Statement of
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before the
Committee on Agriculture
United States House of Representatives

February 28, 1984

This document should not be released before its delivery, scheduled for 9:30 a.m. (E.S.T.), Tuesday, February 28, 1984.

Mr. Chairman, I am pleased to have this opportunity to appear before this Committee. As requested, my testimony today will focus primarily on the economy and on the federal budget. The agriculture sector is greatly affected by trends in the domestic economy and by budgetary decisions. 1/

As you know, the condition of the economy has improved markedly since the recession. Output grew vigorously during the first year of recovery, and the unemployment rate declined at a near record pace from a level that was a post-World War II high. At the same time, the dramatically lower inflation rates that were achieved during the recession held firm in 1983 despite the pace of the recovery. However, interest rates remained at very high levels last year, apparently because of huge current and prospective federal deficits and the anti-inflationary policies of the Federal Reserve. As a result, some sectors—particularly import-competing industries and the export industries, such as agriculture--did not fully participate in the recovery.

Despite the high interest rates and signs of unbalanced growth, most forecasters, including the Congressional Budget Office (CBO), believe that

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1/ The economic and budget outlook are analyzed in detail in a recent three-part CBO report to the Senate and House Committees on the Budget: Part I, The Economic Outook, Part II, Baseline Budget Projections for Fiscal Years 1985-1989, Part III, Reducing the Deficit: Spending and Revenue Options. See also CBO's An Analysis of the President's Budgetary Proposals for Fiscal Year 1985 (February 1984). In addition, CBO has recently prepared a report on agricultural policy: Crop Price-Support Programs; Policy Options for Contemporary Agriculture (February 1984).

the near-term outlook remains favorable. Incoming data seem to confirm that economic growth remains strong, and the consensus forecast calls for economic growth in the 4 to 5 percent range during 1984, with inflation only slightly above the previous year's rate. Nevertheless, given current budget policies, more than the usual degree of uncertainty must be attached to the short-run forecast and the foregoing analysis. The CBO projections imply that deficits will average 4.6 percent of the gross national product (GNP) during the 1980s. The comparable levels in the previous decades were: 0.4 percent in the 1950s, 0.8 percent in the 1960s, and 1.9 percent in the 1970s. We are operating so far outside the range of recent historical experience that any analysis must be put forward tentatively, but the risks posed by such deficits are enormous, even in the short run.

THE FIRST YEAR OF RECOVERY

Output rose 6.2 percent during 1983, close to the average of previous postwar recoveries. The unemployment rate declined dramatically, from the postwar record of 10.7 percent of the civilian labor force in late 1982 to 8.0 percent at the beginning of this year. Inflation also declined in 1983, though the rate of decline appeared to be slowing. The increase in the fixed-weight deflator, a broad measure of inflation, fell from a record 9.8 percent in calendar year 1980 to 6.4 percent in 1982 and to 4.3 percent in 1983.

