	0.2	0.9	2.8
CBO July 1990 forecast	2.3	2.5	2.6
Implicit <b>GNP</b> Deflator			
CBO current forecast	4.4	4.1	3.6
<i>Blue Chip</i>	4.5	4.0	3.6
CBO July 1990 forecast	4.3	4.0	3.8
Consumer Price <b>Index</b> <sup>a</sup>			
CBO current forecast	6.1	4.0	3.5
<i>Blue Chip</i>	6.2	4.1	4.0
CBO July 1990 forecast	4.8	4.4	4.1
<b>Calendar-Year</b> Averages (Percent)			
<b>Civilian</b> Unemployment Rate			
CBO current forecast	5.5	6.8	6.4
<i>Blue Chip</i>	5.5	6.5	6.3
CBO July 1990 forecast	5.3	5.4	5.4
<b>Three-Month</b> Treasury Bill Rate			
CBO current forecast	7.5	6.6	7.0
<i>Blue Chip</i>	7.6	6.3	6.5
CBO July 1990 forecast	7.6	6.9	6.7
Ten-Year <b>Treasury</b> Note Rate			
CBO current <b>forecast</b>	8.6	7.9	7.7
<i>Blue Chip</i> <sup>b</sup>	8.6	7.8	8.0
CBO July 1990 <b>forecast</b>	8.5	7.8	7.4

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators*.

NOTE: The *Blue Chip* forecasts through 1992 are based on a survey of 50 private forecasters, published on January 10, 1991.

a. The consumer price index for all urban consumers (CPI-U).

b. *Blue Chip* does not project a 10-year note rate. The CPI-U values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the **estimated** spread between Aaa bonds and 10-year government notes.



Other forecasters have also revised their views since last summer. The *Blue Chip Economic Indicators*, which provides an average of forecasts made by some 50 economists, has lowered its growth prediction for 1991 since last summer. The current *Blue Chip* average forecast for real GNP growth in calendar year 1991 is slightly lower than CBO's. Moreover, relative to last summer's prediction for 1991, the individual forecasts for growth in the current *Blue Chip* average are more widely dispersed around the average, possibly an indication of the uncertainty present in the current economic climate.

#### THE MEDIUM-TERM ECONOMIC PROJECTIONS

CBO does not try to forecast short-term fluctuations in the economy more than two years into the future. Instead, for the 1993-1996 period, we project the trends in important underlying variables, such as labor supply, productivity, and saving rates. Variables such as real GNP, inflation, and interest rates are projected on the basis of the gaps between the values of these variables that are forecast for the end of 1992 and the potential or long-run values that are implied for them by CBO's projections of underlying economic trends.

## Real Gross National Product

CBO projects that potential GNP will grow on average by about 2.3 percent a year. This projection, which is slightly lower than CBO's estimates of last summer, reflects the recent benchmark revisions to the economic data, which suggest that productivity has been growing more slowly in recent years than earlier data had indicated. In addition, the projected growth in potential output takes account of the expected slowing in the growth of the labor force, as well as the increases in capital per worker that will stem from reductions in the federal deficit.

Real GNP is projected to grow at an average rate of 2.8 percent over the 1993-1996 period as a result of the relatively large gap between actual and potential GNP that appears during 1991 and 1992 because of the recession (see Table 3). A healthy growth rate will be possible as the economy recovers and resources are more fully used.

## Interest Rates

Interest rates in the projection are set by reference to the historical pattern of real interest rates and increases in national wealth that existed during the

TABLE 3. MEDIUM-TERM ECONOMIC PROJECTIONS **FOR**  
CALENDAR YEARS 1993 THROUGH 1996

	Estimated 1990	Forecast		Projected			
		1991	1992	1993	1994	1995	1996
Nominal <b>GNP</b> (Billions of <b>dollars</b> )	5,467	5,700	6,107	6,505	6,919	7,358	7,824
Nominal <b>GNP</b> (Percentage change)	5.1	4.3	7.1	6.5	6.4	6.3	6.3
Real GNP (Percentage change)	0.9	0.0	3.3	2.9	2.8	2.7	2.7
Implicit GNP Deflator (Percentage change)	4.2	4.3	3.7	3.5	3.5	3.5	3.5
<b>Fixed-Weighted</b> GNP Price Index (Percentage change)	4.6	4.6	3.8	3.8	3.8	3.8	3.8
<b>CPI-U</b> (Percentage change)	5.4	4.9	3.5	3.6	3.6	3.6	3.6
Unemployment Rate (Percentage)	5.5	6.8	6.4	6.2	6.0	5.8	5.6
<b>Three-Month</b> Treasury <b>Bill</b> Rate (Percentage)	7.5	6.6	7.0	6.7	6.3	5.9	5.7
Ten-Year Treasury Note Rate (Percentage)	8.6	7.9	7.7	7.6	7.4	7.3	7.2
Tax Bases (Percentage of GNP)							
Corporate <b>profits</b>	5.5	5.2	5.7	5.5	5.2	5.0	4.9
Other taxable income	22.2	22.3	22.1	22.1	22.0	21.8	21.7
Wage and salary <b>disbursements</b>	<u>49.4</u>	<u>49.4</u>	<u>49.4</u>	<u>49.5</u>	<u>49.6</u>	<u>49.8</u>	<u>49.8</u>
Total	77.2	76.8	77.1	77.1	76.8	76.6	76.4

SOURCE: **Congressional** Budget Office.

NOTE: **CPI-U is the consumer price index for all urban consumers.**

1960s. During that decade, real long-term interest rates averaged about 2.3 percent, while about 7.6 percent of real net national product was devoted to increases in wealth--that is, either invested in this country or loaned abroad. In the 1990s, CBO projects that the assumed reduction in the federal deficit will raise the rate of accumulation of national wealth, thereby exerting downward pressure on interest rates. This downward pressure will be offset by the increased capital demands associated with developments in Europe. As a result, CBO projects real short-term interest rates in the mid-1990s of about 2 percent, and real long-term rates of about 3 1/2 percent.

## CONCLUSION

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The nation clearly faces a difficult period in the next several months. A significant economic slowdown seems assured, though just how long and how severe it will be is highly uncertain. A resolution of the conflict in the Gulf will help determine that outcome, but a complete picture of the nation's economic prospects will elude us until we have a clearer picture of the health of the nation's financial system. The slowdown, one hopes, will prove to be short and will provide the foundation for a period of renewed moderate growth and lower inflation.