

Statement of  
Robert D. Reischauer  
Director  
Congressional Budget Office

before the  
Joint Economic Committee  
Congress of the United States

August 1, 1989

**NOTICE**

This statement is not available for public release until it is delivered at 2:00 p.m. (EDT), Tuesday, August 1, 1989.

Mr. Chairman and Members of the Committee, it is a pleasure to be here this morning to discuss the Congressional Budget Office's (CBO's) updated economic projections and the budget outlook. My testimony today will concentrate on the economic outlook, reflected in the July CBO forecast, which we released last week, as well as in the Administration's Midsession Review, the forecasts of the Federal Reserve, and the consensus of private forecasters. In addition, my statement will touch on two related issues: the effects of the dollar's recent rise and the probability of a recession.

Finally, I will discuss the budget outlook. Because CBO's revised baseline budget projections are not yet complete, however, my discussion of that outlook will be based largely on our figures from last winter. Our revised budget projections are scheduled to be released on August 17. In the past, changes in the economic assumptions have been one of the main sources of revisions to the budget outlook. This summer, however, changes in the forecast and technical estimating revisions are unlikely to cause a significant change in the budget numbers.

#### THE JULY CBO FORECAST

---

The pace of economic expansion slowed sharply during the first half of 1989, and CBO, like many other forecasters, projects that the economy will continue to grow during the rest of 1989 and 1990 at the slower pace of

recent months. As a result, CBO projects a slight increase in unemployment, a gradual decline in short-term interest rates, and an easing of inflation from the pace set in the first half of this year. Compared with CBO's winter 1989 forecast, this projection entails a marginally higher level of nominal gross national product (GNP) in 1990, with lower interest rates and slightly higher inflation rates.

Neither CBO's July forecast nor other forecasts discussed here reflects last week's revisions in the GNP data. The revisions will not, however, significantly affect the CBO forecast.

CBO's July forecast reflects the strong consensus among forecasters that the recent slowing in economic growth will not go so far as to turn into a recession during the next several months. After adjusting for inflation, CBO projects that GNP will grow by 2.4 percent in 1989 on a fourth-quarter-to-fourth-quarter basis, and by 2.0 percent in 1990 (see Table 1). CBO's July forecast is slightly less optimistic than last winter's, which envisioned GNP growth rates of 2.9 percent in 1989 and 2.2 percent in 1990. Together with the forecast of the implicit GNP deflator that I will describe below, the forecast implies nominal GNP growth rates of 6.8 percent in 1989 and 6.4 percent in 1990, both of which are quite close to CBO's projections of last winter.

The unemployment rate rises slowly over the next year and a half in CBO's forecast as a result of the slow economic growth that we foresee. While we expect the average unemployment rate for 1989 as a whole to be close to the present level of 5.3 percent, the projection for 1990 is a slightly higher rate of 5.5 percent.

**TABLE 1. THE CBO FORECAST FOR 1989 AND 1990**

	<u>Actual</u> 1988	<u>Forecast</u>	
		1989	1990
<b>Fourth Quarter to Fourth Quarter (Percent change)</b>			
Nominal GNP	7.2	6.8	6.4
Real GNP	2.8	2.4	2.0
Real Nonfarm GNP	3.6	1.8	2.0
Implicit GNP Deflator	4.3	4.2	4.4
CPI-W <sup>a</sup>	4.3	5.2	4.7
<b>Calendar-Year Averages (Percent)</b>			
Civilian Unemployment Rate	5.5	5.3	5.5
Three-Month Treasury Bill Rate	6.7	8.2	7.2
Ten-Year Government Bond Rate	8.8	8.6	8.2

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

a. Consumer Price Index for urban wage earners and clerical workers.

**NOTE:** This table does not reflect the July 27, 1989 revisions in the GNP data.

CBO's projection of a sustained slowing in economic growth reflects the effects of Federal Reserve restraint, which came in reaction to signs that strong economic growth had brought the economy into an inflationary danger zone. In explaining its policy, the central bank has argued that strong economic growth in 1987 and 1988 absorbed virtually all the economy's spare production capacity. The unemployment rate, for example, fell steadily throughout that period, finally reaching a 14-year low of 5.0 percent in March of this year, while capacity utilization in manufacturing rose as high as 84.7 percent in January. Both of these levels are in the range that in the past has been associated with an acceleration of inflation. Preliminary signs of increasing inflation emerged last winter as hourly labor costs accelerated, and they became clearer with strong increases in producer and consumer prices during the spring.