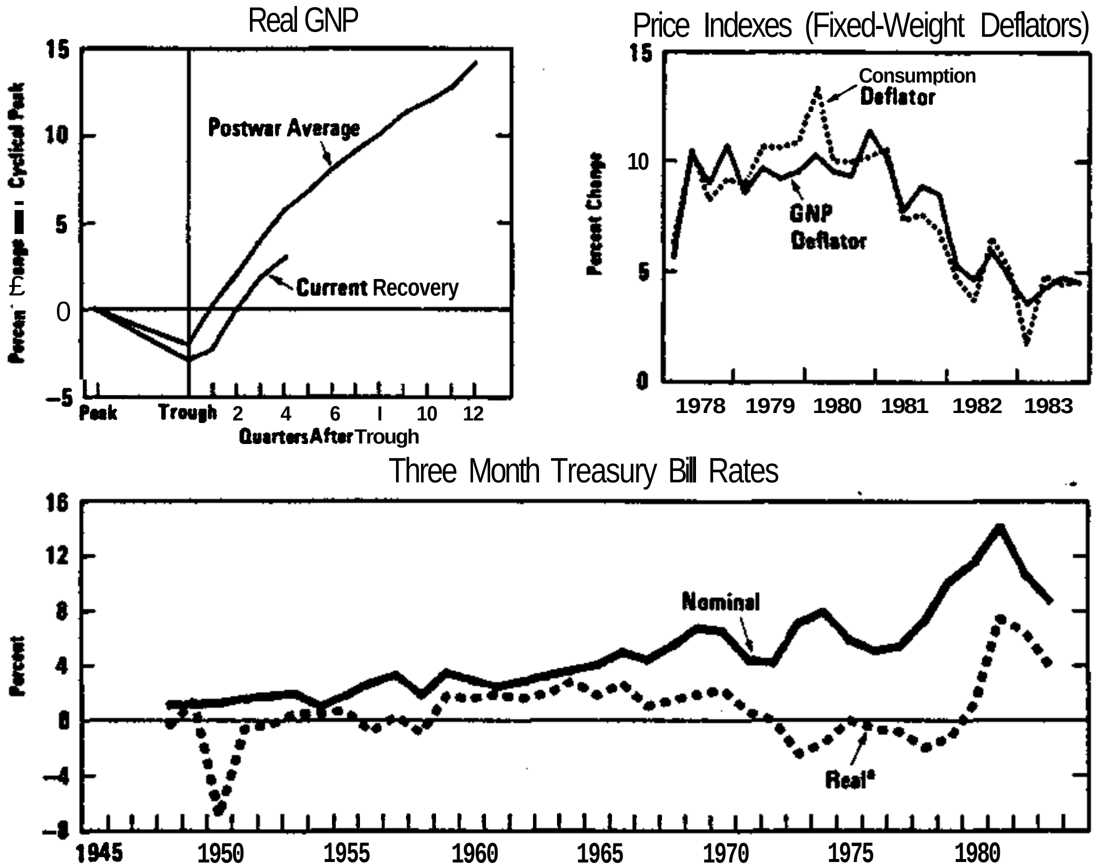
High interest rates, the most unusual feature of this recovery, did not have as large an effect on overall economic growth as many expected (see Figure 1). They did, however, affect the composition of growth. Net exports were particularly hard hit. The U.S. merchandise trade balance ran a record $69 billion deficit in 1983, and some forecasters expect it to exceed $100 billion this year. At the same time, capital inflows were very strong because relatively high interest rates in the United States attracted foreign investors. Of course, the capital inflows benefited domestic investments and prevented interest rates from rising further. But, at the same time, foreign demand for dollars to invest in the United States pushed up the international exchange rate of the dollar to record levels. This in turn reduced foreign demand for the products of U.S. exporters, particularly imposing downward pressure on the dollar value of agricultural products and on farm income. At the same time, cheaper imports supplanted domestic production in many domestic industries. Thus, in 1983, net exports were effectively crowded out by tight credit conditions that arose, at least in part, from large budget deficits.

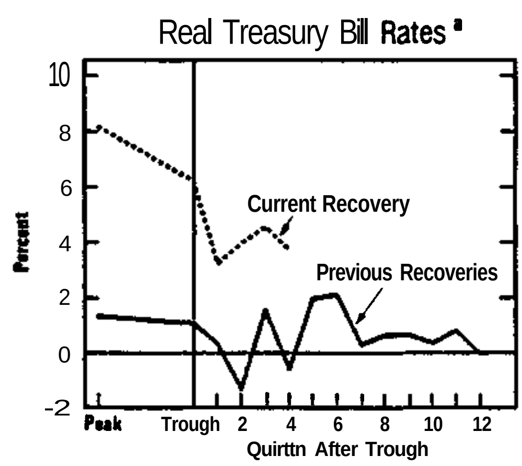
The Farm Sector

These recent economic events have directly affected the farm sector, especially in terms of production costs and farm exports. Items purchased from outside the farm sector, such as seeds, chemicals, fertilizer, fuels, and machinery, account for about two-thirds of cash production costs. Thus as

Figure 1.

Recent Economic Developments





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

[a] Unless otherwise specified real interest rates in this report 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 a proxy for the unobserved real rate, which is the nominal rate less *expected* inflation over the life of the instrument. The inflation rate used for these two figures is that of the consumption deflator (fixed weight since 1958).

inflation moderated in 1983, farmers found that the prices they paid for nonfarm production items increased by 2 percent, the smallest increase in a decade.

