CBO TESTIMONY

Statement of
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NOTICE

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Mr. Chairman and Members of the Budget Committee, I appreciate this opportunity to discuss the economic outlook and the important considerations that the Congress must weigh in the coming months. You face the unenviable task of assessing the current outlook for the economy, judging how effective various policies might be in improving that outlook, and weighing the benefits of such policies against their possible longer-term costs.

THE ECONOMIC OUTLOOK

As every American knows, the economic outlook is, at best, cloudy. The slight expansion in real gross domestic product shown in the data for the second and third quarters signaled to economists that the recession was over, at least for now. But for many Americans, such pronouncements that a recovery has begun appear to be little more than an exercise in semantics, since they have experienced so little improvement in their own economic status.

Certainly, the economy is much weaker than most forecasters--including the Congressional Budget Office (CBO)--had predicted. During the past two or three months, little or no growth in employment or real personal incomes has been visible, and initial claims for unemployment benefits remain high. Retail sales, new orders for durable goods, housing starts, and other indicators

that gauge the strength of overall demand have been weak, as have such monthly indicators of the strength of output as industrial production. To the unemployed, to those too discouraged to seek work, and to those who *have* jobs but are worried about losing them, economists' statistics have little meaning.

Although CBO is still working on its new economic forecast, the consensus among economists is that the economy will grow very slowly over the next six months or so. The consensus forecast predicts only a slight growth in the number of jobs during the first few months of the new year, and unemployment is expected to rise. Moreover, the consensus of forecasters is tinged with pessimism. Many of them are simply worried that even that modest recovery could falter and turn into a renewed recession early next year. Such a prospect appeared quite unlikely only a few months ago.

If the current weakness does turn into a "double-dip" recession, production and incomes could slide for a few months, and unemployment could rise sharply before a sustained recovery begins. Just how weak the economy becomes over the next several weeks will depend on a couple of factors: whether the lower interest rates of recent months begin to stimulate a stronger expansion in spending, and whether such spending begins to translate more clearly into added employment and personal income.

With or without a double-dip recession, most forecasters suggest that the economy will finally begin recovering in earnest sometime around the middle of next year. Even then, virtually no one predicts a growth rate anywhere near what has been typical early in past recoveries. Whereas growth in the average postwar recovery has averaged above 6 percent during the four quarters immediately following the recession's low point, most forecasters are expecting an expansion at roughly half that rate during 1992. As a result, unemployment is projected to decline lethargically and the rate of unemployment is likely to stay above 6.5 percent through most of 1992.

For the longer term, most current projections show the rate of growth settling toward a sustainable or "potential" level of 2.5 percent or less. This rate is lower than that achieved over the postwar period, in large part because growth in the labor force has slowed and because low national saving reduced the growth of productive capital during the 1980s.

WHY THE WEAK RECOVERY?

An unusual coincidence of structural problems has made it difficult for the economy to mount a decisive recovery and is likely to keep the expansion well below customary rates once recovery is under way. The Federal Reserve's

attempts to slow economic growth from the strong pace of the late 1980s, combined with the contractionary effects of last year's crisis in the Persian Gulf, originally pushed the economy into a recession. But the economy faces a number of obstacles as it attempts to bounce back and resume a normal rate of growth. Some of these were present before the recession but have been exacerbated by the downturn; others have developed more recently and are not strongly tied to the recession.

One group of factors hindering recovery involves the aftermath of the boom in spending for real estate and the strong expansion of bank lending for that and other purposes during the 1980s. Those factors left the nation with an overabundance of commercial buildings and, by extension, with a chronic weakness in new construction. Related to the legacy of the 1980s' real estate boom is the current effort among banks and other financial institutions to build capital and improve the quality of their portfolios by being more selective in making new loans. But although tight lending practices may help to strengthen financial institutions, by reducing the availability of funds to some borrowers, especially in the Northeast, they may also be impeding the recovery.

Fiscal policies at the state, local, and federal levels are also working to stunt the short-term prospects for recovery. Under pressure from shortfalls

in revenue brought on by the current downturn, state and local governments have raised taxes and cut spending by at least $15 billion since the beginning of the fiscal year last July. Further, such cutbacks are continuing. The federal government has not eased overall fiscal policy significantly, as it did during previous recoveries. As a result of the limits in the Budget Enforcement Act, few expansionary federal budget initiatives have been adopted this year, making federal fiscal policy tighter than it has been in previous recoveries.