The restrictive monetary policy caused GNP growth to slow, particularly in interest-sensitive sectors of the economy. Having averaged 3.6 percent during 1988, nonfarm real GNP growth slowed to 2.1 percent in the first quarter of 1989. Preliminary evidence suggests that second-quarter growth will be similarly low. Housing and business construction slowed, and demand for autos and other consumer durables was reduced. Business investment in producers' durable equipment has slackened as well.

## The Outlook for Inflation

CBO projects that inflation in consumer prices will be higher for 1989 and 1990 than in recent years. Part of the increase, however, reflects a surge in the first half of this year that is expected to ease. Our forecast for the increase in the Consumer Price Index averages 4.6 percent for the next year and a half. This rate is up from the 4.3 percent rate of 1988 (on a fourth-quarter-to-fourth-quarter basis), but below the rate of the first half of this year. The slowing in the next few months comes about because food and energy prices are expected to slow from their unusually high growth rates of the first half of the year. For the GNP deflator, we currently project growth on a fourth-quarter-to-fourth-quarter basis of 4.2 percent in 1989 and 4.4 percent in 1990. Our current forecast of inflation in consumer prices is close to our winter figures, while our projection of changes in the GNP deflator is somewhat higher than we expected last winter.

## Interest Rates

Federal Reserve tightening resulted both in increases in short-term interest rates and a slowing in the growth rates of the monetary aggregates. Largely as a result of this policy, the three-month Treasury bill rate rose by over three percentage points--from 5.7 percent in February 1988 to 8.8 percent at its peak in March 1989. At the same time, M2, one of the most carefully

watched monetary aggregates, slowed to an average annual growth rate of 3.7 percent between March 1988 and March 1989. This growth put M2 below the bottom of the Federal Reserve's target ranges in both 1988 and the first half of 1989.

CBO forecasts that short-term rates will continue declining gradually. The three-month Treasury bill rate has fallen by about one percentage point since its peak in March, from 8.8 percent to below 8.0 percent in mid-July. The forecast entails moderate continued declines, reflected in an average Treasury bill rate of 8.2 percent for 1989 as a whole and 7.2 percent for 1990. These figures are close to the levels that we projected last winter.

Long-term interest rates increased less than short-term rates during 1988 and the first half of 1989, and have since fallen faster than short-term rates. This pattern has been attributed to a combination of expectations of slower economic growth and inflows of investment funds from abroad. From March 1988 to March 1989, the 10-year Treasury bond rate increased by only one percentage point, from 8.4 percent to 9.4 percent, and has since fallen to about 8 percent. Longer-term rates are influenced by expectations of future short-term rates, which will fall if growth slows substantially. Hence, the slow growth expected by many forecasters for the next year may have helped to reduce long-term rates. In addition, analysts cite an apparent increase in foreign demand for U.S. bonds among reasons for their reduced yields.

CBO forecasts that longer-term interest rates will decline little from present levels. This outlook is reflected in projected levels for the 10-year Treasury bond rate of 8.6 percent for 1989 and 8.2 percent for 1990. These levels are well below our winter forecast, which put this rate at or above 9.0 percent in both years.

### The Effects of the Dollar's Recent Rise

The strong appreciation of the dollar since the beginning of the year has contributed to CBO's forecast of a slowing in the economy by reducing its projection of net exports. The net export deficit improved by \$21 billion in 1982 dollars during 1988 and probably at a similar rate in the first half of this year. These increases have thus far been helping to sustain the economic expansion. In the next 18 months, however, net exports are expected to improve by only about \$6 billion. A rising dollar makes U.S. exports more expensive and slows the growth of demand for these American products. At the same time, it also makes imports cheaper and more likely to be substituted for U.S.-produced goods.

Recent monetary policy actions and several unexpected political developments apparently brought about the rise in the dollar. Rises in interest rates in the United States during the winter may have contributed, since they increased the attractiveness of financial assets in this country and thereby increased the demand for dollars. Analysts also believe that some



weakening of the governments of Japan and West Germany and this spring's events in China may have contributed to the strength of the dollar by heightening perceptions of the United States as a safe haven.

### The Probability of Recession

Recent developments, especially those encompassed in the index of leading economic indicators, suggest that the current slowing of economic growth could turn into a recession in the next nine months. Retail sales have been disappointing in recent months, and the index of leading indicators has fallen in three of the last four months. The latest decline in the index was relatively large, and it involved many of the constituent parts of the index, which is also a bad sign.