There is less to be pleased with, however, in the continued high interest rates, which affect both production costs and commodity exports. With regard to cost, interest expenses on borrowing for land and purchased items have accounted for about 20 percent of farmers' production costs, roughly twice the level of the late 1970s. High interest rates also affect exports, which account for about 25 percent of gross farm income. High interest rates make U.S. debt instruments attractive to foreigners, thus increasing the demand for dollars. This bids up the price of the dollar and increases the amount of foreign currency needed to buy a dollar's worth of goods. The result is that farm commodities are more expensive for foreigners to buy, and exports of farm products fall. The net agricultural trade surplus fell for the second consecutive year in 1983 to $19.5 billion, the lowest level since 1979, thereby adding significantly to the rising U.S. deficit in merchandise trade.

Thus, the agricultural sector receives a double blow as a result of our budget deficit. Its interest costs are higher and the foreign demand for its products is lower.

THE CBO ECONOMIC PROJECTIONS

The CBO baseline economic projections, which are used to generate baseline budget estimates, consist of two parts: (1) a short-run forecast for

TABLE 1. RECENT ECONOMIC INDICATORS (Percent change from previous period at seasonally adjusted annual rates, unless otherwise noted)

	1981	1982	1983	1982 Q3	1982 Q4	1983 Q1	1983 Q2	1983 Q3	1983 Q4
Real GNP	2.6	-1.9	3.3	-1.0	-1.3	2.6	9.7	7.6	4.9
Final sales	1.8	-0.7	2.9	-1.5	4.5	0.6	6.8	5.1	4.8
Consumption	2.7	1.4	4.2	0.9	3.6	2.9	10.0	2.2	5.7
Business fixed investment	5.2	-4.7	1.5	-8.8	-6.6	-1.5	7.9	18.7	29.0
Residential investment	-5.2	-15.4	40.3	-13.0	53.2	57.3	79.5	35.9	1.8
Government purchases	0.8	1.8	0.5	9.4	10.6	-8.8	-1.1	4.4	-2.7
Inventory Change (billions of 1972 dollars)	8.5	-9.4	-3.3	-1.3	-22.7	-15.4	-5.4	3.8	3.9
Net Exports (billions of 1972 dollars)	43.0	28.9	12.6	24.0	23.0	20.5	12.3	11.4	6.3
Industrial Production	2.7	-8.2	6.5	-3.4	-8.1	9.8	18.5	21.8	10.4
Capacity Utilization (percent)	80.2	72.1	75.3	71.7	69.8	71.2	73.9	77.3	78.9
Payroll Employment (millions)	91.2	89.6	90.0	89.3	88.8	88.8	89.5	90.3	91.3
Civilian Unemployment Rate (percent)	7.6	9.7	9.6	10.0	10.6	10.4	10.1	9.4	8.5
Inflation Rate									
CPI-U	10.4	6.1	3.2	7.3	1.5	0.3	4.4	4.1	4.5
GNP deflator (fixed weight)	9.5	6.4	4.3	5.9	4.7	3.4	4.3	4.7	4.1
Productivity a/	1.9	-0.1	3.1	2.3	1.3	3.7	7.1	2.3	1.0
Interest Rates (percent)									
Treasury bill rate	14.0	10.6	8.6	9.3	7.9	8.1	8.4	9.1	8.8
Corporate AAA bond rate	14.2	13.8	12.0	13.8	11.9	11.8	11.6	12.3	12.4
Net Farm Income (billions of 1972 dollars)	15.4	10.7	10.5	7.5	13.4	9.3	8.4	8.7	15.4

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Moody's Investors' Service; U.S. Department of Agriculture.

a/ Output per worker hour, nonfarm business sector.

the 1984-1985 period conditional upon specific policy assumptions; and (2) longer-run projections based upon historical growth trends and the assumption that inflation will gradually decline. The short-run baseline forecast incorporates the federal budget policies currently in place and monetary policies consistent with the Federal Reserve's recently announced targets for money growth. The forecast also assumes that there will be no price shocks or credit crises. For example, crude oil prices are assumed to remain constant, at about $29 per barrel, throughout the forecast period.

The Short-Run Forecast

With these assumptions, real GNP is projected to rise 4.7 percent over the four quarters of 1984 and 3.7 percent during 1985 (see Table 2). Average growth over the two years is slightly above the average for the second and third years of previous postwar recoveries. The civilian unemployment rate is projected to decline from 8.5 percent in the last quarter of 1983 to 7.6 percent by the end of 1984 and to 7.1 percent by late 1985. The growth in real GNP and disposable income, along with improving employment, will help to increase the demand for farm products, particularly animal products.