Economic difficulties in other countries are also slowing the U.S. recovery. Canada, our largest trading partner, is struggling to rebound from a recession of its own, and its economic vital signs remain unstable. Monetary policy has been slowing growth in Japan, and recent declines in the Tokyo stock market have dampened the pace of expansion there. Germany's attempts to control inflationary pressures and support the deutsche mark in the aftermath of unification have helped raise interest rates everywhere. The effects have been especially acute in other countries within the European Monetary System, which have had to raise their own interest rates to keep their currencies within fixed bands relative to the mark. The economic slowdowns that have resulted in those countries have helped limit the market for our exports.

A final group of problems is sapping the strength of the recovery. It arises from the pressures that American businesses face to cut their costs and increase their competitiveness. These pressures stem, in part, from competition from abroad, and, in part, from changes in the structure of the U.S. economy. Analysts point to the shrinking of the defense industry, under way for some years now, as one of the structural convulsions the economy must endure. Many economists expect similar shrinkage in other sectors, such as retailing and finance, where significant excess capacity appears to exist. In these sectors and in the economy as a whole, the recession clearly has intensified pressures to cut costs and improve competitiveness. The result, of course, has been layoffs and other steps to economize.

CAN POLICY HELP THE ECONOMY RECOVER?

With the economic outlook as troubled as it is at the dawn of an election year, quite understandably the Congress is thinking of initiatives to stimulate a recovery and give a boost to a long-run economic expansion. Although I will make no recommendations in this regard today, I will try to explain the trade-offs that may arise between short-term stimulus and established long-term goals of economic policy. I will also discuss factors that are apt to limit

the effectiveness of new fiscal measures in hastening the end of the economic downturn.

Long-Run Goals of Budgetary Policy

Since the late 1980s, the Congress, especially the Budget Committees, have made reducing the budget deficit one of our most important priorities. Many difficult decisions, such as the passage of last year's Budget Enforcement and Omnibus Budget Reconciliation Acts, have flowed from this priority.

There were good reasons for this **focus** on reducing the deficit. Deficits as large as those that have faced us, combined with the strong growth in the federal debt they produce, reduce national saving, robbing the nation of the new investment in plant and equipment, research and development, infrastructure, and other productive assets that would otherwise flow from the large amounts of saving the deficit is absorbing. Investments such as those have historically served as one of the principal sources of economic growth. Indeed, the nation is already feeling the effects of high deficits in this regard: the large deficits and relatively slow investment of the 1980s helped bring on the slow growth of middle-class living standards that is causing so much concern around the nation.

Deficits and the low national rate of saving that they produce are also a significant cause of the chronic deficit in the current account of our balance of payments. Such deficits come about when a nation spends more than it produces and earns. This extra spending is a direct reflection of insufficient saving--a problem that can be laid directly on the doorstep of the federal deficit.

In other words, increasing the deficit to fight the current economic downturn could well end up costing the nation dearly by further reducing longer-term prospects for growth and by keeping the balance-of-payments deficit at high levels. Since the only measures likely to stimulate the economy in the short term are those that increase the deficit significantly, at least for a while, there is a clear trade-off between short-term and long-term goals. Is short-run stimulus worth it? The answer depends in part on whether increasing the deficit is effective in expanding the economy in the short term. Many economists express serious doubts about whether measures of the type being proposed will succeed in stimulating economic growth any time soon. Let me go through some of the reasons for this skepticism.

Budget measures are most apt to stimulate short-term expansion if they increase the deficit significantly and put cash in people's hands fairly quickly. Measures that are known to stimulate overall demand, such as increased

federal purchases, cuts in individual income tax rates, and enacting investment tax credits or accelerated depreciation schemes, also increase the budget deficit. But because of the clear need to satisfy the terms of the Budget Enforcement Act of 1990, many current proposals do not increase the deficit. They cut taxes for some group or sector of the economy but avoid increasing the budget deficit by raising taxes on others or by cutting spending. As a result of the offsetting tax increases or spending cuts, the short-term stimulative impacts of such proposals are likely to be small at best, and could even turn out to be counterproductive.

In past recoveries, the federal budget has provided fiscal stimulus amounting to more than 0.5 percent of gross national product (GNP): sometimes, as in the recovery starting in 1975, the fiscal stimulus was substantially greater, amounting to nearly 2 percent of GNP. Since current policy under the budget agreement would provide no fiscal stimulus, a proposal would have to increase the deficit by more than 0.5 percent of GNP ($30 billion) in 1992 to match the economic boost provided in previous recoveries. Moreover, in light of today's structural problems, an above-average dose of fiscal stimulus may be required to generate an average response.