Other indicators, however, present a more sanguine view of the likelihood of recession. The stock market, which has almost always fallen before previous recessions, continues to rise. Moreover, the index of leading indicators has not yet fallen for three consecutive months, the rule of thumb that is accepted by many economists as indicating a recession. The weakness of retail sales is at least partly offset by the continued growth in personal income, and the recent decline in interest rates is likely eventually to help housing and spending on durable goods.

Direct estimates of the probability of recession during the next nine months place the figure in the 15 percent to 40 percent range. The higher figure of 40 percent stems from calculations using the index of leading economic indicators, while the lower estimate of 15 percent is based on alternative methods of analyzing indicators.

#### Comparison with Other Forecasts

This summer, as in many previous cases, CBO's July forecast is quite close to the consensus of 52 private forecasters reflected in the *Blue Chip* survey, while the Administration's recent projections are somewhat more optimistic. The Administration's forecast, shown in Table 2, entails real GNP growth of 2.7 percent in 1989 and 2.6 percent in 1990--rates that are higher than both the CBO and *Blue Chip* figures in both years. For consumer price inflation, the Administration's forecast is for rates of 4.9 percent in 1989 and 4.1 percent in 1990. The 1990 figure is one-half a percentage point below those of CBO and the *Blue Chip*. Finally, for the Treasury bill rate, the Administration projects a level of 8.0 percent in 1989 and 6.7 percent in 1990. The 1990 figure is about one-half a percentage point below the CBO and *Blue Chip* figures.

TABLE 2. THE CBO FORECAST FOR 1989 AND 1990, IN COMPARISON WITH LAST WINTER'S FORECAST AND RECENT FORECASTS BY ADMINISTRATION AND *BLUE CHIP*

	Actual	Forecast	
	1988	1989	1990
<b>Fourth Quarter to Fourth Quarter (Percent Change)</b>			
<b>Nominal GNP</b>			
CBO Summer	7.2	6.8	6.4
CBO Winter	6.7	6.9	6.6
Administration	7.2	7.1	6.8
<i>Blue Chip</i>	7.2	6.8	6.2
<b>Real GNP</b>			
CBO Summer	2.8	2.4	2.0
CBO Winter	2.6	2.9	2.2
Administration	2.8	2.7	2.6
<i>Blue Chip</i>	2.8	2.2	1.7
<b>Implicit GNP Deflator</b>			
CBO Summer	4.3	4.2	4.4
CBO Winter	4.0	3.9	4.4
Administration	4.3	4.2	4.1
<i>Blue Chip</i>	4.3	4.4	4.4
<b>CPI-W<sup>a</sup></b>			
CBO Summer	4.3	5.2	4.7
CBO Winter	4.3	5.0	4.8
Administration	4.2	4.9	4.1
<i>Blue Chip</i>	4.3	5.3	4.6
<b>Calendar-Year Averages (Percent)</b>			
<b>Civilian Unemployment Rate</b>			
CBO Summer	5.5	5.3	5.5
CBO Winter	5.5	5.5	5.5
Administration	5.4	5.2	5.4
<i>Blue Chip</i>	5.5	5.3	5.7
<b>Three-Month Treasury Bill Rate</b>			
CBO Summer	6.7	8.2	7.2
CBO Winter	6.7	7.9	7.1
Administration	6.7	8.0	6.7
<i>Blue Chip</i>	6.7	8.2	7.4
<b>Ten-Year Government Bond Rate</b>			
CBO Summer	8.8	8.6	8.2
CBO Winter	8.9	9.3	9.0
Administration	8.8	8.5	7.7
<i>Blue Chip</i> <sup>b</sup>	8.9	8.5	8.1

SOURCES: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators*, July 10, 1989; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

- a. The *Blue Chip* projection is for the CPI-U.
- b. *Blue Chip* does not provide a 10-year note rate. The values 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.

NOTE: This table does not reflect the July 27, 1989 revisions in the GNP data.

Only 10 of the 52 *Blue Chip* respondents are as optimistic as the Administration for real GNP growth in 1990, whereas 26 are at least as optimistic as CBO is. Similarly, only 10 out of 52 are as optimistic as the Administration on inflation in 1990, and 13 out of 52 are as sanguine on interest rates.