As measured by the GNP deflator, inflation is expected to rise slightly from 4.1 percent in 1983 to 5.3 percent in 1984 and 5.1 percent in 1985. This increase in inflation reflects temporary factors--for example, the decline in oil prices last year that is not expected to be repeated this year,

TABLE 2. THE CBO FORECAST FOR 1984 AND 1985

Economic Variable	Actual 1982	Actual 1983	Forecast 1984	Forecast 1985
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	2.6	10.5	10.3	9.0
Real GNP	-1.7	6.2	4.7	3.7
GNP Implicit Price Deflator	4.4	4.1	5.3	5.1
Consumer Price Index for Urban Consumers	4.5	3.3	5.1	4.9
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.7	9.6	7.8	7.3
3-Month Treasury Bill Rate	10.6	8.6	8.9	8.6

and a temporary acceleration in food prices in 1984 stemming from last year's drought, the acreage reduction program, and the recent freeze. The price of food at home is projected to rise by more than 4 percent this year. In addition, the relatively rapid reduction of slack in the economy will tend to keep inflation from falling rapidly. However, nothing in the CBO forecast is inconsistent with the hypothesis that inflation is on a long-term downwardtrend.

The three-month Treasury bill rate is expected to average 8.9 percent this calendar year and slightly lower next year. The forecast shows interest rates remaining very high in real terms because of the exceptionally large amount of Treasury borrowing combined with strengthened private credit demands.

The Longer-Run Economic Projections

The baseline economic projections for the 1986-1989 period assume moderate noncyclical growth in output averaging about 3.4 percent per year, with unemployment declining gradually to 6.5 percent by the last year of the projection (see Table 3). Inflation declines very gradually from 5.1 percent in calendar year 1985 to 4.3 percent in 1989, and interest rates decline with inflation.

The projection of real growth in 1986-1989 is based upon historical trends and is not meant to be consistent with policies that are currently in place. Moreover, it is not intended to be an implicit judgment about what would be appropriate growth. 2/ For the seven-year period beginning with the recession trough (1982:4 to 1989:4), growth in real GNP averages 4

2/ Although these longer-run projections for inflation and nominal GNP growth do not reflect specified goals for the economy, they appear to be broadly consistent with statements by both the Administration and monetary authorities. See Economic Report of the President (February 1983), p. 23, and Paul A. Volcker, "We Can Survive Prosperity," an address to the American Economic Association, December 18, 1983.

TABLE 3. LONG-RUN ECONOMIC PROJECTIONS, CALENDAR YEARS 1984-1989

Economic Variable	1983 Actual	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)	3,311	3,651	3,995	4,339	4,704	5,084	5,481
Nominal GNP Growth Rate (percent change, year over year)	7.7	10.3	9.4	8.6	8.4	8.1	7.8
Real GNP (percent change, year over year)	3.3	5.4	4.1	3.5	3.5	3.4	3.3
GNP Implicit Price Deflator (percent change, year over year)	4.2	4.7	5.1	4.9	4.7	4.5	4.3
Consumer Price Index, CPI-U (percent change, year over year)	3.2	4.8	5.1	4.9	4.7	4.5	4.3
Civilian Unemployment Rate (percent, annual average)	9.6	7.8	7.3	7.0	6.8	6.6	6.5
3-Month Treasury Bill Rate (percent, annual average)	8.6	8.9	8.6	8.4	8.2	8.0	7.8

percent in the CBO baseline projection, precisely the same as the average growth rate during the first seven years following previous postwar recessions.

Uncertainty in the Outlook

There is a great deal of uncertainty in the economic outlook, particularly with respect to inflation and interest rates. The major source of uncertainty lies in economic policy.

- Some analysts believe that monetary policy has been too tight since last summer, and fear that there will be *a* slowdown in economic growth during the first half of this year despite the fiscal stimulus. Others are concerned that the Federal Reserve will find it difficult to maintain moderate money growth in the face of large federal deficits and the developing-country debt crisis.