Many current proposals would have limited effects for another reason: some of their provisions, designed to cure longer-term economic problems, undercut the main purpose of stimulating extra spending now. For example, personal income tax provisions meant to further longer-term economic growth by encouraging households to save a higher proportion of their incomes, if effective, would reduce short-term overall demand. They are part of a different economic policy agenda, which is designed to solve the long-run problems that were at the fore before the recession began.

Until the current economic downturn hit, the nation was trying to increase saving to spur long-term investment so that sustained improvements in well-being could be attained. During a recession, however, measures that increase saving are unlikely to provide any short-term economic boost. Recovery depends on getting consumers to do exactly the reverse--to spend more money to help put people back to work. Therefore, including provisions to encourage saving in current economic rescue packages will reduce their effectiveness in boosting the economy and reducing unemployment in the short run.

A final issue concerning the short-run effectiveness of stimulative measures is the risk that they might cause an unusually sharp rise in interest rates. Any effort to stimulate expansion by increasing overall demand is apt

to raise interest rates somewhat. Such increases normally reduce the stimulative impact, but they do not eliminate it. Now, however, some analysts are worried that as the Congress considers budgetary measures that promise to stimulate the economy significantly, it could raise interest rates by more than normal **standards--the** reason being that financial markets might interpret the measures as signaling the end of the hard-won, long-term progress in deficit control that was made through the Budget Enforcement and Omnibus Budget Reconciliation Acts only last year. If interest rates were to rise especially sharply because of such fears, they could reduce or eliminate whatever stimulating effect the budgetary measures might have.

I do not mean to overstate the risk that fiscal actions will generate sharp increases in interest rates. A number of economists discount such fears. In any case, the increase in interest rates could be minimized if the stimulative measures were clearly temporary, and if the short-run increase in the budget deficit were offset in future years in ways that are credible. Some of the proposals now on the table would increase the deficit in the first year or two, but pay for this with reduced deficits later. Such proposals might well avoid strong increases in interest rates, and would provide some near-term fiscal stimulus. Still, the stimulative impact of even these temporary approaches may be limited if individuals and businesses react cautiously

because they anticipate the tax hikes or spending cuts they would face in the future.

What About Monetary Policy?

Part of the job of assessing the need for fiscal measures to stimulate the economy involves deciding whether the reductions in interest rates that the Federal Reserve's monetary policy has engineered in recent months--and additional changes the central bank may bring about in the next few weeks--will by themselves bring about a satisfactory economic recovery. Even before the recession started, the Federal Reserve began reducing short-term interest rates in order to keep the earlier economic expansion going. As a result, the yield on three-month Treasury bills has fallen by more than four percentage points since its peak in March 1989, and now stands at the lowest level in 14 years. Partly in response to declining short-term rates, yields on longer-term securities are also down, though less sharply. The rate on 10-year Treasury bonds has fallen by more than one and one-half percentage points from its peak in late 1990, and is now at its lowest level in more than four years.

In the present economic circumstances, however, such declines in interest rates may be less effective in stimulating the economy. Normally,

lower interest rates stimulate spending in such areas as housing, consumer durables, business investment, and--working through their effects on the value of the dollar--net exports. In some of these areas, the effectiveness of policy may have been reduced in recent months. For example, the credit crunch may be reducing the response of some types of investment spending to monetary stimulus. The excess of commercial structures that the economy inherited from the 1980s may prevent construction from growing significantly regardless of the level of interest rates. Finally, political turbulence and sluggish growth abroad may be stimulating flows of money into financial assets denominated in dollars and therefore may be keeping the dollar from falling as far as it might in response to our declining interest rates. As a result, net U.S. exports may not grow as sharply in response to monetary measures as they normally would.

Nevertheless, most economists still expect declines in interest rates to help bring about recovery. Because financing costs are now historically low, many types of investment and durable consumer goods are easier to buy now than in recent years. Largely as a result, purchases of existing homes and single-family housing starts have recently shown signs of renewed life. Such effects should help bring about a turnaround in spending in some interest-sensitive sectors. Unfortunately, because monetary policy works with long

lags, one cannot be confident that the benefits of lower rates are right around the corner.

CONCLUSION

The Congress and the Administration face a difficult set of decisions: the continuing weakness in the economy is causing serious hardships for millions of Americans. Doing something about it, however, may well undermine progress in solving equally important long-term problems. While a hardheaded analytic perspective might suggest that short-term fiscal measures will not provide much help to the economy, other considerations may convince the Congress that such policies are needed.