TABLE 3. CBO AND ADMINISTRATION MEDIUM-TERM PROJECTIONS  
(Annual averages in percentages)

	Forecast		Projected			
	1989	1990	1991	1992	1993	1994
<b>Nominal GNP</b>						
CBO	7.4	6.2	6.7	6.9	6.9	6.8
Administration	7.5	6.6	7.2	7.0	6.6	6.1
<b>Real GNP</b>						
CBO	2.8	1.7	2.3	2.5	2.5	2.5
Administration	2.9	2.3	3.1	3.2	3.1	3.0
<b>CPI-W</b>						
CBO	5.1	4.7	4.6	4.6	4.6	4.6
Administration	5.0	4.2	3.9	3.6	3.3	3.0
<b>Three-Month Treasury Bill Rate</b>						
CBO	8.2	7.2	6.8	6.5	6.3	6.1
Administration	8.0	6.7	5.3	5.0	4.7	4.4
<b>Ten-Year Government Bond Rate</b>						
CBO	8.6	8.2	8.1	7.9	7.7	7.6
Administration	8.5	7.7	6.8	6.0	5.7	5.4

SOURCES: Congressional Budget Office; Office of Management and Budget.

The current forecasts by members of the Board of Governors of the Federal Reserve and presidents of regional Federal Reserve banks are closer to CBO's forecast than to the Administration's. The so-called "central tendency" of the Federal Reserve forecasts of real growth was 2 percent to 2-1/2 percent in 1989 and 1-1/2 percent to 2 percent in 1990. For inflation, it was 5 percent to 5-1/2 percent in 1989 and 4-1/2 percent to 5 percent in 1990. CBO's forecasts for both real growth and inflation fall within these bands, while the Administration's forecast is above the band for real growth and below it on inflation.

### Medium-Term Projections

Unlike CBO's economic forecast for 1989 and 1990, its economic projections for 1991 through 1994 are largely mechanical calculations based on historical patterns for different economic variables. The projections show real growth at roughly the estimated growth rate of potential GNP, about 2-1/2 percent, while inflation remains near the rate that we forecast for 1990, and interest rates decline gradually (see Table 3).

The Administration's medium-term projections for economic growth and inflation are somewhat more optimistic than CBO's, presumably because of different views of the outlook for growth in productivity. CBO's projections

for productivity are based on the relatively weak average growth in productivity during the 1980s. The Administration's projections, by contrast, have usually been based on the higher average rates of productivity growth over the entire postwar period.

The Administration's interest-rate projections decline more sharply than CBO's, but the difference stems entirely from different projections of inflation: the inflation-adjusted, or "real," interest rates of both groups are nearly the same. CBO projects that three-month Treasury bill rates will fall to about 6.0 percent by 1994, while the Administration assumes a decline to about 4-1/2 percent. Both projections assume that real interest rates will return to historical average levels of about 1.5 percent in 1994 from their much higher levels of the 1980s. Such a decline is likely to be realized only if there is significant progress in reducing the federal deficit.

## THE BUDGET OUTLOOK

---

CBO has only recently completed its economic forecast, and has not yet incorporated it into its budget projections. The new forecast and any technical estimating revisions, however, are unlikely to cause a substantial change in our view of the budget outlook. Since the current fiscal year is more than three-quarters over, we can update our estimate of the 1989 deficit. My discussion of the budget for 1990 and later, however, is based on CBO's winter economic and technical estimating assumptions.

### Fiscal Year 1989

We now estimate that the 1989 deficit will be around \$150 billion, as compared with our February estimate of \$159 billion. While the outlook has improved slightly since the winter, the improvement appears to be considerably less than a number of press reports would indicate. Although the 1989 deficit is almost certain to exceed the Balanced Budget Act target of \$136 billion, it may not exceed the target by much more than the \$10 billion allowed in the law.

The lower 1989 deficit comes largely from higher revenues. Although projected outlays are lower in certain areas, there are offsetting increases elsewhere. For example, the Administration has taken actions to speed up spending by making 50 percent advance deficiency payments on 1989 crops and by advancing the October 1 payday for military personnel to September 29. Uncertainty remains over the cost of deposit insurance during the next few months.

### Fiscal Year 1990

The budgetary framework for 1990 was established by the bipartisan budget agreement of April 14 and has been incorporated in the 1990 budget

resolution. Table 4 provides CBO's estimates of the effects of the policies assumed in the budget resolution.

Using CBO's winter assumptions, fully carrying out the budget resolution would produce a 1990 deficit of \$120 billion--almost \$28 billion below the budget resolution baseline of \$147 billion. Permanent spending cuts and tax increases would account for about \$17 billion of the reductions. Over one-third of the reductions, however, would consist of accounting changes, one-time savings, and asset sales, which would not reduce the deficit in the long run.