- With regard to fiscal policy, the major question is whether deficits will be reduced soon and if so, how. It is difficult for businesses, including farms, and individuals to make effective decisions about the future without knowing what deficit-reducing measures will be taken and the impact these measures are likely to have on their activities. Moreover, the competition between private and federal credit demands will be intense, if policies are not changed. Federal borrowing will decline relative to GNP only in the first years of the projection--and then only slightly--and will remain exceptionally high and increase relative to GNP in later years.

- If action on the deficit is postponed, it is also possible that foreigners will lose confidence in U.S. policies and reduce their investments in this country. While the resulting decline in the exchange value of the dollar would benefit U.S. export and import-competing industries, it would also generate increased domestic inflation and--given a fixed rate of money growth--push up interest rates. It might even force the Federal Reserve to undertake a more restrictive policy in order to maintain stability in foreign exchange markets.

If the value of the dollar declined because of a decline in capital inflows related to a loss of foreign confidence, it is difficult to say whether agriculture would gain or lose on balance. A decline in the exchange value of the dollar would stimulate agricultural exports to the benefit of those farmers producing major crops. But a sharp run-up in interest rates would further aggravate the financial stress of highly leveraged farmers. Different farmers would clearly be affected differently, but whether or not the entire sector would win or lose in the short run, it is clear that such a dollar decline, due to a loss of foreign confidence, would be unhealthy for the economy as a whole.

TABLE 4. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1983 Actual	1984 Base	Projections 1985	1986	1987	1988	1989
			In Billions of Dollars				
Revenues	601	663	733	795	863	945	1,016
Outlays a/	796	852	930	1,012	1,109	1,217	1,323
Deficit	195	189	197	217	245	272	308
			As a Percent of GNP				
Revenues	18.6	18.6	18.7	18.7	18.7	19.0	18.9
Outlays a/	24.7	23.9	23.8	23.8	24.0	24.4	24.6
Deficit	6.1	5.3	5.0	5.1	5.3	5.5	5.7
Reference: Gross National Product (In billions of dollars)	3,229	3,563	3,910	4,251	4,612	4,987	5,379

a/ Defense budget authority for 1985 and 1986 is assumed to be the amounts specified in the most recent Congressional budget resolution; defense budget authority for 1987-1989 is an estimate of the amounts required to achieve real increases of 5 percent per year.

THE BUDGET OUTLOOK

Given baseline economic assumptions and no change in the budget policies now in place, CBO projects the federal deficit as rising from about $189 billion this year to $308 billion in fiscal year 1989 (see Table 4). Despite rapid growth in GNP, the deficit rises from 5.3 percent of GNP in fiscal year 1984 to 5.7 percent in 1989, close to the record level established last year. Federal spending remains very strong in the baseline projection: relative to GNP, it declines from 24.7 percent in fiscal year 1983 (a postwar record) to 23.9 percent this year, but then rises to 24.6 percent by 1989.

Revenues are projected to be 18.6 percent of GNP in fiscal year 1984, rising gradually to 19.0 percent in 1988. 3/

Changes in the Composition of Revenues and Spending

The composition of federal revenues is projected to change somewhat over the next five years. Individual income taxes and social insurance taxes rise faster than other taxes, growing from 80 percent of total revenues in 1984 to 85 percent by 1989. Corporate income taxes, excise taxes, and other receipts continue to diminish in relative importance (see Table 5).

Changes in the composition of federal spending are more substantial. The most rapidly growing category of spending in the baseline is net interest. With large and growing deficits and no reduction in inflation-adjusted interest rates after 1985, federal borrowing costs are projected to double over the next five years. The portion of gross spending (excluding

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3/ CBO's baseline budget projections are designed to show what would happen to the federal budget if current policies were continued into the future. For revenues and for mandatory spending items, current policies are largely defined by the laws now in effect. For discretionary spending, however, the definition of current policy is not as clear, since appropriations are made for only one year at a time. The baseline projections for nondefense appropriations are generally based on fiscal year 1984 funding levels, with future increases to keep pace with inflation. The projections for defense are based on the fiscal year 1984 Congressional budget resolution, which not only allowed defense spending to keep pace with inflation but also provided for roughly 5 percent annual real growth in defense budget authority. While our baseline projections assume 5 percent real growth in defense spending as the best approximation of current policy, CBO has also projected defense expenditures on the same basis as is used for nondefense discretionary programs. These alternative defense projections simply increase 1984 defense budget authority by the rate of inflation and thus allow for no real growth in defense spending.

TABLE 5. BASELINE REVENUE AND OUTLAY PROJECTIONS BY SOURCE OR MAJOR CATEGORY (By fiscal year, in billions of dollars)

	1983 Actual	1984 Base	Projections 1985	1986	1987	1988	1989
Revenues							
Individual income taxes	2S9	294	329	362	396	438	478
Corporate income taxes	37	62	65	71	81	85	85
Social insurance taxes	209	237	269	296	320	354	382
Excise taxes							
Windfall profit taxes	13	9	7	5	4	4	4
Other	22	29	31	27	28	28	29
Estate and gift taxes	6	6	6	5	5	4	5
Customs duties	9	10	11	12	12	12	13
Miscellaneous receipts	16	16	16	17	18	19	20
Total Baseline Revenues	601	663	733	795	863	945	1,016
Outlays							
National defense	210	235	263	295	329	367	408
Entitlements and other mandatory spending							
Social Security	167	176	187	199	213	229	245
Medicare	56	64	74	82	93	105	118
Other	177	158	167	173	182	192	201
Subtotal	400	397	427	455	488	526	564
Nondefense discretionary spending	144	157	164	171	181	191	200
Net interest	90	109	126	144	167	193	216
Offsetting receipts	-48	-46	-49	-53	-56	-60	-65
Total Baseline Outlays	796	852	930	1,012	1,109	1,217	1,323

offsetting receipts) devoted to interest rises from 12 percent in 1984 to 16 percent by 1989. Defense spending grows by 74 percent between 1984 and 1989, assuming real increases of 5 percent per year. The share of defense spending in the budget grows from 26 percent to 29 percent.

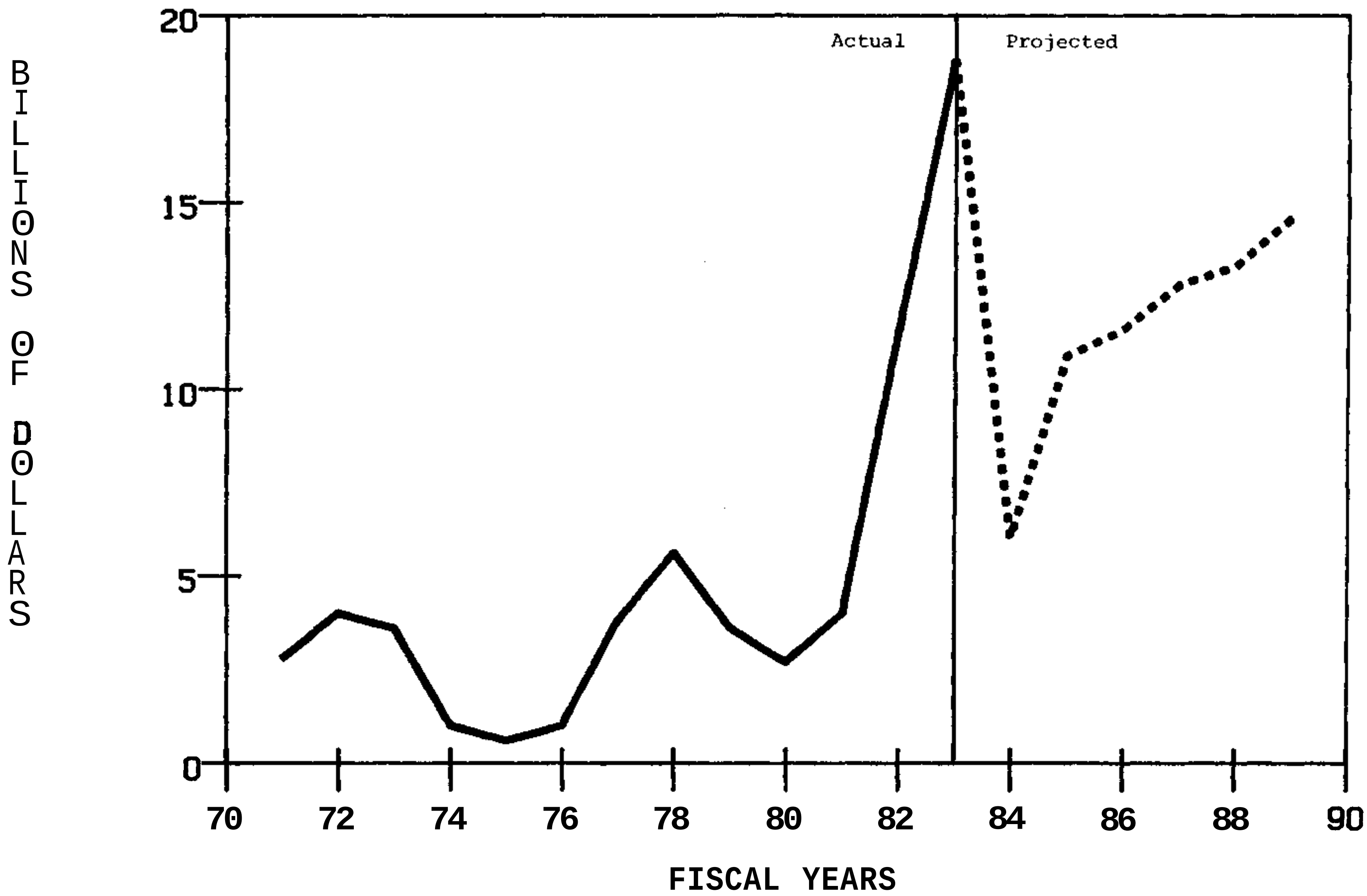
In our projections, domestic spending--the combination of entitlements and discretionary programs--grows by 38 percent between now and 1989. Because this is well below the rate of increase in total outlays, its share of the budget declines from 62 percent in 1984 to 55 percent in 1989. The dollar increase is still substantial, however, from $555 billion in 1984 to $764 billion in 1989. Of this $209 billion increase, $123 billion--or 59 percent--is in just two programs, Social Security and Medicare.