The deficit projections would also be affected by enactment of the savings and loan bill. The conference agreement creates a new on-budget entity, the Resolution Financing Corporation (REFCORP), which will borrow money from the Treasury to help resolve insolvent thrift institutions. The spending of the borrowed funds, however, would be excluded from the budget totals used for the Balanced Budget Act. While CBO has not finished pricing the conference agreement, its budgetary impact should be similar to that of the House-passed bill, which would have added about \$20 billion to the 1990 deficit. An estimated \$23 billion in REFCORP outlays, however, would not be counted for purposes of the Balanced Budget Act.



TABLE 4. CBO ESTIMATES OF FISCAL YEAR 1990 BUDGET RESOLUTION (By fiscal year, in billions of dollars)

	1990	1991	1992
BUDGET RESOLUTION BASELINE DEFICIT	147.3	148.0	143.7
<b>Permanent Deficit Reduction</b>			
Tax revenues	-5.3	-5.3	-5.3
Tax compliance	-0.5	-0.9	-1.0
User fees (offsetting receipts)	-2.5	-3.3	-2.5
Defense	-4.2	-4.2	-3.9
Nondefense discretionary	-0.4	3.3	3.9
Medicare	-2.3	-2.3	-2.3
Agriculture	-0.6	-0.6	-0.6
Postal benefits	-0.5	-0.5	-0.5
Other	0.1	-0.2	-0.2
Debt service	<u>-1.1</u>	<u>-1.9</u>	<u>-1.9</u>
Subtotal	-17.2	-15.9	-14.3
<b>Accounting Changes, One-Time Savings, and Asset Sales</b>			
Postal Service off-budget	-1.8	0.6	-0.8
Farm credit assistance off-budget	-0.4	-0.5	-0.4
Veterans loan assets	-0.5	-0.6	-0.6
Food Stamp write-off	-0.5	0	0
Lump-sum pension payments	-0.6	0	0
Advance farm deficiency payments	-0.9	0	0
Asset sales	<u>-5.7</u>	<u>0.6</u>	<u>0.6</u>
Subtotal	-10.3	0.1	-1.2
Total Changes	-27.5	-15.8	-15.5
BUDGET RESOLUTION DEFICIT	119.8	132.2	128.2
BALANCED BUDGET ACT TARGETS	100.0	64.0	28.0

SOURCES: Congressional Budget Office, based on its economic and technical estimating assumptions of February 1989.

## Fiscal Year 1991

While carrying out the budget resolution would come close to meeting the Balanced Budget Act's requirements for 1990, CBO projects that it will leave much more deficit reduction to be accomplished in fiscal year 1991. If the budget resolution is fully implemented, the 1991 deficit would be \$132 billion. Enactment of the savings and loan bill would add upto \$20 billion, of which about \$14 billion would not be counted for the Balanced Budget Act. The resulting deficit of \$138 billion would exceed the target by about \$74 billion and would surpass the sequestration threshold by \$64 billion.

Deficit reduction of \$64 billion would represent more than twice the amount of permanent deficit reduction achieved in any recent year. To get a sense of how big this reduction would be, consider the hypothetical example of achieving it by imposing an across-the-board cut in spending. Such an approach would require a cut in spending of more than 10 percent, excluding only Social Security benefits, net interest, and outlays from prior-year appropriations.

Such a large deficit reduction in one year would require strong actions by the Federal Reserve in order to prevent short-run reductions in the growth of real GNP and employment. The central bank would have to permit faster money growth and a substantial decline in interest rates in order to stimulate

interest-sensitive spending enough to offset the direct depressing effect of deficit reductions this big.

One way to ease the deficit reduction task in 1991 is to press forward on carrying out the 1990 budget agreement and resolution. Because of identifiable one-time savings, the budget resolution is estimated to save only \$16 billion in 1991, as compared with \$28 billion in 1990. If some of the as yet unspecified 1990 savings are also achieved through accounting changes or timing shifts, or if some of the savings are not accomplished at all, the amount of permanent deficit reduction could be even less, and the further cuts needed in 1991 would be that much greater.

As CBO has stated many times before, large budget deficits exacerbate several major problems of the economy--a low saving rate, a large trade deficit, and mounting foreign debt--all of which impair economic growth. The Congress has made some progress in reducing the budget deficit, but further cuts could help our economy grow more rapidly in the long run. CBO looks forward to assisting the Congress as it continues the important task of reducing the deficit.