Agricultural price support outlays, included in entitlements and other mandatory spending in Table 5, are shown in Figure 2. Under current policy, price support outlays are projected to remain high relative to historic levels, averaging $12.6 billion over 1985-1989 or about 1 percent of gross budget outlays. The President's budget proposes to freeze target prices at the 1985 levels, which according to our estimates reduces projected outlays by a total of $14.8 billion over the 1985-1989 period.

Perhaps the most important point to make about the spending side of the budget is that very few programs are responsible for the bulk of federal outlays. Our projections suggest that, by 1989, spending on defense, Social Security, Medicare, and net interest will be equivalent to almost 100 percent of total tax revenues.

FIGURE 2

PRICE SUPPORT OUTLAYS



SOURCE: Congressional Budget Office

REDUCING DEFICITS

Federal deficits of the magnitude shown in the baseline projection would have major consequences both for the economy and for future budgetary choices.

- Most economists agree that federal deficits of the size projected by CBO keep interest rates higher than they would be otherwise. Fortunately, very large capital inflows from abroad have so far limited the rise in interest rates. But if the capital inflow continued for a long time, foreign claims on U.S. output could rise to such a level that it would reduce our standard of living significantly below what it would be if we decreased government borrowing and relied less on capital inflows.

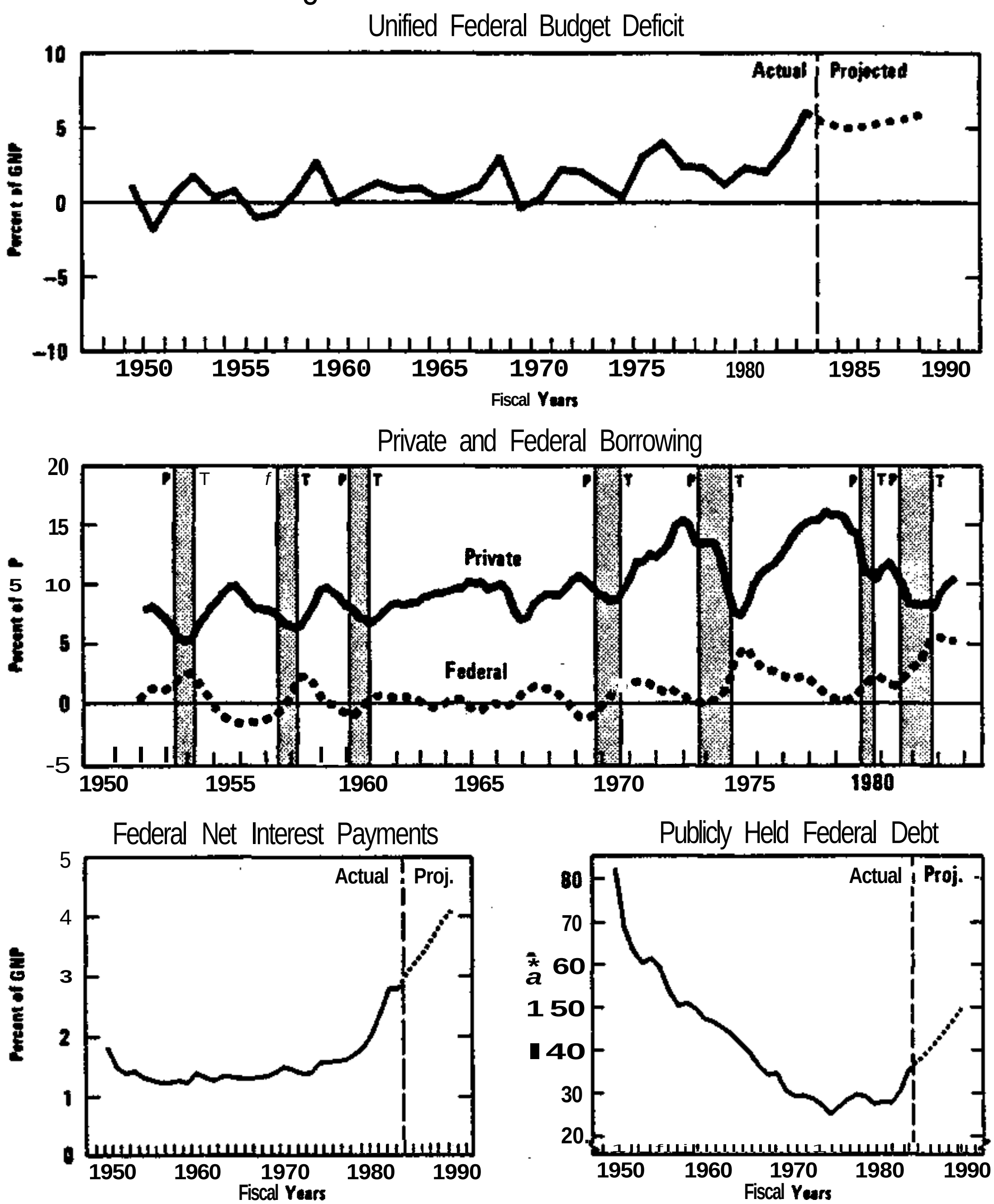
- High interest rates, if they persist, are likely to reduce capital accumulation. Although the economic upswing is now providing a strong stimulus to investment, this may eventually be offset by the retarding effect of high interest rates on structures investment. Over time a reduction in the capital-output ratio will retard growth in productivity, the major source of rising living standards.

- Another consequence of large deficits is the extremely rapid growth in outlays for interest on the debt (see Figure 3). Net interest costs, which were between 1 and 2 percent of GNP for decades, are projected to rise from 2.8 percent of GNP in fiscal year 1983 to 4.0 percent in 1989. In these circumstances, major spending cuts or tax increases are necessary just to avoid the possibility of explosive growth in interest outlays.

While there is widespread agreement that deficits must be reduced in order to reduce interest rates and the cost of financing the debt, the task is very difficult. CBO recently released Part III of its annual report on options for reducing the deficit, including measures both to reduce spending and to increase revenues. The analysis brings out clearly the difficulty of resolving the budget dilemma. The fact is that all spending does some good for

Figure 3,

Government Borrowing



SOURCES: Office of Management and Budget: U.S. Department of Commerce, Bureau of Economic analysis; Congressional Budget Office.

NOTE: P and T lines indicate business cycle peak and trough dates.

someone and all taxes do some harm to someone, so there is never a good spending cut or tax increase in the eyes of the entire electorate. Nonetheless, our budgetary predicament requires that we make difficult choices and search for the least damaging package of deficit reduction options that can command majority support.